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STUDY OF THE OVERALL STATE OF THE FEDERAL TAX SYSTEM AND RECOMMENDATIONS FOR SIMPLIFICATION, PURSUANT TO SECTION 8022(3)(B) OF THE INTERNAL REVENUE CODE OF 1986

VOLUME II: RECOMMENDATIONS OF THE STAFF OF THE JOINT COMMITTEE ON TAXATION TO SIMPLIFY THE FEDERAL TAX SYSTEM

Prepared by the Staff

of the

Joint Committee on Taxation

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INTRODUCTION

This document,[1] is a report of the staff of the Joint Committee on Taxation ("Joint Committee staff") in connection with a study of the overall state of the Federal tax system. This report is being transmitted, as required under section 8022(3)(B) of the Internal Revenue Code of 1986, to the House Committee on Ways and Means and the Senate Committee on Finance. Under section 8022(3)(B), the Joint Committee staff is required to report at least once each Congress on the overall state of the Federal tax system and to make recommendations with respect to possible simplification proposals and other matters relating to the administration of the Federal tax system.[2]

The Joint Committee staff is publishing this study in three volumes. Volume I of this study contains Part One (Executive Summary and Joint Committee on Taxation Staff Study Mandate and Methodology), Part Two (Overall State of the Federal Tax System), and four Appendices (Academic Advisors to the Joint Committee on Taxation, Tax Policy Advisors to the Joint Committee on Taxation, General Accounting Office Materials, and Congressional Research Service Materials). Volume II of this study contains Part Three (Recommendations of the Joint Committee on Taxation Staff to Simplify the Federal Tax System). Volume III of this study contains papers relating to simplification submitted to the Joint Committee on Taxation by tax scholars in connection with the study.

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[1] This document may be cited as follows: Joint Committee on Taxation, *Study of the Overall State of the Federal Tax System and Recommendations for Simplification, Pursuant to Section 8022(3)(B) of the Internal Revenue Code of 1986* (JCS-3-01), April 2001.

[2] Section 8022(3)(B) was added by section 4002(a) of the Internal Revenue Service Restructuring and Reform Act of 1998.

PART THREE.--RECOMMENDATIONS OF THE STAFF OF THE JOINT COMMITTEE ON TAXATION TO SIMPLIFY THE FEDERAL TAX SYSTEM

I. ALTERNATIVE MINIMUM TAX

A. Background

The minimum tax was originally enacted to cutback tax benefits derived from exclusions, deductions and credits that were given preferential tax treatment (known as tax preferences), but has evolved into a completely separate, alternative tax regime within the Federal income tax. Individuals, trusts, estates, and corporations generally must compute their Federal income tax two ways -- first, to determine regular income tax liability, and then a second time to determine minimum tax liability. Although a taxpayer ultimately may not have a minimum tax liability, many taxpayers must make the computation to determine if they do. In addition, the alternative minimum tax regime can limit the benefits of various deductions and credits, even though the taxpayer ultimately does not have a minimum tax liability. Thus, the alternative minimum tax regime affects many more taxpayers than the taxpayers that actually pay a minimum tax.

The concept of a minimum tax was enacted as part of the Tax Reform Act of 1969 (the "1969 Act"). The 1969 Act provided for an "add-on" minimum tax at a rate of 10 percent applied to a specified list of tax preferences,[1] minus an exemption amount (generally $30,000). The add-on minimum tax was added to the taxpayer's regular income tax in determining the amount of income tax owed by the taxpayer. The purpose of the minimum tax was described as follows.

> The prior treatment imposed no limit on the amount of income which an individual or corporation could exclude from tax as the result of various tax preferences. As a result, there were large variations in the tax burdens placed on individuals or corporations with similar economic incomes ... . [I]ndividuals or corporations which received the bulk of their income from such sources as capital gains or were in a position to benefit from ... tax-preferred activities tended to pay relatively low rates of tax. In fact, many individuals with high incomes who could benefit from these provisions paid lower effective rates of tax than many individuals with modest incomes. In extreme cases, individuals enjoyed large economic incomes without paying any tax at all. ... Similarly, a number of large

---

[1] The items of tax preferences that were subjected to the 10 percent add-on minimum tax included: (1) excess investment interest income; (2) accelerated depreciation on personal property; (3) accelerated depreciation on real property; (4) amortizations of rehabilitation expenditures; (5) amortization of certified pollution control facilities; (6) amortization of railroad rolling stock; (7) tax benefits from stock options; (8) bad debt deductions of financial institutions; (9) depletion; and (10) the deduction for capital gains.

corporations paid either no tax at all or taxes which represented very low effective rates.[2]

The Tax Reform Act of 1976 (the "1976 Act") modified the add-on minimum tax to expand the items of tax preference,[3] increase the tax rate to 15 percent, and reduce the exemption amount. The purpose of the modifications to the minimum tax was described as follows.

> The minimum tax was enacted in the Tax Reform Act of 1969 in order to make sure that at least some minimum tax was paid on tax preference items, especially in the case of high-income persons who were not paying their fair share of taxes. However, the previous minimum tax did not adequately accomplish these goals, so the Act contains a substantial revision of the minimum tax for individuals to achieve this objective. ... Congress intended these changes to raise the effective tax rate on tax preference items, especially for high-income individuals who are paying little or no regular income tax.[4]
>
> Congress believed that, as in the case of individuals, it was appropriate to raise the effective tax rate on corporate tax preferences subject to the minimum tax.[5]

The Revenue Act of 1978 (the 1978 Act") restructured the minimum tax into two taxes for individuals. The add-on minimum tax was retained for all tax preferences except with respect to the capital gains deduction and excess itemized deductions. A new alternative minimum tax was established to adjust the taxpayer's income for these two items.[6] The alternative minimum tax applied a three-tier rate schedule (10 to 25 percent) to alternative minimum taxable income in excess of $20,000. Refundable tax credits and foreign tax credits were the only tax credits allowed in computing the alternative minimum tax. If the taxpayer's alternative minimum tax exceeded the taxpayer's regular tax plus the add-on minimum tax, the greater alternative minimum tax would be payable. The purpose of the minimum tax restructuring was described as follows.

---

[2] Joint Committee on Taxation, *General Explanation of the Tax Reform Act of 1969* (JCS-16-70), December 3, 1970, at 105.

[3] The items of tax preference added by the 1976 Act include: (1) certain itemized deductions in excess of 60 percent of adjusted gross income; (2) intangible drilling costs; and (3) accelerated depreciation on leased personal property. The 1976 Act also removed timber capital gains from the list of tax preferences for corporations.

[4] Joint Committee on Taxation, *General Explanation of the Tax Reform Act of 1976* (JCS-33-76), December 29, 1976, at 105.

[5] *Id.* at 107.

[6] In computing alternative minimum taxable income, itemized deductions in excess of 60 percent of modified adjusted gross income generally were disallowed. Certain itemized deductions (medical, casualty, State and local taxes, and estate tax on income in respect of a decedent) were allowed.

> The Congress believes that, in the case of capital gains, the present minimum tax has adversely affected capital formation and that the purpose for which the present minimum tax was enacted can be accomplished better, in the case of capital gains, by the implementation of an alternative minimum tax on capital gains which would be payable only to the extent it exceeds an individual's regular tax liability. By eliminating capital gains as an item of tax preference under the present minimum tax, and by enacting an alternative minimum tax applicable to capital gains and adjusted itemized deductions, the Congress anticipates that capital formation will be facilitated, and every individual will pay at least a reasonable minimum amount of tax with respect to large capital gains.
>
> While the Congress believes that it is appropriate to substitute an alternative minimum tax for the present minimum tax in the case of capital gains and adjusted itemized deductions, it also believes that the present minimum tax should be retained in the case of the other items of tax preference.
>
> ...The alternative minimum tax rates rise to a maximum of 25 percent for those persons with incomes ... exceeding $100,000. Thus, taxpayers paying high regular taxes (i.e., approaching, or in excess of, 25 percent of very large incomes) generally will not be subject to any alternative minimum tax, and they thus will have no disincentive, attributable to the minimum tax, for making capital gain investments. However, the provision will insure that those high income individuals currently paying low regular taxes and realizing large capital gains will pay substantially more tax in the future.[7]

Thus, the current structure of the alternative minimum tax was introduced in 1978.

The Tax Equity and Fiscal Responsibility Act of 1982 (the "1982 Act") expanded the alternative minimum tax and repealed the add-on minimum tax for individuals.[8] The tax preferences that had been subject to the add-on minimum tax became tax preferences for computing the alternative minimum tax. The tax preference for excess itemized deductions was repealed, but only certain itemized deductions were allowed in computing the alternative minimum tax.[9] The 1982 Act increased the exemption from $20,000 to $30,000 ($40,000 for married individuals filing a joint return). The purpose of the minimum tax changes was described as follows.

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[7] Joint Committee on Taxation, *General Explanation of the Revenue Act of 1978* (JCS-7-79), March 12, 1979, at 261-262.

[8] The add-on minimum tax continued to apply to corporations until 1987.

[9] These itemized deductions included: (1) medical expenses in excess of 10 percent of adjusted gross income; (2) interest on indebtedness in connection with the acquisition, construction, or substantial rehabilitation of a principal residence; (3) other interest expense to the extent of net investment income; (4) casualty losses; (5) wagering losses; (6) charitable contributions; and (7) estate tax on income in respect of a decedent.

> Congress amended the present minimum tax provisions applying to individuals with one overriding objective: no taxpayer with substantial economic income should be able to avoid all tax liability by using exclusions, deductions and credits. Although these provisions provide incentives for worthy goals, they become counterproductive when individuals are allowed to use them to avoid virtually all tax liability. The ability of high-income individuals to pay little or no tax undermines respect for the entire tax system and, thus, for the incentive provisions themselves. Therefore, Congress provided an alternative minimum tax which was intended to insure that, when an individual's ability to pay taxes is measured by a broad-based concept of income, a measure which can be reduced by only a few of the incentive provisions, tax liability is at least a minimum percentage of that broad measure. The only deductions allowed, other than costs of producing income, are for important personal or unavoidable expenditures (housing interest, medical expenses and casualty losses) or for charitable contributions, the deduction of which is already limited to a percentage of adjusted gross income.
>
> The changes in the minimum tax also simplify the taxpayer's computations, since the present law add-on minimum tax is repealed. This change actually provides tax reductions for some middle-income taxpayers who pay a minimum tax on some preference income but also have substantial amounts of non-preference income. By adding all preferences into the base of the alternative minimum tax and focusing the minimum tax on high income individuals, the provision increases tax liability only for income classes of taxpayers with over $50,000 of income.[10]

The Tax Reform Act of 1986 (the "1986 Act") further modified the minimum tax provisions of the Code by expanding the base of the alternative minimum tax for individuals, replacing the 15-percent add-on minimum tax for corporations with a broad-based alternative minimum tax, and making various structural changes. For individuals, the three-tier rate schedule was replaced with a single rate of 21 percent. For corporations, the alternative minimum tax rate was set at 20 percent. The general purpose of the modifications was described as follows.

> Congress viewed the minimum taxes under prior law as not adequately addressing the problem, principally for two reasons. First, the corporate minimum tax, as an add-on rather than an alternative tax, was not designed to define a comprehensive income base. Second, the prior law minimum taxes did not sufficiently approach the measurement of economic income. By leaving out many important tax preferences, or defining preferences overly narrowly, the individual and corporate

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[10] Joint Committee on Taxation, *General Explanation of the Revenue Provisions of the Tax Equity and Fiscal Responsibility Act of 1982* (JCS-38-82), December 31, 1982, at 17-18.

> minimum taxes permitted some taxpayers with substantial economic incomes to report little or no minimum taxable income and thus to avoid all liability.[11]

In addition, the 1986 Act made significant changes to the regular income tax. For individuals, many tax preferences were reduced or eliminated and tax shelters were significantly curtailed by the enactment of the passive loss limitations. Individual regular income tax rates (of up to 50 percent) were replaced with a two-tier schedule of 15 and 28 percent. Similarly, for corporations, many tax preferences and special deductions or credits were reduced or eliminated and the top income tax rate was reduced from 46 percent to 34 percent.

The alternative minimum tax rates for individuals were increased to 24 percent by the Omnibus Budget Reconciliation Act of 1990. A two-tier rate structure for individuals (with 26 percent and 28 percent rates) was enacted by the Omnibus Budget Reconciliation Act of 1993.

The Taxpayer Relief Act of 1997 (the "1997 Act") repealed the alternative minimum tax for small corporations (generally with average annual gross receipts under $7.5 million) and cutback on the tax preference for depreciation.[12] The purpose of these changes was described as follows.

> The Congress believed that the alternative minimum tax inhibits capital formation and business enterprise. Therefore, the Act modified the depreciation adjustment of the alternative minimum tax (the most significant business-related adjustment of the alternative minimum tax) with respect to new investments. In addition, the Congress believed that the alternative minimum tax is administratively complex. Therefore, the Act repealed the alternative minimum tax for small corporations.[13]

The Taxpayer Relief Act of 1999, as passed by Congress, would have phased out and repealed the individual alternative minimum tax. The bill was vetoed by President Clinton.[14]

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[11] Joint Committee on Taxation, *General Explanation of the Tax Reform Act of 1986* (JCS-10-87), May 4, 1987, at 432-33.

[12] In addition, the 1997 Act repealed the alternative minimum tax adjustment for farmers using the installment method of accounting.

[13] Joint Committee on Taxation, *General Explanation of Tax Legislation Enacted in 1997* (JCS-23-97), December 17, 1997, at 60.

[14] H.R. 2488, 106th Cong, lst Sess.

B. Present Law

Individual Alternative Minimum Tax

In general

Present law imposes an alternative minimum tax on an individual to the extent the taxpayer's tentative minimum tax liability exceeds his or her regular tax liability.[15] The tentative minimum tax liability is computed for individuals at rates of (1) 26 percent on the first $175,000 of alternative minimum taxable income in excess of a phased-out exemption amount and (2) 28 percent on the amount in excess of $175,000. The exemption amounts are $45,000 in the case of married individuals filing a joint return and surviving spouses; $33,750 in the case of other unmarried individuals; and $22,500 in the case of married individuals filing a separate return, estates, and trusts. These exemption amounts are phased out by an amount equal to 25 percent of the amount that the individual's alternative minimum taxable income exceeds a threshold amount ($150,000 for married individuals filing a joint return and surviving spouses; $112,500 for unmarried individuals; and $75,000 for married individuals filing a separate return, estates, and trusts). The exemption amounts, the threshold phase-out amounts, and the $175,000 rate bracket amount are not indexed for inflation. The lower capital gains rates applicable to the regular tax also apply for purposes of the alternative minimum tax.

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

With certain exceptions discussed below, nonrefundable tax credits may not reduce an individual's tax liability below tentative minimum tax liability.

Preference items in computing alternative taxable income

The minimum tax preference items[16] for individuals are:

(1) The excess of the deduction for percentage depletion over the adjusted basis of mineral property at the end of the taxable year.[17]

(2) The amount by which excess intangible drilling costs arising in the taxable year exceed 65 percent of the net income from oil, gas, and geothermal properties.[18]

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[15] Sec. 55.

[16] Sec. 57.

[17] This preference does not apply to percentage depletion allowed with respect to oil and gas properties.

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

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

(5) Forty-two percent of the amount excluded from income under section 1202 (relating to gains on the sale of certain small business stock).

In addition, losses from any tax shelter farm activity or passive activity are not taken into account in computing alternative minimum taxable income.[19]

Adjustments in computing alternative minimum taxable income

The adjustments[20] that individuals must make to compute alternative minimum taxable income are:

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

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

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

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

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[18] This preference does not apply to independent producers to the extent the producer's alternative minimum taxable income is reduced by 40 percent or less without regard to the preference.

[19] After enactment of the passive activity loss limitations by the 1986 Act, these provisions have little application and generally are considered to be deadwood.

[20] Sec. 56.

pollution control facilities placed in service after December 31, 1998, is calculated using the regular tax recovery periods and the straight-line method.

(5) Miscellaneous itemized deductions are not allowed.

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

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

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

(9) The amount allowable as a deduction for circulation expenditures must be capitalized and amortized over a 3-year period.

(10) The amount allowable as a deduction for research and experimentation expenditures must be capitalized and amortized over a 10-year period.[21]

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

Other rules

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

The various nonrefundable tax credits generally may not reduce an individual's regular tax liability below tentative minimum tax.[22] However, for taxable years beginning in 2000 and 2001 the nonrefundable personal tax credits (i.e., the dependent care credit, the credit for elderly and disabled, the adoption credit, the child credit, the HOPE and Lifetime Learning credits, the credit for interest on certain mortgages, and the D.C. homebuyer credit) may reduce both the regular tax and the alternative minimum tax.[23] The earned income credit and the additional child credit for taxpayers with three or more qualified children are refundable and thus are not limited by the taxpayer's tax liability, but a taxpayer must reduce the amount of these credits by the taxpayer's alternative minimum tax.[24] For taxable years beginning before 2002, the additional child credit is not reduced by the alternative minimum tax.

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[21] No adjustment is required if the taxpayer materially participates in the activity that relates to the research and experimental expenditures,

[22] Secs. 26(a), 29(b)(6), 30(b)(3), and 38(c).

[23] Sec. 26(a)(2).

[24] Secs. 24(d)(2) and 32(h).

If an individual is subject to alternative minimum tax in any year, the amount of tax exceeding the taxpayer's regular tax liability is allowed as a credit in any subsequent taxable year to the extent the taxpayer's regular tax liability exceeds his or her tentative minimum tax liability in such subsequent year.[25] For individuals, the credit is allowed only to the extent that the taxpayer's alternative minimum tax liability is the result of adjustments that are timing in nature. For example, the individual alternative minimum tax adjustments relating to itemized deductions and personal exemptions are not timing in nature, and no minimum tax credit is allowed with respect to these items.

Corporate Alternative Minimum Tax

In general

Present law imposes an alternative minimum tax on a corporation to the extent the corporation's minimum tax liability exceeds its regular tax liability.[26] This alternative minimum tax is imposed on corporations at the rate of 20 percent on alternative minimum taxable income in excess of a $40,000 phased-out exemption amount. The exemption amount is phased-out by an amount equal to 25 percent of the amount that the corporation's alternative minimum taxable income exceeds $150,000.

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

A corporation with average annual gross receipts of less than $7.5 million for the prior three taxable years is exempt from the corporate alternative minimum tax.[27] The $7.5 million threshold is reduced to $5 million for the corporation's first taxable three-year period.

Preference items in computing alternative minimum taxable income

The minimum tax preference items for corporations generally are the same as for individuals.

Adjustments in computing alternative minimum taxable income

The adjustments[28] that corporations must make in computing alternative minimum taxable income are:

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[25] Sec. 53.

[26] Sec. 55.

[27] Sec. 55(e).

[28] Sec. 56.

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

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

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

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

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

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

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

Adjusted current earnings adjustment

The adjusted current earnings adjustment is the amount equal to 75 percent of the amount by which the adjusted current earnings of a corporation exceeds its alternative minimum taxable income (determined without the adjusted current earnings adjustment, or the alternative minimum tax net operating loss deduction).[29] In determining adjusted current earnings, the following rules apply:

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

[29] Sec. 56(g).

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

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

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

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

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

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

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

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

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

Other rules

The combination of the taxpayer's net operating loss carryover and foreign tax credits cannot reduce the taxpayer's alternative minimum tax liability by more than 90 percent of the amount determined without these items.[30]

The various nonrefundable business tax credits allowed under the regular tax generally are not allowed against the alternative minimum tax.[31]

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

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[30] Secs. 56(d) and 59(a).

[31] Secs. 29(b)(6), 30(b)(3), and 38(c).

C. Sources of Complexity

In general

The minimum tax was originally enacted to cut back tax benefits derived from exclusions, deductions and credits that were given preferential tax treatment, but has evolved into a completely separate, alternative tax regime within the Federal income tax. Individuals, trusts, estates, and corporations generally must compute their Federal income tax two ways -- first, to determine regular income tax liability, and then a second time to determine minimum tax liability. Although a taxpayer ultimately may not have a minimum tax liability, many taxpayers must make the computation to determine if they do. In addition, the alternative minimum tax regime can limit the benefits of various deductions and credits, even though the taxpayer ultimately does not have a minimum tax liability. Thus, the alternative minimum tax regime affects many more taxpayers than the taxpayers that actually pay a minimum tax. As a result, the present income tax system, with an alternative minimum tax involving multiple computations for certain items of income, deduction, or credit, is difficult and burdensome to administer and comply with.

Individual alternative minimum tax

It is well known that the alternative minimum tax regime, which requires a lengthy set of alternative computations, is a significant source of complexity for affected taxpayers and for the IRS.

For individuals, there is a 13-line worksheet to determine if the taxpayer must file a 50-line form (Form 6251, to be used for computing the alternative minimum tax) with the taxpayer's annual income tax return. There is 48-line form (Form 8801) to determine the taxpayer's credit for prior payments of the alternative minimum tax.[32] There are ten pages of IRS instructions relating to these worksheets and forms. Complying with the alternative minimum tax requires taxpayers to devote considerable time to try to understand and use the maze of tax rules relating to the tax. Although there are no studies specifically measuring the compliance costs arising from the alternative minimum tax, the IRS estimates that taxpayers spend over 29 million hours annually on Form 6251.[33]

While relatively few individuals have been subject to the alternative minimum tax to date, much larger numbers of individuals will be subject to the alternative minimum tax in the future, as shown in Table 1., below. In addition to the growing numbers of individuals who will pay the minimum tax, other individual taxpayers may be affected by the alternative minimum tax because their personal tax credits may be reduced or limited by the alternative minimum tax. The Joint Committee staff estimates that the number of individual taxpayers paying the alternative minimum tax will rise from 1.9 million in 2002 to 16.4 million in 2011, and the

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[32] These worksheet and forms are attached at the end of this section I.

[33] *Annual Report from the Commissioner of the Internal Revenue on Tax Law Complexity* (June 5, 2000), at 26.

number of individual taxpayers with personal tax credits reduced or limited by the alternative minimum tax will rise from 1.7 million for 2002 to 6.3 million for 2011.[34]

Many of the increasing numbers of alternative minimum taxpayers (and the current ones) are taxpayers for whom the alternative minimum tax was not intended to apply. This is the result of several factors. First, the ability of taxpayers to use tax preferences to produce artificial losses in computing the regular income tax was significantly curtailed by the 1986 Act. Second, major components of the regular tax have been adjusted annually for inflation since 1985 (i.e., personal exemptions, standard deductions, rate brackets, and earned income credit), while the alternative minimum tax exemption amounts and rate brackets have not been adjusted for inflation. Thus, inflation can cause individuals to be alternative minimum taxpayers.[35] Third, lower capital gains rates were enacted in 1997, which can cause an interactive effect with alternative minimum tax. Fourth, the child credit, also enacted in 1997, serves as a structural feature of the Code to make an ability-to-pay adjustment in income taxes for families with children, and is not built in to the alternative minimum tax.

As a result, it is expected that many taxpayers have, and will in the future, become alternative minimum taxpayers because they (1) have large families, (2) live in States with high income taxes, and (3) have significant capital gains. In addition, taxpayers with extremely large medical bills or attorney fees for personal damage litigation could be alternative minimum taxpayers. These generally are not the type of situations that would indicate an individual is avoiding his or her fair share of Federal income taxes.

It is particularly worthy to note that the alternative minimum tax can be a trap for the unwary for taxpayers with large families. In *Klaassen v. Commissioner*,[36] a married couple with ten dependent children was subject to the alternative minimum tax in a year in which their total gross income was $83,000.

In addition, the alternative minimum tax can have the effect of creating disparate treatment of taxpayers depending on where they live. Taxpayers who live in States with high income taxes may be subject to the alternative minimum tax by virtue of State (and local) income taxes, while taxpayers living in States with low income taxes or no income taxes would not.

Corporate alternative minimum tax

Like individuals, corporations are required to compute a second income tax base for the alternative minimum tax, and compute a second tax. Because of the adjusted current earnings adjustment, the second tax base in essence two tax bases. For example, depreciation may be

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[34] See Joint Committee on Taxation, *Overview of Present Law and Economic Analysis Relating to the Marriage Penalty, the Child Tax Credit, and the Alternative Minimum Tax* (JCX-8-01), March 7, 2001, for a more detailed analysis.

[35] With higher rates of inflation, more individuals would be affected by the alternative minimum tax.

[36] 182 F. 3d 932 (10th Cir. 1999), *aff'g* T.C. Memo 1998-241.

computed one way for the regular income tax, but two separate ways for the alternative minimum tax. Many of the corporate alternative minimum tax computations involve timing differences, that is, in the early years of an investment a deduction may be larger for the regular tax than for the alternative minimum tax, but in later years the deduction would be larger for the alternative minimum tax than for the regular tax. Corporations are required to keep extensive records of the various adjustments made for the alternative minimum tax.

The most common reasons for a corporation to be subject to the alternative minimum tax are (1) investments in depreciable property; (2) inventories; (3) foreign tax credits; and (4) net operating losses. At the time the alternative minimum tax was enacted for corporations in 1986, other changes were made in the 1986 Act (and subsequent legislation) to bring depreciation and inventory deductions closer to measuring economic income. As a result, the corporate alternative minimum tax adjustments do not necessarily produce a more accurate measurement of economic income, as was the original purpose of the corporate alternative minimum tax.

D. Recommendations for Simplification

The Joint Committee staff recommends that the individual alternative minimum tax should be eliminated.

The Joint Committee staff recommends that the corporate alternative minimum tax should be eliminated.

The Joint Committee staff believes that the individual alternative minimum tax no longer serves the purposes for which it was intended. The present-law structure of the individual alternative minimum tax expands the scope of the provisions to taxpayers who were not intended to be alternative minimum tax taxpayers. The number of individual taxpayers required to comply with the complexity of the individual alternative minimum tax calculations will continue to grow due to the lack of indexing of the minimum tax exemption amounts and the effect of the individual alternative minimum tax on taxpayers claiming nonrefundable personal credits. The alternative minimum tax can be a trap for the unwary, especially for large families, and creates disparate treatment of taxpayers depending on where they live.

Furthermore, legislative changes since the Tax Reform Act of 1986 (the "1986 Act") have had the effect of more closely conforming the regular tax base for individual taxpayers to the alternative minimum tax base. For example, many of the preference limitations contained in the pre-1986 individual alternative minimum tax were enacted, in part, because of concern with individuals investing in tax shelter activities. The 1986 Act directly addressed this concern with the enactment of the passive loss rules.

The Joint Committee staff believes that the individual alternative minimum tax should be eliminated. Indexing the alternative minimum tax exemption amounts and allowing personal credits against the alternative minimum tax would help to reduce the impact of the alternative minimum tax. However, the Joint Committee staff believes that the utility of the individual alternative minimum tax as a backstop to the regular income tax diminished after enactment of the Tax Reform Act of 1986 and subsequent legislative changes. Thus, the Joint Committee staff believes that the original purpose for the individual alternative minimum tax is no longer served

in any meaningful way and, thus, the complexity of the present-law individual alternative minimum tax is not justified.

Similarly, the Joint Committee staff believes the corporate alternative minimum tax should be eliminated. The corporate alternative minimum tax does not necessarily produce a more accurate measurement of income after the depreciation, inventory and accounting provisions of the Tax Reform Act of 1986, and subsequent legislation, have become fully effective. Thus, the Joint Committee staff believes that the original purpose of the corporate alternative minimum tax is no longer served in any meaningful way, and the elimination of the corporate alternative minimum tax would relieve corporations from computing their tax base using two different methods and complying with burdensome record keeping requirements.

Table 1.--Actual and Projected Individual Income Tax Returns With Tax Liability Under the Individual Alternative Minimum Tax, 1987-2011

Year	Number of returns paying AMT (thousands)	Percentage of filed returns paying AMT	Excess of AMT liability over regular tax liability ($ billions)
1987	140	0.1%	1.7
1988	134	0.1%	1.0
1989	117	0.1%	0.8
1990	132	0.1%	0.8
1991	244	0.2%	1.2
1992	287	0.3%	1.4
1993	335	0.3%	2.1
1994	369	0.3%	2.2
1995	414	0.4%	2.3
1996	478	0.4%	2.8
1997	616	0.5%	4.0
1998	853	.07%	5.0
1999	data not available	data not available	data not available
2000	data not available	data not available	data not available
2001	1,362	1.1%	5.2
2002	1,866	1.4%	6.0
2003	2,345	1.8%	7.0
2004	3,045	2.2%	8.4
2005	4,134	3.0%	10.3
2006	5,234	3.8%	12.4
2007	6,728	4.8%	15.5
2008	8,649	6.1%	19.4
2009	10,698	7.5%	23.9
2010	13,232	9.1%	29.4
2011	16,366	11.2%	36.2

Note: These statistics represent taxpayers who actually pay alternative minimum tax and do not include taxpayers whose regular tax liabilities are affected by the alternative minimum tax through tax credit limitations.
Source: Internal Revenue Service, *Statistics of Income*, 1987-1998; projections for years 2001-2011 from Joint Committee on Taxation staff estimates.

Worksheet To See if You Should Fill in Form 6251—Line 41

Keep for Your Records

Before you begin:

√ Be sure you have read the **Exception** that begins on page 33 to see if you must fill in Form 6251 instead of using this worksheet.

√ If you are claiming the foreign tax credit (see the instructions for Form 1040, line 43, above), enter that credit on line 43.

1. Enter the amount from Form 1040, line 37 . . . . . **1.** _____
2. Are you filing **Schedule A?**
   - ☐ **Yes.** Leave line 2 blank and go to line 3.
   - ☐ **No.** Enter your standard deduction from Form 1040, line 36, and go to line 5. . . . . **2.** _____
3. Enter the **smaller** of the amount on Schedule A, line 4, or 2.5% (.025) of the amount on Form 1040, line 34 . . . . . **3.** _____
4. Add lines 9 and 26 of Schedule A and enter the total . . . . . **4.** _____
5. Add lines 1 through 4 above . . . . . **5.** _____
6. Enter the amount shown below for your filing status.
   - Single or head of household—$33,750
   - Married filing jointly or qualifying widow(er)—$45,000
   - Married filing separately—$22,500

   . . . . . **6.** _____
7. Is the amount on line 5 more than the amount on line 6?
   - ☐ **No.** STOP You do not need to fill in Form 6251.
   - ☐ **Yes.** Subtract line 6 from line 5 . . . . . **7.** _____
8. Enter the amount shown below for your filing status.
   - Single or head of household—$112,500
   - Married filing jointly or qualifying widow(er)—$150,000
   - Married filing separately—$75,000

   . . . . . **8.** _____
9. Is the amount on line 5 more than the amount on line 8?
   - ☐ **No.** Enter -0- here and on line 10 and go to line 11.
   - ☐ **Yes.** Subtract line 8 from line 5.

   . . . . . **9.** _____
10. Multiply line 9 by 25% (.25) and enter the result but do not enter more than line 6 above . . . **10.** _____
11. Add lines 7 and 10 . . . . . **11.** _____
12. Is the amount on line 11 more than the amount shown below for your filing status?
    - Single, married filing jointly, head of household, or qualifying widow(er)—$175,000
    - Married filing separately—$87,500
    - ☐ **Yes.** STOP Fill in Form 6251 to see if you owe the alternative minimum tax.
    - ☐ **No.** Multiply line 11 by 26% (.26) . . . . . **12.** _____
13. Enter the amount from Form 1040, line 40, minus the total of any tax from Form 4972 and any amount on Form 1040, line 43 . . . . . **13.** _____

Next. Is the amount on line 12 more than the amount on line 13?

- ☐ **Yes.** Fill in Form 6251 to see if you owe the alternative minimum tax.
- ☐ **No. Do not** fill in Form 6251.

Form **6251**

Department of the Treasury
Internal Revenue Service

Alternative Minimum Tax—Individuals

▶ See separate instructions.

▶ Attach to Form 1040 or Form 1040NR.

OMB No. 1545-0227

2000

Attachment Sequence No. **32**

Name(s) shown on Form 1040

Your social security number

Part I Adjustments and Preferences

1	If you itemized deductions on Schedule A (Form 1040), go to line 2. Otherwise, enter your standard deduction from Form 1040, line 36, here and go to line 6	1	
2	Medical and dental. Enter the smaller of Schedule A (Form 1040), line 4 **or** 2½% of Form 1040, line 34	2	
3	Taxes. Enter the amount from Schedule A (Form 1040), line 9	3	
4	Certain interest on a home mortgage **not** used to buy, build, or improve your home	4	
5	Miscellaneous itemized deductions. Enter the amount from Schedule A (Form 1040), line 26	5	
6	Refund of taxes. Enter any tax refund from Form 1040, line 10 or line 21	6	( )
7	Investment interest. Enter difference between regular tax and AMT deduction	7	
8	Post-1986 depreciation. Enter difference between regular tax and AMT depreciation	8	
9	Adjusted gain or loss. Enter difference between AMT and regular tax gain or loss	9	
10	Incentive stock options. Enter excess of AMT income over regular tax income	10	
11	Passive activities. Enter difference between AMT and regular tax income or loss	11	
12	Beneficiaries of estates and trusts. Enter the amount from Schedule K-1 (Form 1041), line 9	12	
13	Tax-exempt interest from private activity bonds issued after 8/7/86	13	
14	Other. Enter the amount, if any, for each item below and enter the total on line 14.	14	
15	Total Adjustments and Preferences. Combine lines 1 through 14 ▶	15	

a	Circulation expenditures	h	Loss limitations
b	Depletion	i	Mining costs
c	Depreciation (pre-1987)	j	Patron's adjustment
d	Installment sales	k	Pollution control facilities
e	Intangible drilling costs	l	Research and experimental
f	Large partnerships	m	Section 1202 exclusion
g	Long-term contracts	n	Tax shelter farm activities
		o	Related adjustments

Part II Alternative Minimum Taxable Income

16	Enter the amount from **Form 1040, line 37.** If less than zero, enter as a (loss) ▶	16	
17	Net operating loss deduction, if any, from Form 1040, line 21. Enter as a positive amount	17	
18	If Form 1040, line 34, is over $128,950 (over $64,475 if married filing separately), and you itemized deductions, enter the amount, if any, from line 9 of the worksheet for Schedule A (Form 1040), line 28	18	( )
19	Combine lines 15 through 18 ▶	19	
20	Alternative tax net operating loss deduction. See page 6 of the instructions	20	
21	**Alternative Minimum Taxable Income.** Subtract line 20 from line 19. (If married filing separately and line 21 is more than $165,000, see page 7 of the instructions.) ▶	21	

Part III Exemption Amount and Alternative Minimum Tax

22 **Exemption Amount.** (If this form is for a child under age 14, see page 7 of the instructions.)

IF your filing status is . . .	AND line 21 is not over . . .	THEN enter on line 22 . . .
Single or head of household	$112,500	$33,750
Married filing jointly or qualifying widow(er)	150,000	45,000
Married filing separately	75,000	22,500

22

If line 21 is **over** the amount shown above for your filing status, see page 7 of the instructions.

23	Subtract line 22 from line 21. If zero or less, enter -0- here and on lines 26 and 28 and stop here ▶	23	
24	If you reported capital gain distributions directly on Form 1040, line 13, **or** you completed Schedule D (Form 1040) and have an amount on line 25 or line 27 (or would have had an amount on either line if you had completed Part IV) (as refigured for the AMT, if necessary), go to Part IV of Form 6251 to figure line 24. **All others:** If line 23 is $175,000 or less ($87,500 or less if married filing separately), multiply line 23 by 26% (.26). Otherwise, multiply line 23 by 28% (.28) and subtract $3,500 ($1,750 if married filing separately) from the result ▶	24	
25	Alternative minimum tax foreign tax credit. See page 7 of the instructions	25	
26	Tentative minimum tax. Subtract line 25 from line 24 ▶	26	
27	Enter your tax from Form 1040, line 40 (minus any tax from Form 4972 and any foreign tax credit from Form 1040, line 43)	27	
28	**Alternative Minimum Tax.** Subtract line 27 from line 26. If zero or less, enter -0-. Enter here and on Form 1040, line 41 ▶	28	

For Paperwork Reduction Act Notice, see page 8 of the instructions.

Cat. No. 13600G

Form **6251** (2000)

Part IV Line 24 Computation Using Maximum Capital Gains Rates

Caution: *If you **did not** complete Part IV of Schedule D (Form 1040), see page 8 of the instructions before you complete this part.*

29	Enter the amount from Form 6251, line 23		29	
30	Enter the amount from Schedule D (Form 1040), line 27 (as refigured for the AMT, if necessary). See page 8 of the instructions.	30		
31	Enter the amount from Schedule D (Form 1040), line 25 (as refigured for the AMT, if necessary). See page 8 of the instructions.	31		
32	Add lines 30 and 31	32		
33	Enter the amount from Schedule D (Form 1040), line 22 (as refigured for the AMT, if necessary). See page 8 of the instructions	33		
34	Enter the **smaller** of line 32 or line 33		34	
35	Subtract line 34 from line 29. If zero or less, enter -0- ▶		35	
36	If line 35 is $175,000 or less ($87,500 or less if married filing separately), multiply line 35 by 26% (.26). Otherwise, multiply line 35 by 28% (.28) and subtract $3,500 ($1,750 if married filing separately) from the result		36	
37	Enter the amount from Schedule D (Form 1040), line 36 (as figured for the regular tax). See page 8 of the instructions	37		
38	Enter the **smallest** of line 29, line 30, or line 37 ▶	38		
39	Multiply line 38 by 10% (.10)		39	
40	Enter the **smaller** of line 29 or line 30	40		
41	Enter the amount from line 38	41		
42	Subtract line 41 from line 40 ▶	42		
43	Multiply line 42 by 20% (.20)		43	
	Note: *If line 31 is zero or blank, skip lines 44 through 47 and go to line 48.*			
44	Enter the amount from line 29	44		
45	Add lines 35, 38, and 42	45		
46	Subtract line 45 from line 44	46		
47	Multiply line 46 by 25% (.25)		47	
48	Add lines 36, 39, 43, and 47		48	
49	If line 29 is $175,000 or less ($87,500 or less if married filing separately), multiply line 29 by 26% (.26). Otherwise, multiply line 29 by 28% (.28) and subtract $3,500 ($1,750 if married filing separately) from the result		49	
50	Enter the **smaller** of line 48 or line 49 here and on line 24		50	

Form **8801**

Department of the Treasury
Internal Revenue Service (99)

Credit For Prior Year Minimum Tax—Individuals, Estates, and Trusts

▶ **Attach to your tax return.**

OMB No. 1545-1073

2000

Attachment Sequence No. **74**

Name(s) shown on return

Identifying number

Part I Net Minimum Tax on Exclusion Items

1	Combine lines 16 through 18 of your 1999 Form 6251. Estates and trusts, see instructions	1	
2	Enter adjustments and preferences treated as exclusion items. See instructions	2	
3	Minimum tax credit net operating loss deduction. See instructions	3	( )
4	Combine lines 1, 2, and 3. If zero or less, enter -0- here and on line 15 and go to Part II. If more than $165,000 and you were married filing separately for 1999, see instructions	4	
5	Enter: $45,000 if married filing jointly or qualifying widow(er) for 1999; $33,750 if single or head of household for 1999; or $22,500 if married filing separately for 1999. Estates and trusts, enter $22,500	5	
6	Enter: $150,000 if married filing jointly or qualifying widow(er) for 1999; $112,500 if single or head of household for 1999; or $75,000 if married filing separately for 1999. Estates and trusts, enter $75,000	6	
7	Subtract line 6 from line 4. If zero or less, enter -0- here and on line 8 and go to line 9	7	
8	Multiply line 7 by 25% (.25)	8	
9	Subtract line 8 from line 5. If zero or less, enter -0-. If this form is for a child under age 14, see instructions	9	
10	Subtract line 9 from line 4. If zero or less, enter -0- here and on line 15 and go to Part II. Form 1040NR filers, see instructions	10	
11	If for 1999 you reported capital gain distributions directly on Form 1040, line 13, **or** completed Schedule D (Form 1040 or 1041) and had an amount on line 25 or line 27 of Schedule D (Form 1040) (line 24 or line 26 of Schedule D (Form 1041)) or would have had an amount on either of those lines had you completed them, go to Part III of Form 8801 to figure the amount to enter on this line. **All others:** Multiply line 10 by 26% (.26) **if** line 10 is: $175,000 or less if single, head of household, married filing jointly, qualifying widow(er), or an estate or trust for 1999; or $87,500 or less if married filing separately for 1999. **Otherwise,** multiply line 10 by 28% (.28) and subtract from the result: $3,500 if single, head of household, married filing jointly, qualifying widow(er), or an estate or trust for 1999; or $1,750 if married filing separately for 1999	11	
12	Minimum tax foreign tax credit on exclusion items. See instructions	12	
13	Tentative minimum tax on exclusion items. Subtract line 12 from line 11	13	
14	Enter the amount from your 1999 Form 6251, line 27, or Form 1041, Schedule I, line 38	14	
15	**Net minimum tax on exclusion items.** Subtract line 14 from line 13. If zero or less, enter -0-	15	

Part II Minimum Tax Credit and Carryforward to 2001

16	Enter the amount from your 1999 Form 6251, line 28, or 1999 Form 1041, Schedule I, line 39	16	
17	Enter the amount from line 15 above	17	
18	Subtract line 17 from line 16. If less than zero, enter as a negative amount	18	
19	**1999 minimum tax credit carryforward.** Enter the amount from your 1999 Form 8801, line 26	19	
20	Enter the total of your 1999 unallowed nonconventional source fuel credit and 1999 unallowed qualified electric vehicle credit. See instructions	20	
21	Combine lines 18, 19, and 20. If zero or less, **stop here** and see instructions	21	
22	Enter your 2000 regular income tax liability minus allowable credits. See instructions	22	
23	Enter the amount from your 2000 Form 6251, line 26, or 2000 Form 1041, Schedule I, line 37	23	
24	Subtract line 23 from line 22. If zero or less, enter -0-	24	
25	**Minimum tax credit.** Enter the **smaller** of line 21 or line 24. Also enter this amount on your 2000 Form 1040, line 49; Form 1040NR, line 46; or Form 1041, Schedule G, line 2d	25	
26	**Minimum tax credit carryforward to 2001.** Subtract line 25 from line 21. Keep a record of this amount because you may use it in future years	26	

For Paperwork Reduction Act Notice, see page 4.

Cat. No. 10002S

Form **8801** (2000)

Part III Line 11 Computation Using Maximum Capital Gains Rates

Caution: *If you did not complete Schedule D (Form 1040) for 1999 because you reported capital gain distributions directly on Form 1040, line 13, see the instructions before you complete this part. If you are an individual and you did not complete Part IV of your 1999 Schedule D (Form 1040), complete lines 20 through 27 of that Schedule D before completing this part. For an estate or trust that did not complete Part V of the 1999 Schedule D (Form 1041), complete lines 19 through 26 of that Schedule D before completing this part.*

27	Enter the amount from line 10		27	
28	Enter the amount from your 1999 Schedule D (Form 1040), line 27 (or 1999 Schedule D (Form 1041), line 26)	28		
29	Enter the amount from your 1999 Schedule D (Form 1040), line 25 (or 1999 Schedule D (Form 1041), line 24)	29		
30	Add lines 28 and 29	30		
31	Enter the amount from your 1999 Schedule D (Form 1040), line 22 (or 1999 Schedule D (Form 1041), line 21)	31		
32	Enter the **smaller** of line 30 or line 31		32	
33	Subtract line 32 from line 27. If zero or less, enter -0- ▶		33	
34	Multiply line 33 by 26% (.26) **if** line 33 is: $175,000 or less if single, head of household, married filing jointly, qualifying widow(er), or an estate or trust for 1999; or $87,500 or less if married filing separately for 1999. **Otherwise,** multiply line 33 by 28% (.28) and subtract from the result: $3,500 if single, head of household, married filing jointly, qualifying widow(er), or an estate or trust for 1999; or $1,750 if married filing separately for 1999		34	
35	Enter the amount from your 1999 Schedule D (Form 1040), line 36 (or 1999 Schedule D (Form 1041), line 35). If you did not complete Part IV of your 1999 Schedule D (Form 1040) (Part V of the 1999 Schedule D (Form 1041) for an estate or trust), enter -0-	35		
36	Enter the **smallest** of line 27, line 28, or line 35 ▶	36		
37	Multiply line 36 by 10% (.10)		37	
38	Enter the **smaller** of line 27 or line 28	38		
39	Enter the amount from line 36	39		
40	Subtract line 39 from line 38. If zero or less, enter -0- ▶	40		
41	Multiply line 40 by 20% (.20)		41	

Note: *If line 29 is zero or blank, skip lines 42 through 45 and go to line 46.*

42	Enter the amount from line 27	42		
43	Add lines 33, 36, and 40	43		
44	Subtract line 43 from line 42	44		
45	Multiply line 44 by 25% (.25)		45	
46	Add lines 34, 37, 41, and 45		46	
47	Multiply line 27 by 26% (.26) **if** line 27 is: $175,000 or less if single, head of household, married filing jointly, qualifying widow(er), or an estate or trust for 1999; or $87,500 or less if married filing separately for 1999. **Otherwise,** multiply line 27 by 28% (.28) and subtract from the result: $3,500 if single, head of household, married filing jointly, qualifying widow(er), or an estate or trust for 1999; or $1,750 if married filing separately for 1999		47	
48	Enter the **smaller** of line 46 or line 47 here and on line 11		48	

II. INDIVIDUAL INCOME TAX

A. Structural Issues Relating to the Individual Income Tax

1. Introduction

In conducting this study, the Joint Committee staff focused particular attention on simplifying provisions of the Federal tax laws to reduce the burdens on individual taxpayers, and developed a number of specific recommendations. In addition, the Joint Committee staff decided not to make specific recommendations with respect to a variety of complex provisions because simplification likely would fundamentally alter the underlying policy of the provision. However, further simplification could be achieved by addressing some of the policy aspects of present law.

Specific areas that the Joint Committee staff believes warrant further consideration are discussed below.

2. Filing status

There are five different filing statuses available to an individual when filing his or her return: (1) married individuals filing a joint return; (2) heads of households; (3) unmarried individuals (other than surviving spouses and heads of households); (4) married individuals filing separate returns; and (5) surviving spouses. In general, in order to file as a head of household, a taxpayer must not be married, must not be a surviving spouse, and must either maintain a household that constitutes the principal place of abode for over one half the taxable year of a child or certain dependents or maintain a household that constitutes the principal place of abode for the entire year of a dependent parent. In general, a taxpayer may file as a surviving spouse if the taxpayer's spouse died during either of the two preceding taxable years and the taxpayer maintains a household that constitutes the principal place of abode for the entire year of a dependent child. As discussed more fully below, if certain requirements are satisfied, a married individual with a qualifying child who lives apart from his or her spouse for the last six months of the year is treated as not being married and thus is eligible to file either as single or as head of household.

Filing status is primarily relevant because of the rate structure and the standard deduction. Separate rate schedules apply to each filing status, except that surviving spouses apply the same rate schedules as married individuals filing a joint return. Similarly, separate standard deduction amounts apply to each filing status, and surviving spouses are eligible for the same standard deduction as married individuals filing a joint return.

Filing status also may be relevant for purposes of determining eligibility for certain credits or deductions (e.g., some credits are not available to married taxpayers filing separate

returns). In addition, the income levels at which certain tax benefits phase-in or phase-out often vary by filing status.[37]

For many years, numerous commentators have cited the various filing statuses as a source of complexity and have questioned the rationale for some or all of the different statuses and have suggested that concerns regarding progressivity and ability to pay should be addressed through other provisions, such as exemption amounts. IRS data supports the concerns regarding the complexity of filing status determinations. The IRS has reported that the complexity-related topic appearing most frequently in customer service calls and TeleTax calls in 1999 was filing status.[38] Filing status was the third most common complexity-related math error in 1999.[39] Errors relating to filing status carry through various tax provisions, resulting in numerous errors throughout a return. For example, some taxpayers who are still married mistakenly claim head of household status (rather than married filing separately), thus not only applying incorrect rate schedules and standard deduction amounts, but also incorrectly claiming certain tax benefits for which the taxpayer is in fact ineligible, such as the earned income credit and other tax credits.

The Joint Committee staff agrees multiple filing statuses add complexity, and has made specific recommendations in Section II.B.4. of this Part, below, to modify head of household status and the rules relating to surviving spouses. In addition, further simplification could be achieved by structural changes to the filing status rules. Such changes would involve fundamental questions of overall fairness, relative tax rates for various groups of taxpayers (e.g., married individuals compared to single individuals, taxpayers with children or other dependents and taxpayers without dependents) and progressivity of the income tax and are thus beyond the scope of this study.

3. Determination of marital status

If certain requirements are satisfied, married individuals who live apart are not treated as married for various Code provisions. There are at least four separate rules in the Code under which married individuals who live apart are treated as not married. The most commonly used standard is that contained in section 7703(b), which provides that an individual is treated as not married if:

- the individual files a separate return;
- the individual maintains a household which constitutes the principal place of abode for a qualifying child[40] for more than one-half of the taxable year;

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[37] For a detailed discussion of the various income-based phase-ins and phase-outs in the Code, see Section II.C. of this Part, below.

[38] Department of the Treasury, Internal Revenue Service, *Annual Report from the Commissioner of the Internal Revenue Service on Tax Law Complexity* (June 5, 2000), at 12.

[39] *Id.*

[40] For this purpose, a qualifying child means a son, stepson, daughter, or stepdaughter of the taxpayer with respect to whom the taxpayer is allowed a dependency exemption. For

- the individual furnishes over one-half of the cost of maintaining the household during the taxable year; and
- during the last six months of the year, the individual's spouse was not a member of the household.

Among other things, the section 7703(b) rule applies for purposes of determining filing status, the applicable standard deduction, and eligibility for various tax benefits that are not available to married individuals filing separate returns, including the earned income credit.

The requirements that must be satisfied in order for married individuals who live apart to be treated as not married have been cited by commentators, the IRS, and previously by the Joint Committee staff[41] as causing complexity for taxpayers, particularly lower-income taxpayers. The IRS has reported that for tax year 1997, 10.5 percent of overclaims of the earned income credit were attributable to misapplication of the rules regarding spouses who live apart. As a result of concerns regarding the present-law rules, in September 2000 the IRS and Treasury recommended that a married individual should be eligible to claim the earned income credit if the taxpayer lived with a qualifying child for more than six months of the year and lived apart from his or her spouse for the last six months of the year.

In conducting the present study, the Joint Committee staff discussed various alternatives to the present-law rules regarding spouses who live apart, including a proposal that would eliminate the requirement of a qualifying child and provide that married individuals are treated as unmarried if they live apart for the entire taxable year. Under that proposal, an individual would not be considered to be living apart from his or her spouse during certain absences due to circumstances such as military service, business, education, and similar situations.

Although it may be appropriate to study the issue further, the Joint Committee staff decided not to make a recommendation regarding the treatment of spouses who live apart because the proposals considered by the Joint Committee staff raised fundamental policy concerns. For example, some proposals could expand the class of taxpayers who would be eligible to file as single rather than as filing separate returns. In addition, some commentators believed that some rules might be subject to manipulation by married individuals who are subject to a marriage penalty under present law and thus would prefer to file as two single individuals rather than as married individuals filing a joint return. In particular, there was concern that "commuter" marriages with spouses working in different geographic locations and commuting home periodically might be eligible to file as two single taxpayers--an option not provided generally to married individuals.

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purposes of determining whether the necessary relationship exists, adopted children and foster children are treated as the taxpayer's own child.

[41] Committee on Ways and Means, U.S. House of Representatives, *Written Proposals on Tax Simplification*, WMCP: 101-27, at 10-11 (1990).

4. Exclusions from income

Present law contains almost 40 specific exclusions from gross income. Exclusions from income frequently are provided for nontax policy reasons, such as to encourage particular behavior or in situations in which income inclusion has been determined to be inappropriate. For example, the exclusion from income for employer-provided health care is provided in order to encourage employers to provide health insurance for their employees and to encourage employees to receive some part of their compensation in the form of health insurance. Exclusions are also provided for administrative reasons or for simplification. For example, property or services provided by an employer are excludable from gross income as a de minimis fringe benefit if the value is so small as to make accounting for it unreasonable or administratively impracticable. Simplification also results if a deduction or credit would otherwise be available for the excludable item. For example, present law provides an exclusion from income for working condition fringe benefits provided by an employer. If such expenses were paid by the employee, they would be deductible as a business expense.[42] Providing an exclusion is simpler than requiring the employee to include the item in income and then take a deduction.

The benefit of an exclusion from income increases as a taxpayer's marginal tax rate increases. That is, the higher a taxpayer's marginal tax rate, the more the taxpayer saves in taxes by reason of an exclusion. For employer-provided items excludable from wages for Social Security tax purposes, the taxpayer benefits from reduced Social Security taxes; however, the taxpayer may also have reduced Social Security benefits in the future as a result of the exclusion.

Exclusions from income may result in a perception that the Federal tax laws are unfair. Exclusions reduce perceived horizontal equity in the Federal tax system because taxpayers with equal economic income often pay different amounts of taxes based on the form of income received.

Most exclusions are not available unless specific requirements are satisfied, which creates complexity for individual taxpayers and, in the case of exclusions for employer-provided benefits, for employers as well. Taxpayers bear the burden of demonstrating that an exclusion applies, which may require the taxpayer to keep records and/or provide the employer appropriate records or receipts. The taxpayer may be required to fill out and file additional tax forms in order properly to claim the exclusion (see, e.g., Form 2441-Child and Dependent Care Expenses). Exclusions may provide either simplification or create complexities for taxpayers depending on each taxpayer's circumstances. For example, present law provides an exclusion from income for up to $250,000 of gain on the sale of a principal residence if certain requirements are satisfied.[43] For taxpayers clearly eligible to take advantage of the exclusion, the exclusion reduces recordkeeping requirements relating to the taxpayer's basis. However, taxpayers may nevertheless need to keep basis records if they expect the appreciation in the

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[42] Deductibility is determined without regard to the two-percent floor on miscellaneous itemized deductions or the overall limitation on itemized deductions.

[43] Sec. 121.

residence to exceed the excludable amount, the taxpayer has used the home for purposes other than a principal residence (e.g., rental property), or in certain other cases.

In the case of exclusions for employer-provided benefits, employers generally must make an initial determination of whether an item of income is excludable in order properly to apply withholding and properly to report the item on the employee's Form W-2. Thus, employers need to understand the terms of the exclusions.

Eliminating any particular exclusion would increase the tax liability of taxpayers that had previously benefited from the exclusion. However, to the extent that retaining an exclusion is thought to promote progressivity of the tax system, it may be simpler to adjust other structural elements of the Code, such as the rate structure and exemption amounts, to achieve the desired level of progressivity.

The Joint Committee staff believes that simplification could be achieved if some exclusions were eliminated or significantly modified; however, the Joint Committee staff is not making any recommendations in this regard because fundamental policy questions would need to be addressed. In determining whether any particular exclusion should be eliminated (or substantially revised), the following issues should be addressed:

- Whether the provision promotes simplification or adds to complexity of the Federal tax laws.
- Whether the provision promotes desirable social or economic purposes.
- The effect, if any, that continuation, elimination, or revision of the provision would have on tax equity.
- Whether the tax incentive approach is the most efficient method of achieving the desired result.
- The impact, if any, on the economy if the provision were eliminated or significantly modified.

5. Deductions and credits

The Code contains numerous deductions and credits. Although both deductions and credits reduce tax liability, they operate differently--deductions reduce taxable income, which results in a lower tax liability; credits are applied directly against tax liability. Some credits are refundable, allowing the taxpayer to receive a benefit from the credit in excess of the income tax liability shown on the return (as reduced by any nonrefundable credits).

The present-law deductions and credits add complexity to the Code because of (1) the large number of deductions and credits, (2) the existence of both deductions and credits, and (3) overlapping deductions and credits with similar purposes, most notably the deduction for personal exemptions for children and the child credit. The Joint Committee staff believes the Code could be simplified by reducing the number of deductions and credits, reducing the reliance on both deductions and credits, and consolidating overlapping provisions. Such simplification would involve fundamental policy issues that are beyond the scope of this study. Following is a discussion of issues relevant to simplification of the present-law structure of deductions and credits.

Observers often see deductions and credits as two methods by which to achieve a given outcome. In evaluating whether to choose a deduction or a credit, generally three principles offer guidance: (1) the promotion of economic efficiency; (2) the promotion of fairness; and (3) the promotion of ease of compliance and administration. Unfortunately, these principles often can be in conflict. The most economically efficient tax design may not be perceived as fair and may impose significant compliance burdens. Likewise, a simple design may not be perceived as either fair or efficient.

Under an income tax, the proper measurement of income is important for the promotion of economically efficient outcomes and for providing a yardstick by which to assess the fairness of outcomes. If a deduction or a credit is being considered because one believes that certain expenditures, if taken into account, would more properly measure income or would more properly measure the taxpayer's ability to pay taxes, a deduction would be the preferred policy tool. A deduction directly alters taxable income, the measure of ability to pay.

Sometimes policy makers consider providing a deduction or a credit in order to encourage certain expenditures, i.e., to provide an implicit subsidy to such expenditures through the Code. A deduction for such expenditures provides a reduction in tax liability equal to the deductible amount multiplied by the taxpayer's marginal tax rate. A credit for such expenditures provides a reduction in tax liability equal to the qualified expenditure amount multiplied by the credit rate.[44] Because different taxpayers are in different marginal tax rate brackets, the subsidy rate of a deduction varies across different taxpayers. A credit provides an equal or uniform subsidy rate to all taxpayers who claim the credit. Whether varying subsidy rates or a uniform subsidy rate promotes economic efficiency and/or fairness will depend upon the policy being effectuated.

While most credits are not refundable, the earned income credit and, in certain cases, the child credit are refundable. To the extent refundability is considered desirable, a credit would be the preferred policy.

The burden of added complexity is another factor to consider in the decision to permit a deduction or allow a credit for a given expenditure or purpose. It is not possible to conclude that a deduction is always simpler than a credit or that a credit is always simpler than a deduction. Two main factors determine the additional complexity created by a deduction or a credit: (1) the

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[44] "Credit rate" refers to the percentage of a qualified expenditure that the taxpayer is permitted to claim as a credit against tax liability. The amount of credit need not equal the amount of expenditure. For example, under present law, the dependent care credit has a rate of 20 percent to 30 percent, depending on the taxpayer's income.

A dollar of credit is always more valuable than a dollar of deduction because a credit reduces tax liability dollar for dollar. A dollar of deduction reduces tax liability by the fraction of a dollar equal to the taxpayer's marginal tax rate. Generally a credit is more valuable than a deduction whenever the credit rate is greater than the taxpayer's marginal tax rate.

number of taxpayers affected by the deduction or credit, and (2) the degree of computation and recordkeeping required to claim the deduction or credit.[45]

A credit potentially affects a larger number of taxpayers than would an itemized deduction because a credit can be claimed even though the taxpayer uses the standard deduction. As a result, many more taxpayers would have to maintain records concerning the expenses with respect to which a credit is allowed and undertake any necessary computations to compute the value of a credit. For 2001, it is estimated that 72.1 percent of 2001 filers will use the standard deduction. Consequently, a credit potentially involves more than two and one half times as many taxpayers as does an itemized deduction. On the other hand, not all deductions are itemized deductions. Some deductions are permitted in computing adjusted gross income, i.e., they are commonly referred to as "above-the-line" deductions. An above-the-line deduction would affect as many taxpayers a credit designed to achieve comparable tax reduction.

Claiming either a deduction or a credit generally requires the same recordkeeping burden, but may have differing arithmetic requirements. When deductions and credits are compared in their simplest form, a credit imposes a greater computational burden than does a deduction. To claim a credit, after determining pre-credit tax liability, the taxpayer must total the qualifying expenditures, multiply the sum by the credit rate, and subtract the result from the taxpayer's previously computed tax liability. To claim a deduction, the taxpayer must total the qualifying expenditures and subtract the result from the taxpayer's previously computed adjusted gross income,[46] then compute his or her tax liability. Thus, claiming tax benefits via a tax credit generally requires one additional computation not required of a deduction (multiplication of the expenditures by the credit rate). However, if the credit rate is 100 percent or the credit allowed is a fixed dollar amount (e.g., the $500 child credit), the computational steps are identical. Nor do deductions always take the simplest form. If less than 100 percent of the otherwise qualifying expenditures are permitted to be deducted (e.g., present-law deductions for certain meals and entertainment), to claim the deduction the taxpayer must total the qualifying expenditures, multiple the sum by the inclusion rate, and subtract the result from the taxpayer's previously computed adjusted gross income. This involves the same computational process required of a credit at less than a 100-percent credit rate.

Other limitations may be imposed on both deductions and credits that increase the computational complexity of the deduction or credit. For example, a deduction or credit could be allowed only for expenditures above or below a specified amount. Such limitations determine the amount of otherwise qualifying expenditures to be deducted or credited and add equally to the computational complexity of either a deduction or a credit. Limitations on the ability to claim a deduction or a credit in the current year also increase complexity. For example, most credits are not refundable. If unused credits are permitted to be carried forward or backward to other taxable years special ordering or stacking rules must be provided to determine which of the

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[45] The alternative minimum tax may also add complexity with respect to a deduction or credit. *See* the discussion in Section I. of this Part, above.

[46] In the case of an above-the-line deduction, the taxpayer would subtract the expenditures from "total income" reported on line 22 of Form 1040.

several credits available are actually applied against the current year's tax liability and which are to be carried forward or back. These ordering rules require several lines on each of the forms used for claiming a credit. Likewise, if certain otherwise deductible expenses may be carried forward (e.g., charitable donations) similar ordering rules must be provided. Under present law, certain deductions and credits are not permitted to be claimed by taxpayers above specified income thresholds and the benefits of the deduction or the credit are phased out for certain taxpayers. These limitations and phaseout ranges generally are implemented by separate worksheets for the taxpayer. These limitations and phaseout ranges create equal complexity whether the provision is a deduction or a credit.

While this discussion concludes that credits are not inherently more complicated than deductions, the IRS has informed the Joint Committee staff that more arithmetic errors arise in claiming credits than in claiming deductions. The reason for this is unclear. It may be that present-law deductions are simpler than present-law credits. Because the Code has historically contained more deductions than credits, taxpayers may have greater familiarity with deductions.

6. Above-the-line deductions and itemized deductions

A taxpayer's adjusted gross income is determined by subtracting certain deductions from gross income. These deductions are commonly referred to as "above-the-line" deductions and are allowed to all taxpayers, including those who do not itemize deductions. A taxpayer calculates taxable income by subtracting either the standard deduction or allowable itemized deductions from adjusted gross income. In general, taxpayers choose to itemize their deductions if the total amount of itemized deductions exceeds the standard deduction. Tables 2 and 3 summarize the above-the-line and itemized deductions.

Present law does not reflect a coherent theory for treating some deductions as above-the-line and some deductions as itemized deductions. Although above-the-line deductions are frequently thought of as deductions related to the production of income and itemized deductions are frequently thought of as reflecting ability to pay or encouraging certain behavior, not all deductions can be accounted for under these principles. For example, the above-the-line deduction for contributions to medical savings accounts is not related to the production of income. Rather, the deduction is intended as an incentive to encourage taxpayers to alter the way in which they purchase medical care in an effort to help reduce overall medical costs. Similarly, not all expenses that are related to the production of income are above-the-line deductions. For example, employee business expenses are allowable only as an itemized deduction (subject to the two-percent floor on itemized deductions).

Table 2.–Individual Income Tax Deductions: Above-the-Line Deductions

DEDUCTION	CODE SEC.
Trade or business expenses (other than most employee business expenses)	162
Reimbursed employee business expenses[1]	162, 62(a)(2)(A)
Employee business expenses of performing artists	162, 62(a)(2)(B)
Employee business expenses of certain State or local government officials	162, 62(a)(2)(C)
Losses from the sale or exchange of property	161 et. seq.
Deductions attributable to rents and royalties	161 et. seq., 212, and 611
Certain deductions of life tenants and income beneficiaries of property	167 and 611
Self-employed health insurance expenses	162(l)
Reforestation expenses	194
Alimony paid	215
Moving expenses	217
IRA contributions	219
Medical savings account contributions	220
Qualified student loan interest	221
Pension plan contributions for self-employed individuals	404
One-half of self-employment taxes	164(f)
Amounts forfeited to financial institution because of premature withdrawal of deposits	165
Jury duty pay remitted to employer	62(a)(13)
Required repayments of supplemental unemployment compensation benefits	165
Clean-fuel vehicles and certain refueling property	179A

[1] Reimbursed employee expenses may be excluded from income, rather than included in income and then deducted.

Table 3.–Individual Income Tax Deductions: Itemized Deductions

DEDUCTION	CODE SEC.	AGI[1] FLOOR/CAP
Medical expenses	213	7.5 % of AGI floor
State and local taxes	164	None
Residence interest	163(h)(2)(D)	None
Charitable contributions	170	Cap equal to 50% or 30% of AGI depending on the type of organization to which the contribution is made; cap of 20% of AGI applies to certain gifts of capital gain property
Casualty and theft losses from transaction entered into for profit not connected with a trade or business	165(c)(2)	None
Personal casualty losses (not connected with a trade or business or from a transaction entered into for profit)	165(c)(3), (h)	Floor of $100 per casualty loss; 10% of AGI floor for aggregate casualty losses
Gambling losses (to extent of reported gains)	165(d)	None
Federal estate tax on income in respect of a decedent	691(c)	None
Amortizable bond premium on bonds acquired before 10/23/1986	171	None
Repayment of amounts under a claim of right if over $3,000	1341	None
Certain unrecovered investment in a pension	72(b)(3)	None
Impairment-related work expenses of a disabled person	162	None
Employee business expenses *other than the following expenses deducted above-the-line:* • Reimbursed employee business expenses[3] • Employee business expenses of performing artists • Employee business expenses of certain State and local government officials	162	2% of AGI floor[2]
Expenses to produce or collect income	212(1)	2% of AGI floor[2]
Expenses for the management, conservation, or maintenance of property held for the production of income	212(2)	2% of AGI floor[2]

DEDUCTION	CODE SEC.	AGI[1] FLOOR/CAP
Expenses incurred in connection with the determination, collection, or refund of any tax	212(3)	2% of AGI floor[2]
Excess deductions of an estate	642(h)	2% of AGI floor[2]

[1] AGI refers to adjusted gross income.

[2] The two-percent floor applies to the aggregate of all deductions subject to the floor.

[3] Reimbursed employee business expenses may be excluded from income, rather than included in income and then deducted.

A variety of factors may influence policy makers when deciding whether a new deduction should be above-the-line or an itemized deduction. For example, some deductions may have been added as above-the-line deductions in reaction to other provisions in the Code that would limit the benefits of an itemized deduction. In particular, under present law, the ability of taxpayers to receive the full benefit of an itemized deduction may be limited by the application of the alternative minimum tax, the two-percent floor on itemized deductions, and the overall limitation on itemized deductions.[47] Other aspects of the Code also have led to legislative proposals to create another class of deduction, so-called "between-the-line" deductions. These are deductions that are allowable to all taxpayers whether or not they itemize deductions. However, they do not reduce adjusted gross income, and thus do not affect the application of the various provisions of the Code that have income-based phase-ins or phase-outs.

The Joint Committee staff believes the present-law structure of above-the-line and itemized deductions creates complexities for taxpayers. The lack of a consistent theory behind each type of deduction leads to confusion on the part of taxpayers, and can also increase taxpayer perceptions that the tax laws are unfair. Further, complexity results from the structure of itemized deductions and the various floors that apply to different types of deductions.

Significant changes to the structure of deductions would raise policy issues of equity and overall tax burdens, among others, that are beyond the scope of this study. In addition, to the extent that a particular deduction is intended to encourage certain behavior, issues such as those discussed above with respect to exclusions may also arise.

7. Standard deduction

As discussed above, in computing taxable income, a taxpayer either subtracts itemized deductions or the standard deduction. For taxpayers with modest amounts of expenses, the standard deduction achieves a similar result as itemized deductions, while reducing the taxpayer's filing and compliance burden and reducing the IRS's administrative burden. Some interpret the standard deduction as defining a zero tax bracket that applies for most taxpayers, and view it as an adjustment to reflect taxpayers' ability to pay. In general, taxpayers use the standard deduction if their allowable itemized deductions are less than the standard deduction.

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[47] The Joint Committee staff separately is recommending that these provisions in present law be eliminated. *See* Sections I., II.C., and II.F. of this Part.

A basic standard deduction is provided for each filing status. Additional standard deduction amounts apply to the elderly and blind.

The basic standard deduction for tax year 2001 is as follows: [48]

Filing Status	Standard Deduction
Married individuals filing joint returns; surviving spouses	$7,600
Heads of households	$6,650
Unmarried individuals (other than surviving spouses and heads of households)	$4,550
Married individuals filing separate returns	$3,800

For 2001, an additional standard deduction of $900 is allowed for an elderly or a blind individual who is married or is a surviving spouse; the additional standard deduction is $1,800 for an individual who is both elderly and blind. An additional standard deduction of $1,100 is allowed for a head of household who is elderly or blind ($2,200, if both), or for a single individual (i.e., an unmarried individual other than a surviving spouse or a head of household) who is elderly or blind ($2,200, if both).

The basic standard deduction and the additional standard deduction for the elderly and blind are adjusted for inflation annually.

For 2001, an estimated 110.3 million returns, or 72.1 percent of all filers, will utilize the standard deduction, while an estimated 42.7 million returns, or 27.9 percent of all filers, will itemize. If the standard deduction were raised, even fewer taxpayers would itemize their deductions. Accordingly, increasing the standard deduction would promote simplification in that some taxpayers who previously itemized their deductions would not need to keep the records necessary to prove their itemized deductions nor would they need to complete and file Schedule A.

Although increasing the standard deduction would promote simplification for some taxpayers, it also would provide a windfall to the large number of taxpayers who already claim the standard deduction, with no concomitant increase in simplification.[49] The table below illustrates that a very large proportion of the benefit of increasing the standard deduction would go to taxpayers who already claim the standard deduction. Some observers might consider this an unwarranted benefit that increases the inequities of income measurement under the Code, in that taxpayers with significantly differing amounts of deductible expenses would be entitled to

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[48] Rev. Proc. 2001-13, 2001-3 I.R.B. 337.

[49] An increase in the standard deduction would have similar effects for some taxpayers who cease itemizing because of an increase in the standard deduction. For example, if a taxpayer has itemized deductions that exceed the standard deduction by $1,000, any increase in the standard deduction in excess of $1,000 would provide that taxpayer with a tax reduction with no concomitant increase in simplification.

the same standard deduction. Accordingly, a determination of whether the simplification benefits of an increase in the standard deduction would out weigh these concerns must be made. Because of these significant policy considerations, the staff of the Joint Committee has not made a recommendation regarding the standard deduction.

The following Table 4. illustrates the reduction in the number of returns claiming itemized deductions and the change in tax liability that would result from increasing the standard deduction by different amounts.

Table 4.–Estimated Effects of Increasing the Standard Deduction for Tax Year 2001

Change in Standard Deduction	Reduction in Number of Itemized Returns (millions of returns)	Total Change in Tax Liability (billions of dollars)	Change in Tax Liability for Taxpayers Who Will No Longer Itemize Because of the Increase in the Standard Deduction (billions of dollars)
Increase by $1,000	4.6	-$11.1	-$0.5
Increase by $2,000	7.7	-$22.3	-$1.6
Increase by $3,000	10.6	-$33.6	-$3.3
Increase by $4,000	13.7	-$45.0	-$5.5
Increase by $5,000	16.6	-$56.6	-$8.2

Note: Estimates assume the additional standard deduction for the blind and elderly remains unchanged.
Source: Staff of the Joint Committee on Taxation

8. Dependency exemption, child credit, and earned income credit

The complexities involved in the dependency exemption (particularly as applied to children), the child credit, and the earned income credit have received considerable attention for many years. This focus is due to a variety of factors. The provisions affect large numbers of taxpayers. Misapplication of these rules results in significant levels of errors. The burdens of these complicated rules may fall particularly hard on lower-income taxpayers.

The Joint Committee staff makes specific recommendations to reduce complexity with respect to all these provisions.[50] The Joint Committee staff also believes, however, that further simplification could be achieved by structural changes to these provisions. The dependency exemption, the child credit, and the earned income credit fall within the category of overlapping or duplicative provisions. All provide benefits to taxpayers with children. The legislative history of the child credit indicates that the purpose of the credit is almost identical to the purpose of the dependency exemption for children, and the requirements for the two provisions are very similar. Although the earned income credit has many requirements that differ from those applicable to the dependency exemption and the child credit and provides a relatively small

[50] *See* Section II.B. of this Part, below.

credit to childless workers, it primarily serves to provide benefits to working taxpayers with children.

A variety of proposals to eliminate or reduce the overlapping benefits with respect to children have been proposed. Some proposals would combine the child credit and the dependency exemption, while others would combine all three provisions into a single tax credit. Other proposals focus solely on the earned income credit and possible structural changes to make the earned income credit simpler.[51]

A thorough evaluation of any of the proposals to simplify these provisions would require analysis of policy issues relating to simplification, tax equity, level of benefits provided, and whether the benefits are provided to the same category of individuals targeted by the original provisions.

9. Treatment of capital gains and losses

Under present law, the net capital gain of an individual is subject to lower rates of tax than the rates applicable to ordinary income. Net capital gain is generally the excess of the net gain from the sale or exchange of capital assets held more than one year over the net loss from the sale or exchange of capital assets held not more than one year. Also, the deductibility of capital losses of both individuals and corporations are subject to limitations.

Shortly after the adoption of the Internal Revenue Code of 1954, it was observed that "[t]he subject singly responsible for the largest amount of complexity is the treatment of capital gains and losses."[52] Several decades later, it was stated in testimony before Congress that capital gains treatment "is perhaps the single most complicating aspect of existing law."[53] More recently, capital gains has been described as a law of "fabulous complexity."[54] A principal source of that complexity is in the definition of capital gain and capital loss, and the significant number of rules relating to that definition.[55] The definitional uncertainty has resulted in "[t]he

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[51] Structural issues relating to in the earned income credit are also discussed in Section II.B.3. of this Part, below.

[52] Stanley S. Surrey, *Definitional Problems in Capital Gains Taxation*, 69 Harvard Law Review 985 (1956).

[53] Panel Discussions of the Subject of General Tax Reform Before the Committee on Ways and Means, 93rd Cong., lst Sess. (pt. I) 118 (Statement of Boris Bittker).

[54] J. Andrew Hoerner, *The Capital Gains Controversy*, at 2 (Tax Analysts 1992).

[55] An additional complexity is the computation of the tax on net capital gain. The Joint Committee staff has made a recommendation addressing this complexity in Part I. E., below.

concept of capital gains [being] constantly strained--even perverted--by devious manipulations to bring ordinary income under the tax definition of capital gains."[56]

The Joint Committee staff is not making a recommendation with respect to the definitional complexity relating to capital gains and losses because such a change would alter fundamentally the Federal tax policy relating to the treatment of the sale of capital assets. Thus, making a recommendation to alter the treatment of capital assets was considered to be beyond the scope of the study.

The Code defines "capital gain" in terms of "the sale or exchange of a capital asset"[57]. The Code defines a capital asset as property held by the taxpayer other than certain listed exceptions. A principal exception applies to "stock in trade of the taxpayer or other property of a kind which would properly be included in the inventory of the taxpayer if on hand at the close of the taxable year, or property held by the taxpayer primarily for sale to customers in the ordinary course of his trade or business."[58] This exception is intended to deny capital gain treatment to receipts obtained in the routine conduct of the taxpayer's business, and has lead to innumerable disputes about whether one is a "dealer" holding property for sale to customers, or a "trader" or "investor" entitled to capital gain. Similarly, the proper treatment of property used for the "hedging" of property used in a trade or business has led to much litigation and many disputes.[59]

Generally, if there is net gain from the sale or exchange of property used in a taxpayer's trade or business, gains and losses are treated as capital gains and losses, but if there is a net loss, the gains and losses are treated as ordinary, with exceptions for certain recapture of depreciation, amortization, and depletion deductions and recapture of certain prior losses. Special rules also apply to timber, coal, iron ore, livestock, and unharvested crops.[60]

Another area of complexity is determining whether income from personal services may be transformed into the sale or exchange of property entitled to capital gain, for example, from the sale of a book, patent, good will, trade name, contract not to compete, employment contract, or corporate stock whose value rises because of the personal efforts of the promoter. The statutory definition of a capital asset does not address many of these situations, and so many issues have been left for the courts to address.

Significant complexity involves the transformation of items of income that should be ordinary into appreciation in corporate or partnership interests, which is treated as capital gain.

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[56] Hearings before the Senate Financing Committee on Taxation and Debt Management, 95th Congress, lst Sess., (June 13, 1977) (Testimony of Dan Troop Smith).

[57] *See* secs. 1221-1223 for general rules for determining capital gains and losses.

[58] Sec. 1221(a)(1).

[59] *See Corn Products Refining Co. v. Commissioner*, 350 U.S. 46 (1955) and *Arkansas Best v. Commissioner,* 485 U.S. 212 (1988).

[60] Sec. 1231.

The Code contains highly complicated provisions to prevent individuals from converting what should properly be treated as ordinary income into capital gain. These include some of the most complicated provisions in the Code, such as sections 341 and 751 dealing with "collapsible" corporations and partnerships.[61]

Capital gain treatment requires a "sale or exchange." For this purpose, courts have been faced with the task of distinguishing whether a transaction is a sale or is instead a lease, license, gift, loan, leaseback, or termination. In addition, the Code contains many provisions treating as sales or exchanges, transactions that may not fit the definition of a sale or exchange. These provisions deal with such topics as bad debts, worthless securities, stock redemptions, corporate liquidations, deficit distributions, bond retirements, involuntary conversions, options, extinguishments, and transfers of franchise, mineral, patent and timber interests.

10. Treatment of home mortgage interest of individuals

Personal interest and the home equity debt rules

In general, personal interest is not deductible.[62] Personal interest is any interest, other than interest incurred in connection with the conduct of a trade or business,[63] investment interest, or interest taken into account in computing the taxpayer's income or loss from passive activities for the year. In addition, personal interest does not include qualified residence interest of the taxpayer.

Qualified residence interest, which is deductible, generally means interest on acquisition debt up to $1 million with respect to the taxpayer's principal residence or second residence, plus home equity debt up to $100,000.[64] Both acquisition debt and home equity debt must be secured by the taxpayer's principal residence or second residence. Home equity debt may not exceed the fair market value of the residence, reduced by the amount of acquisition debt on the residence.

It has been argued that the rule allowing a deduction for home equity debt encroaches on the general rule of non-deductibility of personal interest,[65] creating a confusing array of

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[61] *See also* secs. 302, 303, 304, 305, 306, 346, 356 (involving corporations) and secs. 724, 731, 732, 735, 736, and 741 (involving partnerships). In the section of recommendations relating to corporate income tax, the Joint Committee staff is making a recommendation to repeal the collapsible corporation provisions.

[62] Sec. 163(h).

[63] This does not include the trade or business of performing services as an employee. For example, interest on debt to finance an employee business expense is not deductible.

[64] Sec. 163(h)(3).

[65] *See* Jerome Kurtz, *The Interest Deduction Under Our Hybrid Tax System: Muddling Toward Accommodation*, 50 Tax L. Rev. 153, 231-32 (1995) ("[T]he Code denies any deduction for interest on consumer debt, with one very broad exception which, for homeowners, virtually

conflicting policies, causing complexity in the tax law, and yielding disparate treatment of taxpayers. Further, particular requirements of the home equity debt rules have been criticized as arbitrary and subject to manipulation, creating further complexity. These requirements include rules that the individual must own the home, have equity in the home, and give up a security interest in the home. In examining these complexity concerns, however, the Joint Committee staff concluded that tax policy considerations relating to the home equity debt rules would have to be resolved in order for meaningful simplification to be achieved.

If the home equity debt rules were to be modified or eliminated as a simplification measure, some of the following policy issues would have to be addressed. One such issue arises from the present-law requirement that the individual who is allowed a deduction for interest under the general rules described above must be a homeowner, which favors homeowners as compared to non-homeowners. It can be argued that the home equity debt rules add to this inequity.

Similarly, some might question whether the allowance of the home equity debt interest deduction is consistent with the underlying purpose of the home mortgage interest rules to promote home ownership.[66] The deduction for interest on home equity debt arguably encourages individuals who already have acquired or constructed a home and have built up equity in the home to borrow against that equity to qualify for an interest deduction.[67]

The requirement that the homeowner have equity in the home measured by the fair market value of the home (less acquisition debt) may cause complexity in requiring the homeowner to determine the fair market value of the home on a periodic basis (as well as favoring homeowners with equity in their home versus homeowners with little or no equity). This rule is difficult to apply in periods of fluctuating real estate values. Consideration could be given to whether an alternative limit, such as the initial purchase price, would have administrability advantages outweighing any incentive to inflate price.

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swallows the rule – the home equity loan. . . . To allow the deduction of consumer interest only to those owning homes and willing to pledge them as security is totally perverse.").

[66] *See* Julia P. Forrester, *Mortgaging the American Dream: A Critical Evaluation of the Federal Government's Promotion of Home Equity Financing*, 69 Tul. L. Rev. 373, 441-42 (1994) ("Some may argue that the tax deduction for interest on a home equity loan is related to the federal policy favoring home ownership, but even if it does marginally promote home ownership, it is not an appropriate means. Other measures promoting home ownership do so by making home ownership possible for those who might not otherwise be able to purchase a home.").

[67] It should be noted that a more fundamental criticism of the home mortgage interest deduction may also counter the arguments that the home equity debt rules promote home ownership. This more fundamental criticism is that the incremental cost of acquiring a home may be increased by the amount of the tax subsidy for the interest on debt to acquire it, so the homebuyer may be sharing the tax subsidy of the interest deduction with other parties to the transaction, such as the lender or the seller.

The requirement that the homeowner give up a security interest in the home in order for the debt to qualify as home equity debt arguably can be manipulated by taxpayers. Manipulable rules are a source of complexity, because they may constitute an impediment to a tax result that generates tax-law-driven behavior. For example, many automobile dealerships are quite willing to accept a security interest in a car buyer's home without any information about the home's value or whether the home is security for any other debt, in order to provide the individual with an interest deduction under the home equity debt rules.[68] Dealers may take this interest in the home even though a security interest in the automobile is their primary security on the debt (often making the home as security for the debt in form only). The result of this inconsistency can be a perception that the tax rules are unfair as well as complex.

There are some arguments in favor of retaining the deduction for interest on home equity debt. These rules may serve a simplification purpose in the case of an individual refinancing a mortgage.[69] If the rules were repealed, then any refinancing that resulted in a principal balance on the loan that exceeded the outstanding balance of the acquisition debt would require the bifurcation of the interest between the deductible and the nondeductible portions. This would lead to complexity in calculating the interest deduction, particularly on successive refinancings. Another argument in favor of retaining these rules has to do with treating similarly situated taxpayers alike. The home equity debt rules permit taxpayers to deduct some interest secured by their homes, whether they choose to finance the home purchase or to finance the purchase of other items with debt secured by the home.[70]

Modification or elimination of the home equity debt rules would lead to simplification but would also necessitate some significant tax policy decisions. As a result, no recommendation for change to the existing home equity debt rules is provided.

Tracing rules for interest expense as a source of complexity

In determining how to categorize interest expense of an individual as, for example, investment interest (which is deductible within certain limits) or personal interest (which generally is nondeductible), temporary regulations provide rules that essentially adopt a tracing

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[68] *See* Catherine Hubbard, *Home Equity Loans Draws Renewed Concern,* 52 Tax Notes 872 (Aug. 19, 1991).

[69] Martin J. McMahon, Jr., *Castaway: Marooned in the Isles of Complexity Awaiting the Good Ship Simplicity or Simplifying the Interest Deduction for Individual Taxpayers*, (unpublished paper dated February 9, 2001) (hereinafter ").

[70] For example, assume both A and B buy a $100,000 residence and a $15,000 automobile. A pays cash for the car, and finances the home purchase with $95,000 of debt and $5,000 in cash. B finances the car purchase through a home equity loan, having financed the home purchase with $80,000 of debt and $20,000 in cash. Both A and B have borrowed $95,000, secured by the home. For A and B to have the same treatment of interest on that $95,000 of debt, interest on B's home equity debt would have to be deductible.

approach.[71] Interest expense is generally allocated based on the use of the proceeds of the underlying debt.

The present-law allocation of interest expense under the tracing rules is complex and subject to manipulation. The tracing approach may be manipulable by some taxpayers because it generally does not take account of the fungibility of money. A well-advised taxpayer may be able to minimize the impact of the limitations on investment and personal interest by using debt proceeds to acquire investments and equity proceeds to finance personal expenditures. For example, a taxpayer who owns stock (with basis approximately equal to value), and wants to borrow money for a vacation, would sell the stock, borrow money, use the sale proceeds for the vacation, and use the proceeds from the borrowing to repurchase the stock, treating what would have been nondeductible personal interest as deductible investment interest.

The impact of these complex interest tracing rules could be lessened by reducing the number of categories to which interest must be allocated. The allowance for personal interest of individuals, currently structured as a $100,000 home equity debt rule, could be restructured or the home equity debt rule could be eliminated. One proposal considered by the Joint Committee staff would allow individuals could be allowed to deduct personal interest plus investment interest, up to the amount of the individual's net investment income for the year. Eliminating the category of home equity debt, and permitting both personal and investment interest to be deductible up to the amount of the individual's net investment income, would minimize the complexity of present law. Under such a proposal, individuals would still be able to deduct some personal interest, but there would be no requirement that the interest be traced to debt secured by his or her home, or that the debt not exceed the value of the home (reduced by any acquisition debt on the home).[72] Thus, the complexity necessitated by the tracing rules would be eliminated for many individual taxpayers if the home equity debt category were eliminated.

However, taking this approach would necessitate a distinction between investment interest, for which a carryforward would be allowed as under present law, and personal interest, for which no carryforward would be allowed. This distinction would be required in cases in

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[71] Temp. Reg. sec. 1.163-8T (1987). Section 221, involving interest on education loans, has its own limited "tracing like" rules. *See* Prop. Regs. secs. 1.221-(f)(3) and (4) (1999).

[72] The deductible interest allowed under this rule would combine personal and investment interest of individuals. Interest that is deductible (or limited) under another provision of the tax law, such as trade or business income, or interest taken into account in computing the taxpayer's income or loss from passive activities for the year, would not be affected by this proposal. Also unaffected by the proposal would be other categories of interest expense that are deductible under present law by individuals, such as certain student loan interest or interest governed by other special rules. Thus, as a matter of simplification, the proposal would not fully unify the tax treatment of interest expense for individuals, but rather would merely combine two of the present-law categories. The proposal also would not change any of the rules (generally found in regulations) for assigning interest to different categories. To the extent that the regulations take a "tracing" approach, for example, which can be criticized as arbitrary on the grounds that money is fungible, the proposal would not suggest an alternative.

which the individual had combined personal and investment interest amounts that exceeded net investment income for the year. For example, assume an individual had $10,000 of net investment income, $7,000 of investment interest and $5,000 of personal interest. Under the proposal, the individual would deduct $7,000 of investment interest and $3,000 of personal interest. There would be no carryforward. If, however, the individual had $10,000 of net investment income, $12,000 of investment interest and $5,000 of personal interest, the individual would deduct $10,000 of investment interest and carryforward $2,000 of investment interest to the next year. As this example illustrates, complexity would not necessarily be reduced in the carryforward situation.

It could also be argued that many individual taxpayers who are allowed some form of interest deduction under present law have very simple financial arrangements and do not encounter the tracing rules. Thus, it is argued, the complexity of the tracing rules affects relatively few taxpayers under present law.

Further, the approach of combining personal and investment interest might be criticized on policy grounds as substituting one skewed rule for another without any improvement in administrability. Specifically, the approach could be said to have the effect of switching the limited allowance for personal interest away from homeowners with appreciated homes or relatively low mortgage balances and to individuals with capital to invest in income-yielding investments. The practical result of this change could be to limit or disallow any deduction for personal interest to many more taxpayers than under present law, if fewer individuals have net investment income than have positive equity in their homes. Because of these issues, and because the approach of combining the personal and investment limitations may create more complexity than it eliminates, the Joint Committee staff has not included any recommendation with respect to the tracing rules for individual interest deductions.

Complexity relating to home mortgage points

The difference in treatment of points (prepaid interest) on the initial purchase or improvement of the taxpayer's home, and points on the refinancing of the home, is confusing and complex. In general, points are capitalized and amortized over the period of the loan. This rule generally applies to points on a refinancing of the taxpayer's residence. An exception to this general rule, however, permits a current deduction for points on debt incurred for the initial purchase or improvement of the taxpayer's principal residence. This exception does not apply to the taxpayer's second residence. The deduction is allowable only to the extent the points would be deductible as qualified residence interest (if they were not prepaid).

It is argued that allowing a current deduction for all points on initial purchase, improvement, or refinancing of a principal residence or a second residence would be a significant simplification.[73]

Several concerns might be expressed with respect to the idea of a current deduction for all such points. One concern relates to whether the simplification benefit of this approach is

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[73] *See* Martin J. McMahon, Jr., *Castaway*, *supra*.

significant enough to outweigh the change in policy. In general, interest is deductible for income tax purposes only over the period of the debt. While an exception has been made for certain points under present law, extension of this exception to all points involves policy issues that would need to be resolved.

Another concern relates to potential new complexity that could be added by an approach of making all points currently deductible if they otherwise constituted interest on qualified residence debt. Application of the limits on deductibility of home mortgage interest to more types of points would likely result in more situations in which points would receive biforcated treatment. This could add, not reduce, complexity. For example, assume that on a home refinancing a taxpayer borrows a total amount exceeding the limits for deductible interest; e.g., the homeowner increases the principal amount of the loan by $150,000 over the original purchase price, without making any home improvements. Under present law, all of the points would have to be amortized over the period of the refinanced debt. Under the above approach, the points attributable to the original purchase price plus $100,000 would be deductible, but the points attributable to the remaining $50,000 of debt would be amortized over the period of the debt. As a result, the above approach would cause more, not less, complexity for taxpayers. Due to these types of concerns, no recommendation with respect to home mortgage points is included.

B. Filing Status, Personal Exemptions, and Credits

1. Uniform definition of qualifying child

Present Law

In general

Present law contains five commonly used provisions that provide benefits to taxpayers with children: (1) the dependency exemption; (2) the child credit; (3) the earned income credit; (4) the dependent care credit; and (5) head of household filing status. Each provision has separate criteria for determining whether the taxpayer qualifies for the applicable tax benefit with respect to a particular child. The separate criteria include factors such as the relationship (if any) the child must bear to the taxpayer, the age of the child, and whether the child must live with the taxpayer. Thus, a taxpayer is required to apply different definitions to the same individual when determining eligibility for these provisions, and an individual who qualifies a taxpayer for one provision does not automatically qualify the taxpayer for another provision. The requirements for each of these five provisions are described in detail immediately following, and are summarized in Table 10., following the Joint Committee staff's recommendation for simplification, below.

Dependency exemption[74]

In general

Taxpayers are entitled to a personal exemption deduction for the taxpayer, his or her spouse, and each dependent. For 2001, the amount deductible for each personal exemption is $2,900. The deduction for personal exemptions is phased out for taxpayers with incomes above certain thresholds.[75]

The dependency exemption does not have a separate set of rules that apply to children. Thus, the general dependency test applies in determining whether a taxpayer may claim a dependency exemption for any child.

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[74] Secs. 151 and 152. Under the statutory structure, section 151 provides for the deduction for personal exemptions with respect to "dependents." The term "dependent" is defined in section 152. Most of the requirements regarding dependents are contained in section 152; section 151 contains additional requirements that must be satisfied in order to obtain a dependency exemption with respect to a dependent (as so defined). In particular, section 151 contains the gross income test, the rules relating to married dependents filing a joint return, and the requirement for taxpayer identification number. The other rules discussed here are contained in section 151.

[75] Sec. 151(d)(3).

In general, a taxpayer is entitled to a dependency exemption for an individual if the individual: (1) satisfies a relationship test or is a member of the taxpayer's household for the entire taxable year; (2) satisfies a support test; (3) is a child of the taxpayer under a certain age or satisfies a gross income test; (4) is a citizen or resident of the U.S. or resident of Canada or Mexico;[76] and (5) did not file a joint return with his or her spouse for the year.[77] In addition, the taxpayer identification number of the individual must be included on the taxpayer's return.

Relationship or member of household test

Relationship test.--The relationship test is satisfied if an individual is the taxpayer's (1) son or daughter or a descendent of either (e.g., grandchild or great-grandchild); (2) stepson or stepdaughter; (3) brother or sister (including half brother, half sister, stepbrother, or stepsister); (4) parent, grandparent, or other direct ancestor (but not foster parent); (5) stepfather or stepmother; (6) brother or sister of the taxpayer's father or mother; (7) son or daughter of the taxpayer's brother or sister; or (8) the taxpayer's father-in-law, mother-in-law, son-in-law, daughter-in-law, brother-in-law, or sister-in-law.

An adopted child (or a child who is a member of the taxpayer's household and who has been placed with the taxpayer for adoption) is treated as a child of the taxpayer. A foster child is treated as a child of the taxpayer if the foster child is a member of the taxpayer's household for the entire taxable year.

Member of household test.--If the relationship test is not satisfied, then the individual may be considered the dependent of the taxpayer if the individual is a member of the taxpayer's household for the entire year. Thus, a taxpayer may be eligible to claim a dependency exemption with respect to an unrelated child who lives with the taxpayer for the entire year.

For the member of household test to be satisfied, the taxpayer must both maintain the household and occupy the household with the individual.[78] A taxpayer or other individual does not fail to be considered a member of a household because of "temporary" absences due to special circumstances, including absences due to illness, education, business, vacation, and military service.[79] Similarly, an individual does not fail to be considered a member of the taxpayer's household due to a custody agreement under which the individual is absent for less

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[76] A legally adopted child who does not satisfy the residency or citizenship requirement may nevertheless qualify as a dependent (provided other applicable requirements are met) if (1) the child's principal place of abode is the taxpayer's home and (2) the taxpayer is a citizen or national of the United States. Sec. 152(b)(3).

[77] This restriction does not apply if the return was filed solely to obtain a refund and no tax liability would exist for either spouse if they filed separate returns. Rev. Rul. 54-567, 1954-2 C.B. 108.

[78] Treas. Reg. sec. 1.152-1(b).

[79] *Id.*

than six months.[80] Indefinite absences that last for more than the taxable year may be considered "temporary." For example, the IRS has ruled that an elderly woman who was indefinitely confined to a nursing home was temporarily absent from a taxpayer's household. Under the facts of the ruling, the woman had been an occupant of the household before being confined to a nursing home, the confinement had extended for several years, and it was possible that the woman would die before becoming well enough to return to the taxpayer's household. There was no intent on the part of the taxpayer or the woman to change her principal place of abode.[81]

Support test

In general.--The support test is satisfied if the taxpayer provides over one half of the support of the individual for the taxable year. To determine whether a taxpayer has provided more than half of an individual's support, the amount the taxpayer contributed to the individual's support is compared with the entire amount of support the individual received from all sources, including the individual's own funds.[82] Governmental payments and subsidies (e.g., Temporary Assistance to Needy Families, food stamps, and housing) generally are treated as support provided by a third party. Expenses that are not directly related to any one member of a household, such as the cost of food for the household, must be divided among the members of the household. If any person furnishes support in kind (e.g., in the form of housing), then the fair market value of that support must be determined.

Multiple support agreements.--In some cases, no one taxpayer provides more than half of the support of a individual. Instead, two or more taxpayers, each of whom would be able to claim a dependency exemption but for the support test, together provide more than half of the individual's support. If this occurs, the taxpayers may agree to designate that one of the taxpayers who individually provides more than 10 percent of the individual's support can claim a dependency exemption for the child. Each of the others must sign a written statement agreeing not to claim the exemption for that year. The statements must be filed with the income tax return of the taxpayer who claims the exemption.

Special rules for divorced or legally separated parents.--Special rules apply in the case of a child of divorced or legally separated parents (or parents who live apart at all times during the last six months of the year).[83] If such a child is in the custody of one or both of the parents for more than one half of the year, then the parent having custody for the greater portion of the year

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[80] *Id.*

[81] Rev. Rul. 66-28, 1966-1 C.B. 31.

[82] In the case of a son, daughter, stepson, or stepdaughter of the taxpayer who is a full-time student, scholarships are not taken into account for purpose of the support test. Sec. 152(d).

[83] For purposes of this rule, a "child" means a son, daughter, stepson, or stepdaughter (including an adopted child or foster child, or child placed with the taxpayer for adoption). Sec. 152(e)(1)(A).

is deemed to satisfy the support test; however, the custodial parent may release the dependency exemption to the noncustodial parent by filing a written declaration with the IRS.[84]

Gross income test

In general, an individual may not be claimed as a dependent of a taxpayer if the individual has gross income that is at least equal to the personal exemption amount for the taxable year.[85] If the individual is the child of the taxpayer and under age 19 (or under age 24, if a full-time student), the gross income test does not apply.[86] For purposes of this rule, a "child" means a son, daughter, stepson, or stepdaughter (including an adopted child of the taxpayer, a foster child who resides with the taxpayer for the entire year, or a child placed with the taxpayer for adoption by an authorized adoption agency).

Earned income credit[87]

In general

In general, the earned income credit is a refundable credit for low-income workers. The amount of the credit depends on the earned income of the taxpayer and whether the taxpayer has one, more than one, or no "qualifying children." In order to be a qualifying child for the earned income credit, an individual must satisfy a relationship test, a residency test, and an age test. In addition, the name, age, and taxpayer identification number of the qualifying child must be included on the return.

Relationship test

An individual satisfies the relationship test under the earned income credit if the individual is the taxpayer's: (1) son or daughter or a descendant of either;[88] (2) stepson or stepdaughter; or (3) eligible foster child. An eligible foster child is an individual (1) who is a brother, sister, stepbrother or stepsister of the taxpayer (or a descendant of any such relative) or who is placed with the taxpayer by an authorized placement agency, and (2) who the taxpayer cares for as her or his own child. A married child of the taxpayer is not treated as meeting the relationship test unless the taxpayer is entitled to a dependency exemption with respect to the

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[84] Special support rules also apply in the case of certain pre-1985 agreements between divorced or legally separated parents. Sec. 152(e)(4).

[85] Certain income from sheltered workshops is not taken into account in determining the gross income of permanently and totally disabled individuals. Sec. 151(c)(5).

[86] Sec. 151(c).

[87] Sec. 32.

[88] A child who is legally adopted or placed with the taxpayer for adoption by an authorized adoption agency is treated as the taxpayer's own child. Sec. 32(c)(3)(B)(iv).

married child (e.g., the support test is satisfied) or would be entitled to the exemption if the taxpayer had not waived the exemption to the noncustodial parent).[89]

Residency test

Except for a foster child, the residency test is satisfied if the individual has the same principal place of abode as the taxpayer for more than one half of the taxable year. In the case of a foster child, the individual must have the same principal place of abode as the taxpayer for the entire taxable year. The residence must be in the United States.[90] As under the dependency exemption (and head of household filing status), temporary absences due to special circumstances, including absences due to illness, education, business, vacation, and military service are not treated as absences for purposes of determining whether the residency test is satisfied.[91] Under the earned income credit, there is no requirement that the taxpayer maintain the household in which the taxpayer and the qualifying individual reside.

Age test

In general, the age test is satisfied if the individual has not attained age 19 as of the close of the calendar year. In the case of a full-time student, the age test is satisfied if the individual has not attained age 24 as of the close of the calendar year. In the case of an individual who is permanently and totally disabled, no age limit applies.

Child credit[92]

Taxpayers with incomes below certain amounts are eligible for a child credit of up to $500 for each "qualifying child" of the taxpayer. For purposes of this credit, a qualifying child is an individual: (1) with respect to whom the taxpayer is entitled to a dependency exemption for the year; (2) who satisfies the same relationship test applicable to the earned income credit; and (3) who has not attained age 17 as of the close of the calendar year. In addition, the child must be a citizen or resident of the United States.[93]

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[89] Sec. 32(c)(3)(B)(ii).

[90] The principal place of abode of a member of the Armed Services is treated as in the United States during any period during which the individual is stationed outside the United States on active duty. Sec. 32(c)(4).

[91] IRS Publication 596, *Earned Income Credit (EIC)*, at 14. H. Rep. 101-964 (October 27, 1990), at 1037.

[92] Sec. 24.

[93] The child credit does not apply with respect to a child who is a resident of Canada or Mexico and is not a U.S. citizen, even if a dependency exemption is available with respect to the child. Sec. 24(c)(2). The child credit, is however, available with respect to a child dependent who is not a resident or citizen of the United States if: (1) the child has been legally adopted by

Dependent care credit[94]

The dependent care credit may be claimed by a taxpayer who maintains a household that includes one or more qualifying individuals and who has employment-related expenses. A qualifying individual means (1) a dependent of the taxpayer under age 13 for whom the taxpayer is entitled to a dependency exemption, (2) a dependent of the taxpayer who is physically or mentally incapable of caring for himself or herself,[95] or (3) the spouse of the taxpayer, if the spouse is physically or mentally incapable of caring for himself or herself. In addition, a taxpayer identification number for the qualifying individual must be included on the return.

A taxpayer is considered to maintain a household for a period if over one half the cost of maintaining the household for the period is furnished by the taxpayer (or, if married, the taxpayer and his or her spouse). Costs of maintaining the household include expenses such as rent, mortgage interest (but not principal), real estate taxes, insurance on the home, repairs (but not home improvements), utilities, and food eaten in the home.

A special rule applies in the case of a child who is under age 13 or is physically or mentally incapable of caring for himself or herself if the custodial parent has waived his or her dependency exemption to the noncustodial parent.[96] For the dependent care credit, the child is treated as a qualifying individual with respect to the custodial parent, not the parent entitled to claim the dependency exemption.

Head of household filing status[97]

A taxpayer may claim head of household filing status if the taxpayer is unmarried (and not a surviving spouse) and pays more than one half of the cost of maintaining a home which is the principal place of abode for more than one half of the year of (1) an unmarried son, daughter, stepson or stepdaughter of the taxpayer or an unmarried descendant of the taxpayer's son or daughter, (2) an individual described in (1) who is married, if the taxpayer may claim a dependency exemption with respect to the individual (or could claim the exemption if the taxpayer had not waived the exemption to the noncustodial parent), or (3) a relative with respect

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the taxpayer; (2) the child's principal place of abode is the taxpayer's home; and (3) the taxpayer is a U.S. citizen or national. *See* sec. 24(c)(2) and sec. 152(b)(3).

[94] Sec. 21.

[95] Although such an individual must be a dependent of the taxpayer as defined in section 152, it is not required that the taxpayer be entitled to a dependency exemption with respect to the individual under section 151. Thus, such an individual may be a qualifying individual for purposes of the dependent care credit, even though the taxpayer is not entitled to a dependency exemption because the individual does not meet the gross income test.

[96] Sec. 21(e)(5).

[97] Sec. 2(b).

to whom the taxpayer may claim a dependency exemption.[98] If certain other requirements are satisfied, head of household filing status also may be claimed if the taxpayer is entitled to a dependency exemption with respect to one of the taxpayer's parents.

Sources of Complexity

The use of different tests to determine whether a taxpayer may claim the dependency exemption, the earned income credit, the child credit, the dependent care credit, and head of household status with respect to a child causes complexity for taxpayers and the IRS. In order to determine whether a child qualifies a taxpayer for each of the provisions, the taxpayer must apply up to five different tests (in addition to applying the other rules applicable to the particular provision). In IRS Publication 17, *Your Federal Income Tax (for Individuals)*, the explanations of whether a child qualifies under each of these provisions total approximately 17 pages, comprised of the following:

- Dependency exemption: nine pages, including one flowchart for use in determining whether someone is a dependent, and a worksheet for use in applying the support test;[99]
- Earned income credit: three pages, including a chart illustrating the definition of qualifying child;[100]
- Child credit: part of one page;[101]
- Dependent care credit: three pages, including a flow chart for use in determining eligibility for the credit, and a flow chart for determining whether a child of divorced or separated parents qualifies the taxpayer for the credit;[102]
- Head of household filing status: one page, including a chart illustrating the requirements for head of household filing status.[103]

In addition, there is a separate IRS publication for the earned income credit (Publication 596), which includes a seven-page description of the rules relating to qualifying children.

The rules relating to qualifying children are a source of errors for taxpayers both because the rules for each provision are different and because of the complexity of particular rules. The variety of rules cause taxpayers inadvertently to claim tax benefits for which they do not qualify

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[98] Sec. 2(b)(1)(A)(ii), as qualified by sec. 2(b)(3)(B). An individual for whom the taxpayer is entitled to claim a dependency exemption by reason of a multiple support agreement does not qualify the taxpayer for head of household filing status.

[99] IRS Publication 17, *Your Federal Income Tax (for Individuals)*, 24-32.

[100] *Id.* at 240-242.

[101] *Id.* at 229.

[102] *Id.* at 211-214.

[103] *Id.* at 21-22.

as well as to fail to claim tax benefits for which they do qualify. For example, a taxpayer who is entitled to a dependency exemption with respect to a child whom the taxpayer supports but with whom the taxpayer does not live may erroneously believe that the taxpayer also is eligible for the earned income credit with respect to the child. As another example, consider a custodial parent who has waived the dependency exemption under the rules relating to divorced and separated parents. The taxpayer may erroneously believe that ineligibility for the dependency exemption and the child tax credit as a result of the waiver extends to the earned income credit and head of household filing status.

The rules relating to qualifying children may contribute substantially to errors in applying various Code provisions. For example, the IRS has reported that the single largest amount of overclaims of the earned income credit--about 22 percent--was due to claiming the credit with respect to children who did not meet the eligibility requirement for a qualifying child. The IRS attributes most of these errors to taxpayers claiming children who did not meet the residency requirements.[104] Although there may be varying reasons for such failures, one source may be the erroneous belief that the person entitled to the dependency exemption is also entitled to the earned income credit (i.e., a failure to recognize the separate residency requirement for earned income credit as compared to the support test for the dependency exemption).

Certain of the rules for each tax benefit are themselves complex. In particular, the support test for the dependency exemption (and the child credit) and separate maintenance of household tests for the dependent care credit and head of household filing status can require significant information gathering and calculations by the taxpayer. In some cases, it may be extremely difficult for the taxpayer to correctly apply these tests, because the taxpayer may require information not readily available (or even inaccessible), such as support provided by third parties and government subsidies. Moreover, the support tests and maintenance of household tests are similar, but not identical. The former test seeks to determine the amount of support for a particular individual, whereas the latter looks to a household. The kinds of expenses taken into account under each test are different; a taxpayer may inadvertently believe that satisfying one test satisfies the other.

The different rules regarding qualifying children have been identified as a source of complexity for taxpayers for over a decade. For example, in 1989, the American Bar Association recommended that the dependency exemption be replaced with a residency requirement and that the rules regarding qualifying children for the earned income credit and head of household filing status be conformed. The American Bar Association and the American Institute of Certified Public Accountants continue to advocate a similar proposal. The Commissioner of Internal Revenue identified filing status definitions, including those relating to dependents, as major sources of complexity.[105] Because these provisions affect so many taxpayers, the Commissioner's report concludes that "any complexity in the Code around filing

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[104] Department of the Treasury, Internal Revenue Service, *Compliance Estimates for Earned Income Tax Credit Claimed on 1997 Returns* (September 2000), at 10.

[105] Department of the Treasury, Internal Revenue Service, *Annual Report from the Commissioner of the Internal Revenue Service on Tax Law Complexity* (June 5, 2000), at 13.

definitions can result in prodigious overall burden."[106] The National Taxpayer Advocate has proposed applying a residency test to the definition of child dependent as well as the earned income credit in legislative recommendations for fiscal years 1997, 1998, 1999, and 2000.

Recommendation for Simplification

The Joint Committee staff recommends that a uniform definition of qualifying child should be adopted for purposes of determining eligibility for the dependency exemption, the earned income credit, the child credit, the dependent care credit, and head of household filing status. Under this uniform definition, in general, a child would be a qualifying child of a taxpayer if the child has the same principal place of abode as the taxpayer for more than one half the taxable year. A "child" would be defined as an individual with a specified relationship to the taxpayer and who is less than a specified age. A tie-breaking rule would apply if more than one taxpayer claims a child as a qualifying child. Under the tie-breaking rule, the child generally would be treated as a qualifying child of the child's parent.

Detailed discussion of proposal

In general

The proposal would replace the separate rules for defining an eligible child under the dependency exemption, the child credit, the earned income credit, the dependent care credit, and head of household filing status with a single rule defining qualifying child. The proposal would be the sole method for determining whether a child is a qualifying child for purposes of these provisions. This proposal would not modify other parameters of each tax benefit (e.g., the earned income requirements of the earned income credit) or the rules for determining whether individuals other than children qualify for each tax benefit.

Adopting a uniform definition of qualifying child would achieve simplification by making it easier for taxpayers to determine whether they qualify for the various tax benefits relating to children. Adopting a uniform definition would reduce inadvertent taxpayer errors arising from confusion due to differing definitions of qualifying child. A uniform definition also would make the applicable provisions easier for the IRS to administer.

Residency test

In general.--Under the proposal, a child (as defined below) generally would be considered a qualifying child if the child has the same principal place of abode as the taxpayer for more than one half the taxable year. Special rules, described below, would apply in the case of children who are students or disabled.

The Joint Committee staff proposes a residency test as the uniform rule because it is generally easier to apply than a support test. Although in some cases both tests present difficult

[106] *Id.*

issues, any support test involves calculations that will not arise under a residency test and will always be more difficult to apply than a residency test.

Adopting a residency test for all five provisions providing tax benefits with respect to children would simplify the tax laws, but also would change the beneficiary of certain tax benefits. For example, a taxpayer who now qualifies for a dependency exemption with respect to a child who is supported by, but does not live with, the taxpayer would not be entitled to the dependency exemption under the proposal.

The residency requirement under the proposal generally follows the present-law residency requirements under head of household filing status, the earned income credit, and the provisions for determining whether certain individuals qualify as a dependent. As under the present-law rules, temporary absences due to special circumstances, including absences due to illness, education, business, vacation, and military service, would not be treated as absences.

Tie-breaking rules.--If a child would be a qualifying child with respect more than one individual (e.g., a child lives with his or her mother and grandmother in the same household) and more than one person claims a benefit with respect to that child, then the following "tie-breaking" rules would apply. First, if one of the individuals claiming the child as a qualifying child is the child's parent (or parents who file a joint return), the child would be deemed the qualifying child of the parent (or parents). Second, if both parents claim the child and the parents do not file a joint return, then the child would be deemed a qualifying child first with respect to the parent with whom the child resides for the longest period of time and second with respect to the parent with the highest adjusted gross income. Finally, if the child's parents do not claim the child, then the child would be deemed a qualifying child with respect to the individual with the highest adjusted gross income.

For example, suppose H and W are married and live together from January through August (8 months) with their child, C. H moves out of the household at the beginning of September, and C lives with W for the rest of the year. H and W do not file a joint return. C has lived with both H and W for more than six months of the year. Both H and W claim the applicable tax benefits with respect to C. Under the tie-breaking rule, C is treated as a qualifying child with respect to W because C lived with W for a greater portion of the year (12 months, compared with 8 months living with H).

Special rules for students and disabled children.--The proper application of the residency test to children who are students or disabled may be unclear under present law. For example, consider the case of a child who lived with his parents until graduating from high school at age 17 and then moved away to attend a four-year college. Under the rules relating to "temporary" absences under present law (and which would be adopted under the proposal), the child could be considered to be residing with his parents while he is away at school. Although there is little published guidance, existing authority indicates that whether an absence is "temporary" hinges on whether the child is intending to establish a new residence independent from his parents.[107]

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[107] *See, e.g.,* Treas. Reg. sec. 1.152-1(b); Rev. Rul. 66-28, 1966-1 C.B. 31.

Similar issues arise with respect to disabled children who do not live at home. In such cases, the child may never be expected to return to the family home because the child requires institutionalized care. As discussed above, although the issue is unclear, there is some precedent that such an absence is "temporary" for purposes of the residency requirement even though it is likely that the individual will never return to his or her former home because of medical reasons.

Adopting a residency test for all five major tax benefits relating to children would place additional pressure on the definition of a "temporary" absence, potentially increasing complexity in some cases. Determining whether an absence is "temporary" can be difficult for taxpayers because there is little published guidance and the issue is inherently a factual determination that may hinge on intent, which is difficult to demonstrate.

The Joint Committee staff believes that an objective alternative to the residency test in common situations in which a child may be absent from the home for indefinite and lengthy periods will provide more certainty to taxpayers than the present-law rules. Thus, the Joint Committee staff recommends that, if a child who is a student or is disabled does not meet the residency test, the child may nevertheless be a qualifying child of a taxpayer who provides support for the child in an amount at least equal to the exemption amount (i.e., $2,900 for 2001). If a child who is a student or is disabled would be a qualifying child with respect to more than one taxpayer and more than one such taxpayer claims the child as a qualifying child, then the child would be considered a qualifying child of the taxpayer who provided the greatest amount of support for the child. As under present law, the child could not claim a personal exemption for himself or herself if another person is entitled to the exemption.[108]

For purposes of this rule, an individual would be considered a student if the individual is a full-time student during each of five calendar months during the year. This is the present-law definition under the dependency exemption and the earned income credit.[109] Other definitions also could be used without undermining the goal of simplification.

An individual would be considered disabled if he or she is physically or mentally incapable of caring for himself or herself. This is the present-law definition under the dependent care credit.[110] Other definitions also could be used without undermining the goal of simplification.

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[108] 151(d)(2).

[109] Secs. 151(c)(4) and 32(c)(3)(c)(ii).

[110] Sec. 21(b)(1).

Definition of child

Relationship requirement.--In order to be a "child" as defined under the proposal, the individual must be the son, daughter, stepson, stepdaughter, brother, sister, stepbrother, stepsister, or a descendant of any such individuals. An adopted child (or a child placed with the taxpayer for adoption by an authorized placement agency) would be treated as a child of the taxpayer by blood. A foster child who is placed by an authorized placement agency would be treated as the taxpayer's child, except that descendants of foster children would not automatically be considered children of the taxpayer (i.e., they would independently have to satisfy the relationship test). These familial relationships are similar to those used under the present-law earned income credit and child credit.

The Joint Committee staff believes that more simplification would be achieved by using a broader definition of a child, namely, providing that a child includes any relative of the taxpayer who is within the applicable age limit (described below). The need to determine whether a child bears a particular relationship to a taxpayer adds one additional rule that taxpayers must apply. In addition, such a rule may cause confusion for some taxpayers because it draws an arbitrary line based on certain familial relationships that taxpayers themselves may not draw. For example, a taxpayer may care for a minor nephew and cousin as his or her own children in his or her home. The nephew may be a qualifying child, but the cousin could not be, because "cousin" is not included in the specified relationships.

The Joint Committee staff decided not to recommend a broader definition of qualifying child due to concerns that a broader definition would involve a policy change with respect to some provisions. In particular, a broader definition could significantly expand the class of persons for which the earned income credit and the child credit could be claimed, which involves policy implications beyond the scope of this simplification study.

Age requirement.--Under the proposal, a "child" must be under age 19 (or under age 24 in the case of a student (as defined above)). No age limit would apply with respect to disabled children (as defined above). Under present law, two of the affected provisions have significantly lower age limits; the dependent care credit, which has an age limit of 13 (except in the case of persons who are incapable of caring for themselves), and the child credit, which has an age limit of 17. Although the Joint Committee staff believes that, to achieve the greatest amount of simplification, a uniform age should be adopted for purposes of defining a qualifying child, the Joint Committee staff also believes that the dependent care credit has a different policy objective than the other provisions for which the definition of qualifying child is relevant and that this different objective warrants a different rule. The dependent care credit provides a subsidy for individuals who incur employment-related expenses for the care of a child or certain other individuals, which expenses generally cease to be unnecessary many years before the child realizes the age of majority. In contrast, the other provisions relating to children generally have the objective of reducing tax liability for taxpayers with children, including teenage children. Because determining the age of a child is not generally difficult, the Joint Committee staff believes a limited exception to the generally applicable age limit for the dependent care credit would not undermine the objectives of simplification. Thus, The Joint Committee staff recommends that, for purposes of the dependent care tax credit, an individual would not be a child unless the individual is under age 13.

The Joint Committee staff does not recommend a lower age for the child credit because there does not appear to be a separate policy underlying the present-law credit than that underlying the dependency exemption. The legislative history of the child credit indicates that it is intended to provide tax relief for families with children, which is similar to the policy of the dependency exemption.[111] In the absence of an overriding policy concern, the Joint Committee staff believes that the objectives of simplification should govern.

Other requirements

A child would not be considered a qualifying child unless a taxpayer identification number for the child is provided on the return. Present-law rules regarding citizenship or country of residence would continue to apply to each provision as under present law.

Effect of proposal on particular provisions

Dependency exemption

The proposal would eliminate the support test with respect to children of the taxpayer (as defined under the proposal) and replace it with the residency requirement described above. A modified support test would apply to children who are students or disabled. The rules relating to multiple support agreements would not apply with respect to children because the support test would not apply. The gross income test would not apply to children as defined under the proposal.

The age limitations under the proposal are the same as those used under the present-law dependency exemption to define a child.

As mentioned above, by replacing the support test with a residency test, the proposal may shift the benefit of the dependency exemption in some cases from one person to a different person.

Under present law, the custodial parent may waive the right to claim the dependency exemption to the noncustodial spouse in certain circumstances. The Joint Committee staff believes that this rule primarily is designed to avoid difficult determinations under the present-law support test. Thus, waivers are not necessary under the proposed residency test.

Some view the present-law waiver rules as a bargaining chip in divorce and separation negotiations. If waiver rules are considered desirable in the case of divorce or separation, the Joint Committee staff believes appropriate rules could be developed without unduly undermining the simplification achieved by the proposal.

The proposal would retain the present-law dependency rules with respect to individuals other than children (as defined under the proposal).

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[111] As discussed in Section II.A. of this Part, above, further simplification could be achieved by combining the dependency exemption and child credit, but this involves policy considerations beyond the scope of this study.

Earned income credit

In general, the proposal adopts a definition of qualifying child that is similar to the present-law rule under the earned income credit. Thus, the proposal would result in similar effects under the earned income credit as under present law, except in certain limited situations.

The relationships used to define a child under the proposal are the same as those under the earned income credit, except that the earned income credit does not include descendants of a stepson or stepdaughter (unless such a descendent was placed with the taxpayer by an authorized foster care agency). The earned income credit applies a one-year residency test to foster children, while the proposal would apply a six-month test to all children. Thus, the proposal would extend the earned income credit to some taxpayers who would not be able to claim the credit under present law. The Joint Committee staff decided to recommend a six-month rule for all cases because a single rule is easier to apply than two separate rules.

The age limitation under the present-law earned income credit is the same as that under the proposal.

The proposal would replace the present-law adjusted gross income tie-breaking rule under the earned income credit and replace it with the tie-breaking rules of the proposal. Thus, for example, a parent of a child who is ineligible for the earned income credit solely because an individual with higher adjusted gross income could claim the credit would be eligible for the credit under the proposal.

Child credit

The child credit uses the same relationships to define an eligible child as the earned income credit. Thus, the discussion above relating to the definition of child under the earned income credit applies to the child credit.

As discussed above, the age limitation under the proposal is higher than the age limitation of the child credit under present law. Thus, the proposal would result in an expansion of the child credit.

Under present law, the child credit generally is available with respect to a child for whom the taxpayer can claim a dependency exemption. Because the proposal would, in some cases, shift the dependency exemption from one taxpayer to another, the proposal would also shift the child credit from one taxpayer to another.

Dependent care credit

The requirement that a taxpayer maintain a household in order to claim the dependent care tax credit would be eliminated with respect to children (as defined under the proposal) and replaced with the residency test. Thus, if other applicable requirements are satisfied, a taxpayer would be able to claim the credit with respect to a child who lives with the taxpayer for more than one half the year, even if the taxpayer does not provide over one half the cost of maintaining the household.

Because the present-law maintenance of household test and the proposal both rely on residency, the proposal is likely to result in similar effects as the present-law dependent care credit. The proposal may result in some additional taxpayers being eligible for the credit because they meet the residency requirement of the proposal, but not the maintenance of household test.

The rules for determining eligibility for the credit with respect to individuals other than children would remain as under present law.

Head of household filing status

Under the proposal, a taxpayer would qualify for head of household filing status with respect to a child only if the child is a qualifying child as defined under the proposal. The proposal would retain the requirement that the taxpayer maintain the household in which the qualifying child resides (i.e., the taxpayer must provide more than one half the cost of maintaining the household). While retaining this requirement adds some complexity, the Joint Committee staff believes that this requirement is integral to head of household filing status and that eliminating the requirement would result in an expansion of the number of people who would claim head of household status that is not commensurate with the simplification that would be achieved. The rules for determining whether a person other than a child (such as, a dependent parent) qualifies the taxpayer for head of household status would remain as under present law.

Table 5.–Comparison of Provisions Relating to Qualifying Children

	DEPENDENCY EXEMPTION (Secs. 151 and 152)	EARNED INCOME CREDIT (Sec. 32)	CHILD CREDIT (Sec. 24)	DEPENDENT CARE CREDIT (Sec. 21)	HEAD OF HOUSEHOLD FILING STATUS (Sec. 2(b))	JOINT COMMITTEE STAFF PROPOSAL
1. Tax benefit	Deduction of $2,900 for each dependent (for 2001); exemptions phaseout for higher-income taxpayers	For 2001, maximum credit is $2,424, for one child and $4,008 for more than one child[1]	Credit of $500 per child[2]	Credit of 30% of up to $2,400 of work-related expenses if one qualifying dependent, $4,800 if more than one[3]	More favorable rate schedule and higher standard deduction than single taxpayers	Same as present law (A separate recommendation would modify the dependent care credit)
2. Relationship test[4]						
• **Son, daughter, stepson, stepdaughter**	Yes	Yes	Yes	Yes	Yes	Yes
• **Grandchildren**	Yes (subject to gross income test)	Yes	Same as dependency exemption	Same as dependency exemption	Yes	Yes
• **Stepchildren**	Yes	Yes	Yes	Yes	Yes	Yes
• **Stepgrandchildren**	Yes, but only if a member of the taxpayer's household for the entire year and the gross income limit test is met	No	Same as dependency exemption	Same as dependency exemption	No	Yes

Table 5.–Comparison of Provisions Relating to Qualifying Children

	DEPENDENCY EXEMPTION (Secs. 151 and 152)	EARNED INCOME CREDIT (Sec. 32)	CHILD CREDIT (Sec. 24)	DEPENDENT CARE CREDIT (Sec. 21)	HEAD OF HOUSEHOLD FILING STATUS (Sec. 2(b))	JOINT COMMITTEE STAFF PROPOSAL
• **Brothers, sisters**	Yes (subject to gross income test)	Treated as foster child	Treated as foster child and subject to gross income test	Same as dependency exemption	Yes, if qualify as a dependent	Yes
• **Nieces, nephews**	Yes (subject to gross income test)	Treated as foster child	Treated as foster child and subject to gross income test	Same as dependency exemption	Yes, if qualify as a dependent	Yes
• **Adopted children and children placed for adoption**	Yes	Yes	Yes	Yes	Yes	Yes

Table 5.–Comparison of Provisions Relating to Qualifying Children

	DEPENDENCY EXEMPTION (Secs. 151 and 152)	EARNED INCOME CREDIT (Sec. 32)	CHILD CREDIT (Sec. 24)	DEPENDENT CARE CREDIT (Sec. 21)	HEAD OF HOUSEHOLD FILING STATUS (Sec. 2(b))	JOINT COMMITTEE STAFF PROPOSAL
• **Foster children**	Treated as own child if lives with taxpayer for entire year	Yes, if lives with the taxpayer for the year, taxpayer cares for the child as his or her own, and is (a) a brother, sister, stepbrother, stepsister (or descendent) or (b) is placed by an authorized placement agency	Same as earned income credit	Same as dependency exemption	Yes, if qualify as a dependent	Yes, if placed by an authorized placement agency
• **Married children**	No, if child files a joint return (unless return is to claim a refund and no tax would be owed by either spouse filing separately)	Same as dependency exemption	Same as dependency exemption	Same as dependency exemption	Yes, if qualify as a dependent	Same as dependency exemption

Table 5.–Comparison of Provisions Relating to Qualifying Children

	DEPENDENCY EXEMPTION (Secs. 151 and 152)	EARNED INCOME CREDIT (Sec. 32)	CHILD CREDIT (Sec. 24)	DEPENDENT CARE CREDIT (Sec. 21)	HEAD OF HOUSEHOLD FILING STATUS (Sec. 2(b))	JOINT COMMITTEE STAFF PROPOSAL
3. Age limit						
• **Purpose of limit**	Gross income test applies to children over the age limit	Determines eligibility for credit	Determines eligibility for credit	Determines eligibility for credit	NA	Defines child. Can determine eligibility for benefit
• **General limit**	Under 19	Same as dependency exemption	Under 17	Under age 13	No age limit	Under 19
• **Full-time students**	Under 24	Same as dependency exemption	General age limit applies	General age limit applies	No age limit	Under 24
• **Disabled children**	Under 19	No age limit	Same as dependency exemption	No age limit, but must qualify as a dependent	No age limit	No age limit
4. Requirement that child be a dependent	NA	Child does not have to qualify for dependency exemption and often will not	Child must qualify for dependency exemption	Child must qualify for dependency exemption	Child does not have to qualify for dependency exemption, unless the child is married	Same definition of qualifying child will apply for all provisions

Table 5.–Comparison of Provisions Relating to Qualifying Children

	DEPENDENCY EXEMPTION (Secs. 151 and 152)	EARNED INCOME CREDIT (Sec. 32)	CHILD CREDIT (Sec. 24)	DEPENDENT CARE CREDIT (Sec. 21)	HEAD OF HOUSEHOLD FILING STATUS (Sec. 2(b))	JOINT COMMITTEE STAFF PROPOSAL
5. Residency requirements	No requirement (i.e., child does not have to live with the taxpayer)	Child must live with taxpayer for over one half the year (whole year in the case of foster children)	Same as dependency exemption	Child must live with the taxpayer for the period during which the expenses incurred	Child must live with the taxpayer for over one half the year	Child must live with the taxpayer for over one half the year
6. Support test	Taxpayer must provide over one half of the child's support	No support test	Same as dependency exemption	Taxpayer must provide over one half of the support for the household for the period during which the expenses were incurred	Taxpayer must provide over one half the support for the household	None; except that a student or disabled child that does not meet the residency test is a qualifying child of an individual who provides support at least equal to the exemption amount

Table 5.–Comparison of Provisions Relating to Qualifying Children

	DEPENDENCY EXEMPTION (Secs. 151 and 152)	EARNED INCOME CREDIT (Sec. 32)	CHILD CREDIT (Sec. 24)	DEPENDENT CARE CREDIT (Sec. 21)	HEAD OF HOUSEHOLD FILING STATUS (Sec. 2(b))	JOINT COMMITTEE STAFF PROPOSAL
7. Gross income limit	Individual cannot be claimed as a dependent if earns more than the exemption amount; gross income test does not apply to son, daughter, stepson or stepdaughter under applicable age limit	No limit	Same as dependency exemption	Same as dependency exemption	No limit	No limit
8. Citizenship requirements	Child must be a U.S. citizen or resident or a resident of Canada or Mexico (or an adopted child living with parent who is a U.S. citizen)	Abode in which the child lives must be in the US. (special rule for military personnel living outside the US)	Same as dependency, except does not include provision regarding residents of Canada and Mexico	Same as dependency exemption	No special rules	Present-law rules would apply for each provision

Table 5.–Comparison of Provisions Relating to Qualifying Children

	DEPENDENCY EXEMPTION (Secs. 151 and 152)	EARNED INCOME CREDIT (Sec. 32)	CHILD CREDIT (Sec. 24)	DEPENDENT CARE CREDIT (Sec. 21)	HEAD OF HOUSEHOLD FILING STATUS (Sec. 2(b))	JOINT COMMITTEE STAFF PROPOSAL
9. Tie-breaker rules	If no one person provides over one half the support, but more than one person together does, then those persons who provide at least 10% of the support can agree in writing that one of such persons is entitled to the exemption	If two people qualify with respect to the same child, the person with the highest modified AGI is entitled to the credit	Whoever gets the dependency exemption is entitled to the child credit	No special rules	None; if a child qualifies as a dependent pursuant to a multiple support agreement, then the child does not qualify the taxpayer for head of household status	Tie-breaker rules apply only if more than one person otherwise eligible actually claim child as a qualifying child; parent generally is entitled to claim the child
10. TIN requirement	Yes	Yes	Yes	Yes	No specific requirement	Yes

Table 5.–Comparison of Provisions Relating to Qualifying Children

	DEPENDENCY EXEMPTION (Secs. 151 and 152)	EARNED INCOME CREDIT (Sec. 32)	CHILD CREDIT (Sec. 24)	DEPENDENT CARE CREDIT (Sec. 21)	HEAD OF HOUSEHOLD FILING STATUS (Sec. 2(b))	JOINT COMMITTEE STAFF PROPOSAL
11. Rules applicable in the case of divorce or legal separation	Custodial parent generally receives the exemption if the parents together provide over one half the support; custodial parent may waive the right to the exemption to the other parent	No special rule; custodial parent will receive the credit because qualification based on residency	Taxpayer receiving the dependency exemption is entitled to the credit	Child is treated as qualifying individual with respect to custodial parent	No special rule; custodial parent will be entitled to head of household status because qualification is based on residency	No special rules

[1] Credit amount depends on earned income and is phased out for taxpayers with earned income or, if higher, modified adjusted gross income above certain levels. The maximum credit amount is indexed. An earned income credit is available for lower-income individuals with no qualifying children.

[2] Credit is refundable if taxpayer has three or more children. Credit is phased out for taxpayers with income above certain levels.

[3] Credit percentage is reduced to 20 percent for taxpayers with income above certain levels. Present law also provides an exclusion for employer-provided dependent care expenses of up to $5,000 per year (regardless of number of qualifying individuals). The exclusion is not subject to a phase-out.

[4] Persons other than children may qualify the taxpayer for the dependency exemption, the dependent care credit, or head of household filing status if certain requirements are satisfied.

2. Dependent care tax benefits

Present Law

Dependent care tax credit

A taxpayer who maintains a household that includes one or more qualifying individuals may claim a nonrefundable credit against income tax liability for up to 30 percent of a limited amount of employment-related expenses. Eligible employment-related expenses are limited to $2,400 if there is one qualifying individual or $4,800 if there are two or more qualifying individuals. Thus, the maximum credit is $720 if there is one qualifying individual and $1,440 if there are two or more qualifying individuals. The applicable dollar limit ($2,400/$4,800) of otherwise eligible employment-related expenses is reduced by any amount excluded from income under an employer-provided dependent care assistance program. For example, a taxpayer with one qualifying individual who has $2,400 of otherwise eligible employment-related expenses but who excludes $1,000 of dependent care assistance must reduce the dollar limit of eligible employment-related expenses for the dependent care tax credit by the amount of the exclusion to $1,400 ($2,400 - $1,000 = $1,400). A qualifying individual is (1) a dependent of the taxpayer under the age of 13 for whom the taxpayer is eligible to claim a dependency exemption, (2) a dependent of the taxpayer who is physically or mentally incapable of caring for himself or herself, or (3) the spouse of the taxpayer; if the spouse is physically or mentally incapable of caring for himself or herself.

The 30 percent credit rate is reduced, but not below 20 percent, by 1 percentage point for each $2,000 (or fraction thereof) of adjusted gross income above $10,000. The credit is not available to married taxpayers unless they file a joint return.

Exclusion for employer-provided dependent care

Amounts paid or incurred by an employer for dependent care assistance provided to an employee generally are excluded from the employee's gross income and wages if the assistance is furnished under a program meeting certain requirements. These requirements include that the program be described in writing, satisfy certain nondiscrimination rules, and provide for notification to all eligible employees. Dependent care assistance expenses eligible for the exclusion are defined the same as employment-related expenses with respect to a qualifying individual under the dependent care tax credit.

The dependent care exclusion is limited to $5,000 per year, except that a married taxpayer filing a separate return may exclude only $2,500. Dependent care expenses excluded from income are not eligible for the dependent care tax credit (sec. 21(c)).

Sources of Complexity

There are three principal differences between the dependent care tax credit and the exclusion for employer-provided dependent care: (1) the credit has different dollar limits based on the number of qualifying individuals, whereas the maximum amount of the exclusion is the same regardless of the number of qualifying individuals; (2) the credit is reduced for persons with incomes above certain levels, whereas the amount of the exclusion does not vary by

income; and (3) the credit is not available to married taxpayers who file separate returns, whereas one-half the maximum exclusion is available to such taxpayers.

These differences create transactional complexity for taxpayers who are eligible for both provisions because it is harder for taxpayers to determine which provision they should use. These differences may also create unfairness in the tax laws, because whether a taxpayer utilizes the provision that is best for him or her may depend on the taxpayer's level of sophistication and his or her understanding of the tax laws.

Various aspects of the dependent care tax credit also create complexities. In particular, the different dollar limits based on the number of qualifying individuals are more complicated than a flat dollar amount, such as that under the exclusion. In addition, the reduction of the credit based on income creates computational complexity.[112] This reduction also makes it necessary to deny the credit to married taxpayers filing separate returns to prevent such taxpayers from splitting income and claiming a greater credit than they would receive if they filed a joint return.

Recommendation for Simplification

The Joint Committee staff recommends that the dependent care credit should be conformed to the exclusion for employer-provided dependent care assistance by: (1) providing that the maximum amount of expenses eligible for the credit is $5,000 regardless of the number of qualifying individuals; (2) eliminating the reduction of the credit based on adjusted gross income; and (3) providing that married taxpayers filing separate returns are eligible to claim up to one half of the otherwise allowable credit.

The proposal would provide simplification for taxpayers who are eligible for both the dependent care credit and the exclusion for employer-provided dependent care assistance by making the two provisions more economically equivalent. This should also increase fairness of the tax laws.

The proposal also would simplify the dependent care credit by eliminating features of the credit that require additional calculations by taxpayers.

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[112] The Joint Committee staff has recommended repealing various income phase-out provisions of the Code, including the phase-down of the dependent care credit. The Joint Committee staff believes that the progressivity sought to be achieved through such provisions can be achieved in a simpler manner through the rate structure. *See* discussion in Section I.C., below.

3. Modifications to the earned income credit

Present Law

In general

Eligible low-income workers are able to claim a refundable earned income credit. The amount of the credit that may be claimed depends upon whether the taxpayer has one, more than one, or no qualifying children. In addition, to claim the credit, the taxpayer must have earned income.

The term earned income includes wages, salaries, tips, and other employee compensation, as well as net earnings from self employment. Employee compensation includes anything of value received by the taxpayer from the employer in return for services of the employee, including nontaxable earned income. Nontaxable forms of compensation treated as earned income for this purpose include the following: (1) elective deferrals under a cash or deferred arrangement or section 403(b) annuity (sec. 402(g)); (2) employer contributions for nontaxable fringe benefits, including contributions for accident and health insurance, dependent care (sec. 129), adoption (sec. 137), educational assistance (sec. 127), and miscellaneous fringe benefits (sec. 132); (3) salary reduction contributions under a cafeteria plan (sec. 125); (4) meals and lodging provided for the convenience of the employer (sec. 119); and (5) housing allowances or the rental value of a parsonage for the clergy.

The maximum earned income credit is phased in as a taxpayer's earned income increases. The credit is phased out for taxpayers with earned income (or if greater, modified adjusted gross income[113]) over certain levels.

The earned income credit is not available to married individuals filing separate returns. In addition, a taxpayer with disqualified income in excess of certain amounts for the tax year cannot claim the earned income credit.[114]

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[113] "Modified adjusted gross income " means adjusted gross income determined without regard to certain losses and increased by certain amounts not includible in gross income. The losses disregarded are: (1) net capital losses (up to $3,000); (2) net losses from estates and trusts; (3) net losses from nonbusiness rents and royalties; (4) 75 percent of certain net losses from businesses, computed separately with respect to sole proprietorships (other than farming), farming sole proprietorships and other businesses. The amounts added to adjusted gross income to arrive at modified adjusted gross income include: (1) tax-exempt interest; and (2) nontaxable distributions from pensions, annuities, and individual retirement plans (but not nontaxable rollover distributions or trustee-to-trustee transfers). Sec. 32(c)(5).

[114] Disqualified income is the sum of: (1) interest and dividends includible in gross income for the taxable year; (2) tax-exempt interest received or accrued in the taxable year; (3) net income from rents and royalties not derived in the ordinary course of business; (4) capital gain net income; and (5) net passive income.

Qualifying child and adjusted gross income tie-breaker rules

To claim the earned income credit, a taxpayer must either (1) have a qualifying child or (2) meet the requirements for childless adults. A qualifying child must meet a relationship test, an age test, and a residence test. First, the qualifying child must be the taxpayer's child, stepchild, adopted child, grandchild, or foster child. Second, the child must be under age 19 (or under age 24 if a full-time student) or permanently and totally disabled regardless of age. Third, the child must live with the taxpayer in the United States for more than half the year (a full year for foster children).

If a child otherwise qualifies with respect to more than one person, the child is treated as a qualifying child only of the person with the higher modified adjusted gross income. For example, assume mother and child live with the child's grandmother. Mother and grandmother have no income other than from their jobs. Mother's income from a part time job is $9,000. Grandmother's income from her job is $15,000. The son is the qualifying child of both the mother and grandmother. Because the grandmother has the higher modified adjusted gross income, only the grandmother may claim the earned income credit. The mother cannot claim the earned income credit, even if the grandmother does not.

A valid social security number (taxpayer identification number) must be provided for each qualifying child with respect to whom the earned income credit is claimed.

To claim the earned income credit without a qualifying child, the taxpayer must be over age 24 and under age 65. In addition, the taxpayer cannot be the dependent or qualifying child of another taxpayer.

Calculation of the credit

The earned income credit is determined by multiplying a credit rate by the taxpayer's earned income up to an earned income amount. The maximum amount of the credit is the product of the credit rate and the earned income amount. The maximum credit amount applies to taxpayers with (1) earnings at or above the earned income amount and (2) modified adjusted gross income (or earned income, if greater) at or below the phaseout threshold level.

For taxpayers with modified adjusted gross income (or earned income, if greater) in excess of the phase-out threshold, the credit amount is reduced by the phase-out rate multiplied by the amount of modified adjusted gross income (or earned income, if greater) in excess of the phase-out threshold. The credit amount is $0 at the "breakeven" income level, i.e., the point at which a specified percentage of "excess" income above the phase-out threshold offsets exactly the maximum amount of the credit. The earned income amount and the phase-out threshold are indexed for inflation. Table 6., below shows the earned income credit parameters for taxable year 2001.[115]

[115] The table is based on Rev. Proc. 2001-13, 2001-03 I.R.B. 337.

Table 6.--Earned Income Credit Parameters (2001)

	Two or more qualifying children	One qualifying Child	No qualifying children
Credit rate (percent)	40.00%	34.00%	7.65%
Earned income amount	$10,020	$7,140	$4,760
Maximum credit	$4,008	$2,428	$364
Phase-out begins	$13,090	$13,090	$5,950
Phase-out rate (percent)	21.06%	15.98%	7.65%
Phase-out ends	$32,121	$28,281	$10,710

Sources of Complexity

In general

The complexity of the earned income credit has received considerable attention almost since its enactment in 1975. The earned income credit has also received attention because of the relative high error rates associated with the provision. For 1997, approximately 20 million people claimed more than $30 billion of earned income credits. According to the IRS, an estimated $7.8 billion of earned income credit claims for that year (25.6 percent) were erroneously paid.[116] While there may be a variety of reasons for such errors, the Joint Committee staff believes a significant factor is complexity.

Qualifying child and adjusted gross income tie-breaking rule

One of the principal earned income credit errors involves the qualifying child eligibility rules. In its study of 1994 and 1997 returns, the IRS found that the most common error involved taxpayers claiming children who did not meet the eligibility criteria. The IRS attributes most of these errors to taxpayers claiming the earned income credit for children who do not meet the residency requirement.[117] A portion of these errors may be attributed to the different eligibility requirements for claiming a child as a dependent and as a qualifying child for purposes of the earned income credit. That is, taxpayers may erroneously believe that because they are entitled to a dependency exemption with respect to a child they are also eligible for the earned income credit.

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[116] Internal Revenue Service, *Compliance Estimates for Earned Income Tax Credit Claimed on 1997 Returns* (September 2000), at 3 (hereinafter referred to as "IRS 1997 Compliance Study").

[117] *See also,* Treasury Inspector General for Tax Administration, *Management Advisory Report: Administration of the Earned Income Credit* (Ref. No. 2000-40-160, September 2000) and General Accounting Office, *Earned Income Credit: IRS' Tax Year 1994 Compliance Study and Recent Efforts to Reduce Noncompliance* (GAO/GGD-98-150, July 1998).

The adjusted gross income tie-breaker rules also result in significant complexity. In its most recent study, the IRS found that the second largest amount of errors, 17.1 percent of overclaims, was attributable to improper application of the adjusted gross income tie-breaking rules.[118]

Definition of earned income

Present law requires both the IRS and taxpayers to keep track of nontaxable amounts for determining earned income credit eligibility even though such amounts generally are not necessary for other tax purposes. Many items of nontaxable earned income are not reported on Form W-2. As a result, a taxpayer may not know the correct amount of nontaxable earned income received during the year. Further, the IRS cannot easily determine such amounts. Many taxpayers are confused about what is taxable income and what is nontaxable income.[119]

Recommendations for Simplification

The Joint Committee staff recommends that the definition of qualifying child for purposes of the earned income credit should be conformed to the uniform definition of qualifying child (including the tie-breaking rule) recommended by the Joint Committee staff. In addition, the Joint Committee staff recommends that earned income for purposes of the earned income credit should be defined to include wages, salaries, tips, and other employee compensation to the extent includible in gross income for the taxable year, and net earnings from self employment.[120]

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[118] IRS 1997 Compliance Study at 10. Another significant error involves filing status errors that occur when married taxpayers erroneously file returns with filing status as single or head of household when they should file as married taxpayers filing separate returns. Married taxpayers filing separate returns are not eligible for the earned income credit. The IRS estimated that 10.5 percent of earned income credit overclaims resulted from misreporting of filing status among married taxpayers. *Id.* at 11. Filing status errors are discussed further in Sections II.A.2. and 3. of this Part, above.

[119] The IRS reported that the fourth largest amount of overclaims (approximately 14 percent) was due to income reporting errors, including overreporting of earned income, underreporting of earned income or adjusted gross income, underreporting of investment income, and reporting errors attributable to incorrect filing status. IRS 1997 Compliance Study at 11. It is not possible to determine what portion of such errors may be attributable to underreporting nontaxable earned income. It is possible that some underreporting of such income is not detected by the IRS because of the difficulty of determining the amount of nontaxable income.

[120] In its recommendations for repeal of deadwood provisions of the Code, the Joint Committee staff recommends repeal of the "supplemental child credit" (sec. 32(n)). The supplemental child credit does not affect any taxpayer's tax liability, earned income credit, or child tax credit.

Qualifying child and adjusted gross income tie-breaking rule[121]

In this study, the Joint Committee staff has recommended that a uniform definition of qualifying child be adopted for purposes of determining eligibility for the dependency exemption, the earned income credit, the child credit, the dependent care credit, and head of household filing status. The uniform definition of child would achieve simplification by making easier for taxpayers to determine whether or not they qualify for the various tax benefits for children. Adopting a uniform definition would reduce inadvertent taxpayer errors resulting from differing definitions of a qualifying child.

Under the uniform definition proposed by the Joint Committee staff, in general, a child would be a qualifying child of a taxpayer if the child has the same principal place of abode as the taxpayer for more than one-half the taxable year. A "child" would be defined as an individual with a specified relationship to the taxpayer who is less than a specified age.

In general, the proposal adopts a definition of qualifying child that is similar to the present-law rule under the earned income credit. Thus, the proposal would result in similar effects under the earned income credit as under present law, except in certain limited situations.

The relationships used to define a child under the proposal are the same as those under the earned income credit, except that the earned income credit does not include descendants of a stepson or stepdaughter (unless such a descendent was placed with the taxpayer by an authorized foster care agency). The earned income credit applies a one-year residency test to foster children, while the proposal would apply a six-month test to all children. Thus, the proposal would extend the earned income credit to some taxpayers who would not be able to claim the credit under present law. The Joint Committee staff decided to recommend a six-month rule for all cases because a single rule is easier to apply than two separate rules.

The age limitation under the present-law earned income credit is the same as that under the proposal.

Under the Joint Committee staff proposal, the present-law tie-breaking rule for the earned income credit would be replaced. Under the proposal, if the child would be a qualifying child with respect more than one individual (e.g., a child lives with his or her mother and grandmother in the same household) and more than one person actually claims a benefit with respect to that child, then the following tie-breaking rules would apply. First, if one of the individuals claiming the child as a qualifying child is the child's parent (or parents who file a joint return), the child would be deemed the qualifying child of the parent (or parents). Second, if both parents claim the child and the parents do not file a joint return, then the child would be deemed a qualifying child first with respect to the parent with whom the child resides for the longest period of time and second with respect to the parent with the highest adjusted gross income. Finally, if the child's parents do not claim the child, then the child would be deemed a qualifying child with respect to the individual with the highest adjusted gross income.

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[121] *See, also*, the discussion in Section II.B.1., above.

Definition of earned income

The Joint Committee staff recommends that the definition of earned income for purposes of the earned income credit should be modified to include wages, salaries, tips, and other employee compensation, to the extent includible in gross income for the taxable year, and net earnings from self-employment. The proposal would simplify the definition of earned income by excluding nontaxable amounts. As noted above, the amount of nontaxable employee compensation is often difficult to ascertain for both the taxpayer and the IRS. The proposal would enable taxpayers and the IRS to determine earned income based on amounts already shown on Form W-2 and included in the tax return.

Structural issues

Since its enactment in 1975, the earned income credit has been modified many times. The legislative history of the various earned income credit changes indicates a variety of purposes to be served by the earned income credit, including to provide an incentive to work, to increase the fairness of the tax laws by recognizing that lower-income individuals have a reduced ability to pay taxes, to offset the effects of social security and self-employment taxes, and to alleviate poverty.[122] Although the earned income credit has been available to childless workers since 1994, most of the benefits of the earned income credit are provided to workers with children.

The number of taxpayers claiming the earned income credit has increased from 6.2 million in 1975 to over 20 million in 1997. The level of complexity associated with the provision has increased as well. The earned income credit has expanded from a single line on the tax return into a separate publication and schedule for earned income credit instructions and computations.[123] The most recent IRS study on the earned income credit showed that approximately 65 percent of taxpayers claiming the earned income credit for 1997 used a paid preparer. The increasing complexity of the earned income credit could be a significant factor in the use of paid preparers.[124]

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[122] *See, e.g.*, S. Rep. *No.* 94-36 (1975), at 11, 33. "[T]he committee agrees with the House that this tax reduction bill should provide some relief at this time from the social security tax and the self-employment tax for low income individuals. The committee believes, however, that the most significant objective of the provision should be to assist in encouraging people to obtain employment, reducing the unemployment rate and reducing the welfare rolls." *Id.* at 33. *See also*, H. Rep. 103-111 (1993) at 609 ("Providing a larger basic [earned income credit] to larger families recognizes the role the [earned income credit] can play in alleviating poverty. Moreover this larger credit may provide work incentives and increase equity by reducing the tax burden for those workers with a lower ability to pay taxes.")

[123] Treasury Inspector General for Tax Administration, *Management Advisory Report: Administration of the Earned Income Credit* (Ref. No. 2000-40-160, September 2000), at 1.

[124] *Id.* at 7.

In the course of this study, the Joint Committee staff reviewed a variety of proposals intended to simplify the earned income credit that the Joint Committee staff determined involve fundamental policy issues that go beyond the question of simplification. Such proposals include the following:

- Eliminate the credit for childless workers;
- Eliminate the advance payment option;
- Require earned income credit claimants to be pre-certified for eligibility by the IRS;
- Combine the earned income credit, the child tax credit, and the dependency exemption into a single provision;
- Exempt a certain portion of earnings from payroll taxes[125]; and
- Increase funding for the IRS Volunteer Income Tax Assistance program to allow more lower-income individuals access to free tax help.

Evaluation of these proposals would involve a variety of issues, including issues of fairness of the tax laws, the policy goals behind the earned income credit and the extent to which the proposal would accomplish those goals, and whether the proposal increases simplification or adds new complexity to the Code.

4. Determinations relating to filing status[126]

Present Law

In general

There are five different filing statuses under present law: (1) married individuals filing a joint return; (2) head of household; (3) unmarried individuals (other than surviving spouses and heads of households); (4) married individuals filing separate returns; and (5) surviving spouses. Filing status is primarily relevant because of the rate structure and the standard deduction. Separate rate schedules apply to each filing status; surviving spouses apply the same rate schedules as married couples filing a joint return. Similarly, separate standard deduction amounts apply to each filing status; surviving spouses are eligible for the same standard deduction as married couples filing a joint return. Filing status also may be relevant for purposes of determining eligibility for certain credits or deductions (e.g., some credits are not available to married taxpayers filing a joint return). In addition, the income levels at which certain tax benefits phase in or phase out often vary by filing status.[127]

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[125] This approach, combined with modifications to the child credit or dependency exemption, is suggested in one of the acamedic papers submitted for this study. Annette Nellen, *Simplification of the EITC through Structural Changes,* at 10-12 (printed in Volume III).

[126] Structural issues relating to filing status are discussed in Section II.A. of this Part, above.

[127] For a detailed discussion of the various income-based phase-ins and phase-outs in the Code, *see* Section II.C. of this Part, below.

Head of household filing status

A taxpayer may file as a head of household if the taxpayer is unmarried (and not a surviving spouse) and pays more than one half of the cost of maintaining a home which is the taxpayer's home and the principal place of abode for more than one half of the taxable year of:

(1) an unmarried son, daughter, stepson, or stepdaughter of the taxpayer or an unmarried descendant of the taxpayer's son or daughter;

(2) an individual described in (1) who is married, if the taxpayer may claim a dependency exemption with respect to the individual (or could claim the exemption if the taxpayer had not waived the exemption to the noncustodial parent); or

(3) a relative with respect to whom the taxpayer may claim a dependency exemption.[128]

A taxpayer may also file as a head of household if the taxpayer is unmarried (and not a surviving spouse) and pays more than one half of the cost of a household which constitutes for the entire taxable year the principal place of abode of a parent of the taxpayer for whom the taxpayer is entitled to a dependency exemption.

Surviving spouse filing status

A taxpayer whose spouse dies during the taxable year may file a joint return for the year of death. In addition, a taxpayer who qualifies as a "surviving spouse" may obtain the benefits of the increased standard deduction and the rate brackets for married taxpayers filing a joint return for two years after the year of death.

A taxpayer may file as a surviving spouse if all the following requirements are satisfied:

(1) the taxpayer's spouse died during either of the two years preceding the taxable year;

(2) the taxpayer pays over one half the cost of maintaining a home which is the taxpayer's home and the principal place of abode for the entire taxable year of a son, stepson, daughter, or stepdaughter of the taxpayer with respect to whom the taxpayer is entitled to claim a dependency exemption;

(3) the taxpayer has not remarried during the taxable year; and

(4) for the taxable year in which the spouse died, the taxpayer and spouse were eligible to file a joint return.

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[128] Sec. 2(b)(1)(A)(ii), as qualified by sec. 2(b)(3)(B). An individual for whom the taxpayer is entitled to claim a dependency exemption by reason of a multiple support agreement does not qualify the individual for head of household filing status.

Sources of Complexity

As discussed above, the need to determine filing status has been identified as a source of complexity by commentators for many years.[129] The IRS has reported that the complexity-related topic appearing most frequently in customer service calls and TeleTax calls in 1999 was filing status.[130] Filing status was the third most common complexity-related math error in 1999.[131] Errors relating to filing status affect not only the standard deduction amount and rate brackets, but can also cause errors throughout a return.

The rules relating to head of household filing status create complexities for taxpayers with children, in part because a child that qualifies as a dependent may or may not qualify the taxpayer for head of household status. Similarly, a child that qualifies a taxpayer for head of household status may not qualify as dependent of the taxpayer. Such discrepancies in definitions may lead to numerous inadvertent errors.

As is the case with head of household status, the same child that qualifies as a dependent of the taxpayer may not qualify the taxpayer for surviving spouse status, and vice versa. In addition, it may not be clear to taxpayers that a dependent is required for surviving spouse status, and taxpayers may inadvertently believe that any surviving spouse is entitled to claim the status.

Recommendation for Simplification

The Joint Committee staff recommends that head of household filing status should be available with respect to a child only if the child qualifies as a dependent of the taxpayer under the Joint Committee staff's recommended uniform definition of qualifying child.

The Joint Committee staff recommends that surviving spouse status should be available only for one year and that the requirement that the surviving spouse have a dependent be eliminated.

Head of household filing status

Under the proposal, a taxpayer would qualify for head of household filing status with respect to a child only if the child is a qualifying child as defined under the Joint Committee staff recommendation proposing a uniform definition of qualifying child.[132] Applying the uniform definition would reduce taxpayer errors due to differing requirements with respect to children.

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[129] *See* discussion in Section II.A.2. of this Part, above.

[130] Department of the Treasury, Internal Revenue Service, *Annual Report from the Commissioner of the Internal Revenue Service on Tax Law Complexity* (June 5, 2000), at 12.

[131] *Id.*

[132] *See* Section II.A.1. of this Part, above.

The proposal would retain the requirement that the taxpayer maintain the household in which the taxpayer and the qualifying child reside (i.e., the taxpayer must provide more than one half the cost of maintaining the household). Although retaining this requirement adds some complexity, the Joint Committee staff believes that this requirement is integral to head of household filing status and that eliminating the requirement would result in an expansion of the number of people who would claim head of household status that is not commensurate with the simplification that would be achieved. The rules for determining whether a person other than a child qualifies the taxpayer for head of household status would remain as under present law.

Surviving spouse filing status

The proposal would reduce the complexity related to surviving spouse status by reducing the requirements that must be satisfied in order to qualify for the filing status. Under the proposal, a taxpayer would be eligible to file as surviving spouse for a year if:

(1) the taxpayer's spouse died during the preceding the taxable year;

(2) the taxpayer has not remarried during the taxable year; and

(3) for the taxable year in which the spouse died, the taxpayer and spouse were eligible to file a joint return.

By eliminating the requirement for a dependent, the proposal would expand the class of taxpayers who are eligible to claim surviving spouse status. The proposal would also reduce by one year the period of time such status can be claimed by a taxpayer.

The Joint Committee staff believes the justification for requiring a surviving spouse to have a dependent is unclear, particularly given the availability of head of household status. Eliminating this requirement would make the provision simpler and would also increase the fairness of the tax laws, in that taxpayers whose spouses have recently died would be treated in a similar manner. The Joint Committee staff believes that, to the extent considered desirable, providing additional tax relief for taxpayers with children may be accomplished in a simpler manner through other provisions of the Code.

C. Income-Based Phase-outs and Phase-ins

Present Law

The Code includes over 20 provisions that are phased in or out for taxpayers with incomes above certain levels. These phase-outs[133] limit the ability of certain taxpayers to claim certain deductions, credits, or other tax benefits. Table 12., below, provides a summary of theses provisions. Income-based phase-outs have the effect of increasing marginal tax rates for affected taxpayers.[134]

As Table 7., below, demonstrates, with the exception of the HOPE and Lifetime Learning credits, which use the same income range, each phase-out uses a different income range. In addition, the provisions use varying definitions of income. Most provisions start with adjusted gross income and make various modifications, such as including certain items of income that are excludable for income tax purposes. Other definitions of income are also used. For example, the earned income credit uses earned income as well as adjusted gross income.

It is possible for taxpayers to be subject to more than one of the phase-outs simultaneously. Certain of the phase-outs do not overlap. For example, a taxpayer could not simultaneously be subject to the personal exemption phase-out and the phase-out for the deductibility of qualified student loan interest. Other phase-outs do overlap. Table 8., below, can be used as a general guide to the income levels at which multiple phase-outs can overlap. Some care must be used in interpreting the table, however. For example, the table shows that taxpayers with $20,000 to $30,000 of adjusted gross income could be subject to a combination of the earned income credit and dependent care credit phase-outs and the phase-in of the taxation of Social Security benefits. However, a taxpayer who must include a portion of Social Security benefits in gross income is unlikely to claim the earned income credit or dependent care tax credit given the different demographics of the taxpayers who receive Social Security compared to those who typically claim the credits.

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[133] The term "phase-outs" is used generally to refer to both phase-ins and phase-outs. Although the benefits of most of the provisions at issue phase out as income rises, there are some exceptions. For example, the earned income credit phases in as earned income increases. Provisions also may be characterized as both phase-ins and phase-outs. For example, the provision that requires certain taxpayers to include in gross income a portion of Social Security benefits could be characterized as a phase-in of the income inclusion or a phase-out of the exclusion.

[134] For a complete description and analysis of the operation of these phase-outs, *see* Joint Committee on Taxation, *Present Law and Analysis Relating to Individual Effective Marginal Tax Rates* (JCS-3-98), February 3, 1998.

Table 7.–Summary of Present-Law Individual Tax Provisions With Income-Based Phase-ins or Phase-outs (2001)

Provision	Joint Filers	Single and Head of Household Filers	Married Filing Separately	Income Base for Phase-in/out	Indexed	Operation of Phase-in/out
1. Phase-in of earned income credit (sec. 32)	*No children*: $0-$4,760 *One child*: $0-$7,140 *Two children*: $0-$10,020	Same as joint filers	No credit	Earned income[1]	Yes	Credit is a percentage of earned income up to the threshold
2. Phase-out of earned income credit (sec. 32)	*No children*: $5,950-$10,710 *One child*: $13,090-$28,281 *Two children*: $13,090-$32,121	Same as joint filers	No credit	Greater of (a) earned income and (b) AGI plus tax-exempt interest and nontaxable pension payments, and disregarding certain losses	Yes	Credit reduced by percentage of income over the threshold. Phase-out percentage varies by number of children
3. Partial phase-out of dependent care tax credit (sec. 21)	$10,000-$28,001	Same as joint filers	No credit	AGI	No	Credit rate reduced (but not below 20%) by 1 percentage point for each $2,000 (or fraction) over the threshold
4. Phase-out of credit for elderly and disabled (sec. 22)	$10,000-$25,000	$7,500-$17,500	$5,000-$12,500	AGI	No	Credit base reduced by one-half of income over the threshold[2]

Table 7.–Summary of Present-Law Individual Tax Provisions With Income-Based Phase-ins or Phase-outs (2001)

Provision	Joint Filers	Single and Head of Household Filers	Married Filing Separately	Income Base for Phase-in/out	Indexed	Operation of Phase-in/out
5. Phase-out of exclusion for social security ("SS") and railroad retirement ("RR") benefits (sec. 86)	*First tier*: $32,000 *Second tier*: $44,000	*First tier*: $25,000 *Second tier*: $34,000	*First and second tiers*: $0	Modified AGI plus one-half of SS or RR benefits; modified AGI is AGI plus tax-exempt interest and disregarding the exclusions under secs. 135, 137, 911, 931, and 933 and the deduction under sec. 221	No	Includible amount is generally one-half of income in excess of first tier (but no more than one-half of SS benefits), plus 85% of excess above second tier, but no more than 85% of SS benefits
6. Phase-out of eligibility for deductible IRA (sec. 219)	$53,000-$63,000	$33,000-$43,000	$0-$10,000	AGI disregarding the exclusions under secs. 135, 137, and 911 and the deduction under sec. 221. AGI is determined after application of secs. 86 and 469 and before application of this provision.	Statute provides **scheduled** increases, with indexing thereafter	Ratable reduction;[3] special rounding rules
7. Phase-out of deductibility of interest on qualified student loans (sec. 221)	$60,000-$75,000	$40,000-$55,000	No deduction	Modified AGI.[4] AGI is determined after application of secs. 86, 135, 137, 219, and 469 and before application of this provision	Yes	Ratable reduction[3]

Table 7.–Summary of Present-Law Individual Tax Provisions With Income-Based Phase-ins or Phase-outs (2001)

Provision	Joint Filers	Single and Head of Household Filers	Married Filing Separately	Income Base for Phase-in/out	Indexed	Operation of Phase-in/out
8. Phase-out of adoption credit and exclusion (secs. 23 and 137)	$75,000-$115,000	Same as joint filers	No credit or exclusion	Modified AGI[4]	No	Ratable reduction[3]
9. Phase-out of HOPE credit (sec. 25A)	$80,000-$100,000	$40,000-$50,000	No credit	Modified AGI[4]	Yes	Ratable reduction[3]
10. Phase-out of Lifetime Learning Credit (sec. 25A)	$80,000-$100,000	$40,000-$50,000	No credit	Modified AGI[4]	Yes	Ratable reduction[3]
11. Phase-out of exclusion of interest from education savings bonds (sec. 135)	$83,650-$113,650	$55,570-$70,750	No exclusion	AGI disregarding secs. 137, 221, 911, 931, 933, AGI determined after applying secs. 86, 469, and 219 and before applying this section	Yes	Ratable reduction[3]
12. Ability to make an IRA to Roth IRA conversion (sec. 408A)	$100,000	Same as joint filers	Not eligible for rollover	Same as IRA deduction rules, except that the conversion amount and minimum required distributions from retirement plans are excluded	No	Cliff; not eligible for conversion if income exceeds threshold

Table 7.–Summary of Present-Law Individual Tax Provisions With Income-Based Phase-ins or Phase-outs (2001)

Provision	Joint Filers	Single and Head of Household Filers	Married Filing Separately	Income Base for Phase-in/out	Indexed	Operation of Phase-in/out
13. Phase-out of rental real estate losses and rehab credit under passive loss rules (sec. 469(i))	$100,000-$150,000 ($200,000-$250,000 for rehab credit)	Same as joint filers	$50,000-$75,000 ($100,000-$125,000 for rehab credit)	AGI, disregarding amounts includible under sec. 86, amounts excludable under secs. 135 and 137, the deductions under secs. 219 and 221 and certain passive activity losses	No	Maximum allowable amount reduced by 50% of income above threshold
14. Phase-out of first-time D.C. homebuyer credit (sec. 1400(C))	$110,000-$130,000	$70,000-$90,000	$70,000-$90,000	Modified AGI[4]	No	Ratable reduction[3]
15. Phase-out of child credit (sec. 24)	$110,000-various[5]	$75,000-various[5]	$55,000-various[5]	Modified AGI[4]	No	Credit reduced by $50 for each $1,000 (or fraction) over the threshold
16. Overall limitation on itemized deductions (sec. 68)	$132,950-various	Same as joint filers	$66,475-various	AGI	Yes	Deductions reduced by lesser of 3% of AGI over threshold and 80% of deductions
17. Phase-out of IRA deduction if spouse is in a retirement plan (sec. 219(g)(7))	$150,000-$160,000	NA	NA	Same as regular IRA deduction	No	Ratable reduction;[3] special rounding rules
18. Phase-out of eligibility for Roth IRA (sec. 408A)	$150,000-$160,000	$95,000-$110,000	$0-$10,000	Same as regular IRA deduction	No	Ratable reduction[3] special rounding rules

Table 7.–Summary of Present-Law Individual Tax Provisions With Income-Based Phase-ins or Phase-outs (2001)

Provision	Joint Filers	Single and Head of Household Filers	Married Filing Separately	Income Base for Phase-in/out	Indexed	Operation of Phase-in/out
19. Phase-out of eligibility for education IRA (sec. 530)	$150,000-$160,000	$95,000-$110,000	Same as single	Modified AGI[4]	No	Ratable reduction[3]
20. Phase-out of personal exemptions (sec. 151)	$199,450-$321,950	*Single:* $132,950-$225,450 *H/H*: $166,200-$288,700	$99,725-$160,975	AGI	Yes	Allowable exemptions reduced by 2 percent for each $2,500 (or fraction, $1,250 for married filing separately) by which income exceeds threshold

Note: AGI = adjusted gross income.

[1] The credit is disallowed if the taxpayer has excess investment income.
[2] The credit base is also reduced by certain excludable pension and disability payments.
[3] Credit, deduction, exclusion is phased out ratably over the income range.
[4] Modified AGI is AGI determined without regard to the exclusions under sections 911, 931, and 933.
[5] Phase-out range depends on number of children.

Source: Staff of the Joint Committee on Taxation.

Table 8.–Phase-ins and Phase-outs By Income Range

Income Range (000)**	Applicable Phase-outs Married Filing Joint Returns	Applicable Phase-outs Single And Head of Household Returns
$0 – 10	1	1, 4
10 – 20	2, 3, 4	2, 3, 4
20 – 30	2, 3, 4	2, 3, 5
30 – 40	2, 5	2, 5, 6
40 – 50	5	6, 7, 9, 10
50 – 60	6	7, 11
60 – 70	6, 7	11
70 – 80	7, 8	8, 14, 15
80 – 90	8, 9, 10, 11	8, 14, 15
90 – 100	8, 9, 10, 11	8, 15, 18, 19
100 – 110	8, 11, 12, 13	8, 12, 13, 15, 18, 19
110 – 120	8, 11, 13, 14, 15	8, 13 15*
120 – 130	13, 14, 15, 16	13, 16, 20
130 – 140	13, 15, 16	13, 16, 20
140 – 150	13, 15*, 16	13, 16, 20
150 – 160	16, 17, 18, 19	16, 20
160 – 170	16	16, 20
170 – 180	16	16, 20
180 – 190	16	16, 20
190 – 200	16, 20	16, 20
200 +	16, 20, 21	16, 20, 21

Table 8.–Phase-ins and Phase-outs By Income Range

KEY TO PHASE-INS AND PHASE-OUTS IN TABLE 13:

1 – Phase-in of earned income credit

2 – Phase-out of earned income credit

3 - Partial phase-out of dependent care credit

4 – Phase-out of credit for elderly and disabled

5 – Phase-out of exclusion for social security ("SS") and railroad retirement ("RR") benefits

6 – Phase-out of eligibility for deductible IRA

7 – Phase-out of deductibility of interest on qualified student loans

8 Phase-out of adoption credit and exclusion

9 - Phase-out of HOPE credit

10 - Phase-out of Lifetime Learning credit

11 - Phase-out of exclusion of interest from education savings bonds

12 - Ability to rollover an IRA to Roth IRA rollover

13 - Phase-out of $25,000 exclusion for rental real estate losses under passive loss rules

14 - Phase-out of first-time D.C. homebuyer credit

15 - Phase-out of child credit

16 – Adjusted gross income limitation on itemized deductions

17 - Phase-out of IRA deduction if spouse is in a retirement plan

18 - Phase-out of eligibility for Roth IRA

19 - Phase-out of eligibility for education IRA

20 - Phase-out of personal exemptions

21 - Phase-out of rehab tax credit under passive loss rules

* - Would need 5 or more children for phase-out to extend beyond $150,000

** - Definition of income varies by phase-out provision

Sources of Complexity

For 2001, the Joint Committee staff estimates that across all taxpayers, over 30 million worksheet calculations will be required to implement phase-outs, including 11.6 million for the earned income credit, 6.1 million for the overall limitation on itemized deductions, 5.7 million for the phase-in relating to the taxation of Social Security benefits, and 2.1 million for the personal exemption phase-out.

Phase-outs increase complexity in several ways. Taxpayers in the phase-out range must perform separate worksheet calculations to determine the amount of the allowable tax benefit. Such calculations are also often required of a taxpayer who is ultimately fully eligible, or fully ineligible, for the tax benefit. The worksheet calculation is required in these cases because there is no way to readily determine if the phase-out does not apply to the taxpayer other than by performing the worksheet calculations. At the very least, taxpayers using a particular tax benefit that has a phase-out must read additional instructions to determine if the phase-out applies to them. Additional calculations increase both the time required to prepare the taxpayer's return and the probability of making an error. Obtaining and understanding the necessary forms, or worksheets, and instructions also lengthens the return preparation process. Taxpayers may not find all the information that they need to complete their tax return in the standard Form 1040 instruction booklet. For example, the Form 1040 booklet refers the many taxpayers subject to the phase-out of the child credit need to IRS Publication 972 for the necessary worksheet.

In addition to the additional time required of the taxpayer to educate himself or herself on the applicability of the phase-out to their particular circumstances, the worksheets themselves can be quite complicated to complete. All of the worksheets require some combination of addition, subtraction, multiplication, division, cross-references to line entries on other forms or schedules, comparison of numbers or line entries to see which is smaller or larger, and yes or no answers to various qualitative questions. Most of the worksheets are 10 to 20 lines long, although that figure can understate the amount of calculations required as individual lines on the worksheets may themselves require numerous calculations to determine the appropriate entry for that line. For example, the overall limitation on itemized deductions requires a 10-line worksheet. However, the first line of that worksheet requires the adding up of seven lines from Schedule A, and the second line requires the adding up of four lines of Schedule A.

If a phase-out applies to an exclusion or above-the-line deduction, such as the IRA deduction, the student loan interest deduction, or the exclusion of saving bond interest, additional calculations are required because adjusted gross income cannot be used as the income measure for the phase-out, because with an exclusion one cannot know adjusted gross income until the appropriate amount of the exclusion is determined. Thus, for purposes of the phase-out, a measure of modified adjusted gross income must be determined which requires the adding up of multiple lines of the 1040. For example, the 10-line worksheet for student loan interest deduction also requires the adding up of nine lines of the 1040 form to determine one line entry on the worksheet. Similarly, the ten-line IRA deduction worksheet also requires the adding up of eight lines of the 1040 form to determine one line entry on the worksheet. Finally, the 14-line form 8815 for determining excludable saving bond interest includes a five-line worksheet, which itself requires the adding up of 14 lines of the Form 1040 to determine one entry on the worksheet, just to determine modified adjusted gross income for purposes of the phase-out.

Phase-outs also create transactional complexity and inequities based on the taxpayer's understanding of the law. Because taxpayers cannot always predict what their income will be for any given year or may be unaware of all of the requirements of the Code, phase-outs make it harder for taxpayers to plan to take advantage of tax benefits. For example, a taxpayer who files as a head of household with $40,000 of income and has a child in the first year of college would be eligible for a HOPE credit of up to $1,500. However, if the taxpayer recognized a $10,000 capital gain to pay tuition, the taxpayer would no longer be eligible for the credit. The well-advised taxpayer who needed the funds to pay tuition might be able to avoid such a result by doing the capital gain transaction in a tax year prior to the year tuition will be paid.

Phase-outs may lead to taxpayer confusion regarding the individual income tax. One source of this confusion is that the phase-outs have the effect of increasing marginal tax rates, but are not stated as statutory rates. This makes it difficult for taxpayers to estimate their total tax liability in advance for such purposes as making appropriate estimated tax payments, which can then lead to estimated tax penalties. Although taxpayers generally understand when a deduction or credit is available with respect to a particular activity, they may not fully understand all the details of particular provisions. This complexity and lack of clarity may cause taxpayer frustration.

Recommendation for Simplification

The Joint Committee staff recommends that the following phase-outs should be eliminated:

- **The overall limitation on itemized deductions (sometimes referred to as the "PEASE" limit),**
- **The phase-out of personal exemptions (sometimes referred to as "PEP"),**
- **The phase-out of child tax credit,**
- **The partial phase-out of the dependent care tax credit,**
- **The phase-outs relating to individual retirement arrangements ("IRAs"),**
- **The phase-out of HOPE and Lifetime Learning credits,**
- **The phase-out of the deduction for student loan interest,**
- **The phase-out of the exclusion for interest on education savings bonds, and**
- **The phase-out of the adoption credit and exclusion.**[135]

The Joint Committee staff believes that the Federal individual income tax laws would be simplified if the tax base were uniformly defined regardless of income,[136] tax credits were uniformly applied regardless of income, and concerns regarding the overall progressivity of the

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[135] The Joint Committee staff is also recommending that the phase-out of the exclusion for a portion of Social Security benefits be eliminated, and that a fixed percentage of Social Security benefits be includible in income for all taxpayers. This recommendation is discussed in Section II.D. of this Part, below.

[136] Phase-outs of exclusions and deductions effectively mean that the definition of the tax base varies with income.

tax laws were addressed solely through the rate structure. Accordingly, the Joint Committee staff recommends the elimination of those phase-outs which primarily address progressivity concerns.[137] In addition to creating complexity, the phase-outs also conflict with the fundamental principle of tax policy that a tax structure should reflect ability to pay, which principle is often the primary rationale for phase-outs.[138] Thus, it is possible to achieve both simplification and greater adherence to ability to pay principles by eliminating certain phase-outs.

The Joint Committee staff recommendation would achieve simplification by completely eliminating certain worksheets and instructions, such as those for the personal exemption phase-out, the overall limitation on itemized deductions, the student loan interest deduction, and the phase-out relating to individual retirement arrangements. The worksheets and forms and instructions relating to the other phase-outs that the Joint Committee staff recommends eliminating would all be substantially shortened, as the portions of such forms relating to the income-based phase-outs would be eliminated.

The Joint Committee staff recommendation would lead to the elimination of approximately 75 worksheet or form lines, with the precise number depending on how the IRS redesigned certain of the forms or worksheets to account for the elimination of the phase-outs. The elimination of the phase-outs would also eliminate many transactional complexities associated with tax planning and predicting in advance one's tax liabilities for such purposes as complying with estimated tax laws. The elimination of the phase-outs would also eliminate certain inequities whereby only some taxpayers of similar ability to pay from a lifetime perspective are forced into phase-outs based on the pattern of their annual income, while other well-advised taxpayers may time income and expenses to maximize benefits.

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[137] The Joint Committee staff makes no recommendation with respect to the phase-outs relating to the earned income credit, the tax credit for the elderly and disabled, the D. C. homebuyer credit, the allowance of certain rental real estate losses under the passive loss rules, and qualified mortgage revenue bonds. It is believed that these phase-outs serve purposes other than, or in addition to, achieving progressivity. It has also been argued that the phase-outs relating to individual retirement arrangements serve purposes other than progressivity. This issue is discussed in Section III.B. of this Part, below. The Joint Committee staff is recommending eliminating the adjusted gross income phase-out for contributions to education individual retirement accounts as deadwood, as discussed in Section XVII of this Part, below. As presently structured, the provision is easily avoided and has little substantive effect.

[138] For example, the policy premise underlying the child credit is that families with children have a decreased ability to pay tax relative to families of equal incomes that do not have children. The policy is based on the existence of children, not on the level of income. Thus, the phase-out is in direct conflict with the policy underlying the credit. For example, the phase-out means that families with children that are subject to the phase-out are taxed the same as families without children that have the same income, which does not recognize the impact of children on ability to pay. Similarly, a family with children that is subject to the phase-out that earns $100,000 might only have the same ability to pay as a family without children that earns $90,000, but would have a higher tax liability.

Although it might at first blush seem that phase-outs are consistent with ability to pay principles and maintain the progressivity of the Federal individual income tax (i.e., upper income taxpayers can and should pay more income taxes), the appropriate inquiry should focus on the total tax liability of upper-income individuals relative to tax liabilities of others.[139] The desired degree of progressivity does not have to be sacrificed by eliminating phase-outs because the rate structure can be adjusted to achieve whatever degree of progressivity is desired. Furthermore, achieving progressivity directly through the rate structure avoids the negative consequences (in addition to complexity) of achieving progressivity through phase-outs, which overstate the ability to pay of certain-upper income individuals.

Some simple examples can illustrate these concepts. Consider the case of four families. Two families, one with two children and one without, each earn $50,000, and two families, one with two children and one without, each earn $100,000. Assume that the tax system must raise $50,000 and that the aggregate degree of progressivity initially is established by taxing the families earning $50,000 a combined $10,000, and by taxing the families earning $100,000 a combined $40,000. Further assume that the family earning $50,000 with children has a tax liability of $4,000, that the family earning $50,000 without children has a tax liability of $6,000, and that each of the families earning $100,000 has a tax liability of $20,000. A $1,000 per child credit is permitted at $50,000 of income, but is phased out by $100,000 of income. (This tax system is generally representative of the concept of income-based phase-outs.) This tax structure is depicted as "Tax System 1" in Table 9., below.

[139] The notion that phase-outs increase progressivity is true only if all other aspects of the tax system are held unchanged. For example, if a tax system without any adjustments for children is altered to include such an adjustment, then phasing out the adjustment would produce greater progressivity than the identical system without the phase-out. However, the resulting tax system will not accurately reflect ability to pay, because upper-income taxpayers without children will not pay higher taxes than upper-income taxpayers with children.

Table 9.--Examples of Alternative Tax Systems

			Tax					
	Child Credit	Child Credit Phase-out	$50,000 family with no children	$50,000 family with two children	$100,000 family with no children	$100,000 family with two children	Total taxes	Degree of Progressivity[1] 0 = Least 100 = Most
Tax System 1.....	Yes	Yes	$6,000	$4,000	$20,000	$20,000	$50,000	80
Tax System 2.....	Yes	No	$6,000	$4,000	$21,000	$19,000	$50,000	80
Tax System 3.....	Yes	No	$4,000	$2,000	$23,000	$21,000	$50,000	88
Tax System 4.....	Yes	Yes	$8,000	$6,000	$18,000	$18,000	$50,000	72

[1] Progressivity is measured as the percentage of total taxes that the two upper income families account for.

Note that the combined $40,000 tax liability of the two families earning $100,000 can be redistributed to reflect the presence of children (i.e., by eliminating the phase-out of the child credit) while maintaining overall progressivity: the family with children would pay $19,000 while the family without children would pay $21,000, maintaining the combined burden at $40,000. This tax structure is depicted as "Tax System 2" in Table 14. If desired, the tax system could be made more progressive despite the elimination of the phase-out of the child credit by taxing the family earning $100,000 with children $21,000 and taxing the family earning $100,000 without children $23,000, while reducing the tax liabilities on the $50,000 families to $2,000 and $4,000 respectively, thus maintaining overall revenue at $50,000. This tax structure is depicted as "Tax System 3" in Table 14. Finally, the tax system could be made less progressive despite the existence of a phase-out of the child credit by taxing each of the families with $100,000 of earnings $18,000, while taxing the families with $50,000 of earnings $6,000 and $8,000 respectively. This tax structure is depicted as "Tax System 4" in Table 14.

These examples demonstrate that income-based phase-outs of tax benefits are not integral to a progressive tax system, as the least progressive of the tax systems shown in Table 14 phases out the child credit, while the most progressive one does not. Progressivity can be achieved through changes to the rate structure, and if phase-outs are eliminated progressivity concerns could be addressed through this mechanism. Although overall progressivity would be maintained, the tax liabilities of different individuals or groups may be different compared to present law. For example, if the phase-out of the child credit were eliminated and rates were adjusted accordingly, a higher-income childless couple might pay more in taxes relative to present law, because they would not be eligible for the present-law child credit but might experience an increase in rates.

D. Taxation of Social Security Benefits

Present Law

Income taxation of Social Security benefits

Under present law, Social Security benefits are taxed under a two-tier system. Taxpayers receiving Social Security benefits are not required to include any portion of such benefits in gross income if their "provisional income" does not exceed a first-tier threshold, which is $25,000, in the case of unmarried individuals, or $32,000, in the case of married individuals filing joint returns.[140] For purposes of these computations, a taxpayer's provisional income is defined as adjusted gross income plus: (1) tax-exempt interest; (2) excludable interest on educational savings bonds; (3) adoption assistance payments; (4) certain deductible student loan interest; (5) certain excludable foreign-source earned income; (6) certain U.S. possession income; and (7) one-half of the taxpayer's Social Security benefits. A second-tier threshold for provisional income is $34,000, in the case of unmarried individuals, or $44,000, in the case of married individuals filing joint returns.[141]

If the taxpayer's provisional income exceeds the first-tier threshold but does not exceed the second-tier threshold, then the amount required to be included in income is the lesser of (1) 50 percent of the taxpayer's Social Security benefits, or (2) 50 percent of the excess of the taxpayer's provisional income over the first-tier threshold.

If the amount of provisional income exceeds the second-tier threshold, then the amount required to be included in income is the lesser of: (1) 85 percent of the taxpayer's Social Security benefits; or (2) the sum of (a) 85 percent of the excess of the taxpayer's provisional income over the second-tier threshold, plus (b) the smaller of (i) the amount of benefits that would have been included in income if the 50 percent inclusion rule (described in the previous paragraph) were applied, or (ii) one-half of the difference between the taxpayer's second-tier threshold and first-tier threshold.[142]

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[140] In the case of a married individual who files a separate return, the first-tier threshold is generally zero. However, if the individual lives apart from his or her spouse for the entire year, the first-tier threshold is $25,000.

[141] In the case of a married individual who files a separate return, the second-tier threshold is generally zero. However, if the individual lives apart from his or her spouse for the entire year, the second-tier threshold is $34,000.

[142] Special rules apply in some cases under present law. Tier I Railroad Retirement benefits are similar to Social Security benefits and are taxed in the same manner as Social Security benefits. In the case of nonresident individuals who are not U.S. citizens, 85 percent of Social Security benefits are includible in gross income and subject to the 30-percent withholding tax (sec. 871(a)(3)). The taxation of Social Security benefits may also be specified in income tax treaties between the United States and other countries.

Revenues from the first tier tax on Social Security benefits are dedicated to the Social Security Trust Fund. Revenues from the second tier tax are dedicated to the Hospital Insurance Trust Fund.

Social security taxes

As part of the Federal Insurance Contributions Act, a tax is imposed on employees and employers up to a maximum amount of employee wages. The tax is composed of two parts, old-age survivor, and disability insurance, commonly referred to as Social Security, and Medicare hospital insurance. The Social Security tax rate is 6.2 percent on both the employer and the employee (for a total rate of 12.4 percent).[143] The Social Security tax rate applies to wages up to the Social Security wage base cap, which is $80,400 for 2001. "Wages" generally includes all remuneration for employment, but there are specific exemptions. The wage base cap is adjusted annually for changes in average wages. Revenues from the Social Security tax are credited to the Social Security Trust Fund.

Under the Self-Employment Contributions Act, a tax is imposed on an individual's net earnings from self employment. The Social Security portion of the self-employment tax rate is equal to the combined tax rates for employers and employees (i.e., 12.4 percent) and is capped at the same level (i.e., $80,400 of net earnings from self employment for 2001).[144] A self-employed individual may deduct one half of his or her self-employment taxes.

Sources of Complexity

The National Taxpayer Advocate has reported that "[o]ne of the most complex computations that is required on the Form 1040 is the computation of the taxable portion of Social Security benefits."[145] The explanation of the taxation of Social Security benefits spans almost four full pages in IRS Publication 17, Your Federal Income Tax. An 18-line worksheet is included with the instructions for Form 1040 to assist taxpayers in calculating the taxable portion of their Social Security benefits. The lengthy worksheet is needed because of the many factors and steps that are relevant in determining the taxable portion of Social Security benefits.

In response to requests for information from the Joint Committee staff in connection with this study, the GAO reported that mistakes in the calculation of taxable Social Security benefits was one of the 10 most common taxpayer errors on IRS Form 1040 for 1999. The IRS has also reported that errors in calculating the amount of taxable Social Security benefits was one of the

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[143] The Medicare hospital insurance tax rate is 1.45 percent on both the employer and the employee (for a total tax rate of 2.9 percent). There is no limit on the amount of wages subject to the Medicare hospital insurance tax. Revenues from the Medicare hospital insurance tax are credited to the Hospital Insurance Trust Fund.

[144] Similarly, the Medicare hospital insurance portion of the self-employment tax rate is 2.9 percent, and is applied to all net earnings from self-employment.

[145] National Taxpayer Advocate, *FY 1999 Annual Report to Congress,* at 39.

10 most frequently made math errors in 1998. Such errors accounted for 3.6 percent of the total math errors determined by the IRS for 1998.[146]

The formula for determining the amount of includible Social Security benefits may also cause transactional complexity for taxpayers; the difficulty of the computations and the need to determine adjusted gross income may make it difficult for taxpayers to estimate in advance the amount of taxable benefits.

Recommendation for Simplification

The Joint Committee staff recommends that the amount of Social Security benefits includible in gross income should be a fixed percentage of benefits for all taxpayers. The Joint Committee staff further recommends that the percentage of includible benefits should be such that the amount of benefits excludable from income approximates individuals' portion of Social Security taxes.[147]

The proposal would provide both computational and transactional simplification for Social Security recipients.[148] Under the proposal, the multiple-page IRS explanation of taxation of Social Security benefits and the related worksheet could be eliminated. In place of the complicated calculations required under present law, a recipient of Social Security benefits would need to perform only one calculation (multiplying the amount of benefits by the applicable percentage) to determine the amount of benefits includible in gross income. The simplified method would also make it easier for taxpayers to estimate their tax liability in advance.

The proposal is consistent with the policies underlying the present-law two-tier system for taxing Social Security benefits. This system is a product of two separate pieces of legislation--the Social Security Amendments Act of 1983 ("SSAA 1983"), which imposed taxes

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[146] Internal Revenue Service, *Annual Report from the Commissioner of the Internal Revenue Service on Tax Law Complexity* (June 5, 2000), at 47.

[147] In the case of self-employed individuals, the individual's portion refers to one half of the Social Security portion of self-employment taxes. The proposal would also apply to the taxation of tier I Railroad Retirement benefits. In the case of nonresident individuals who are not U.S. citizens, the amount of Social Security benefits includible in gross income and subject to withholding tax would be equal to the percentage of benefits includible in income generally under the proposal. The proposal would not be intended to override the treatment of Social Security benefits provided in existing income tax treaties to which the United States is a party. As under present law, appropriate transfers to the Social Security Trust Funds or the Hospital Insurance Trust Fund could be adopted under the proposal to the extent considered appropriate.

[148] A similar proposal has been made by the National Taxpayer Advocate. National Taxpayer Advocate, *FY 1999 Annual Report to Congress,* at 39-40; National Taxpayer Advocate, *FY 2000 Annual Report to Congress,* at 89.

on Social Security benefits for the first time (the first-tier tax),[149] and the Omnibus Budget Reconciliation Act of 1993 ("OBRA 1993"), which imposed the second-tier taxation of Social Security benefits.

The legislative history to SSAA 1983 provides three reasons for taxing a portion of Social Security benefits: (1) the policy of excluding all Social Security benefits from gross income was inappropriate; (2) Social Security benefits are in benefits received under other retirement systems that are subject to taxation to the extent they exceed a worker's after-tax contributions and taxing Social Security benefits will improve equity in the tax system; and (3) taxing Social Security benefits would improve the solvency of the Social Security trust funds.[150] According to the legislative history, the maximum amount of Social Security benefits includible in gross income was limited to 50 percent in recognition of the fact that such benefits are partially financed by after-tax contributions. The provision was also designed to ensure that only those taxpayers who have substantial taxable income from other sources would be taxed on a portion of Social Security benefits.[151]

The legislative history to OBRA 1993 provides two reasons for the increase in the amount of Social Security benefits includible in gross income: (1) to provide greater conformity of the tax treatment of Social Security benefits to the tax treatment of private pensions; and (2) to enhance the horizontal and vertical equity of the individual income tax system by treating all income in a more similar manner.[152]

Consistent with a stated objective of both the first- and second-tier Social Security taxes, the recommendation would more closely conform the tax treatment of Social Security benefits with the tax treatment of private pensions. The treatment would not be precisely conformed because the proposal recommends a fixed percentage that would approximate individuals' portion of Social Security taxes, whereas the amount of excludable private pension benefits is equal to the exact amount of the employee's after-tax contributions.

However, providing a uniform percentage for taxing Social Security benefits would achieve greater simplification than if following the private pension rules were followed exactly, which would require each recipient of Social Security benefits to determine (1) the amount of

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[149] Prior to 1984, Social Security benefits were excluded from adjusted gross income. This exclusion was based upon a series of administrative rulings issued by the Internal Revenue Service in 1938 and 1941. I.T. 3194 1938-1 C.B. 114 (lump-sum payments made under the Social Security Act are not includible in gross income); I.T. 3229, 1938-2 C.B. 136 (lump-sum payments made under the Social Security Act to a deceased employee's estate are not includible in gross income); and I.T. 3447, 1941-1 C.B. 191 ("sundry" insurance benefits paid to recipients under the Social Security Act are not includible in gross income). *See also,* Rev. Rul. 70-217, 1970-1 C.B. 12 (updating and restating I.R. 3447).

[150] H. Rep. 98-25 (1983), Part I, at 24; S. Rep. 98-23 (1983), at 25.

[151] H. Rep. 98-25 (1983), Part I, at 24; S. Rep. 98-23 (1983), at 26.

[152] H. Rep. 103-111 (May 25, 1993), at 654; S. Rep. 103-37 (June, 1993), at 120.

Social Security or self-employment taxes paid by or on behalf of the individual and (2) perform the calculations necessary to determine the amount of each Social Security payment attributable to such taxes. Thus, conforming the tax treatment of Social Security benefits to the pension rules would impose additional complexity. In addition, new rules might need to be developed in some cases because the Social Security benefit structure provides for payments that are not comparable to those provided under private pension plans. Applying a fixed percentage for all benefit recipients would avoid such computational difficulties.[153]

Another stated objective of both the first- and second-tier tax on Social Security benefits is to achieve greater equity in the tax system by taxing all income in a more similar manner. The proposal also is consistent with this objective. The present-law structure favors lower-income individuals who receive Social Security benefits over lower-income individuals who receive income from other sources. The changes made by OBRA 1993 reduced this inequity compared with prior law, and the proposal would further reduce this inequity.

The elimination of the present-law income thresholds would result in more taxpayers including in income a portion of their Social Security benefits. To the extent the present-law income thresholds are intended to provide relief for lower-income taxpayers, the Joint Committee staff believes this objective can be accomplished in a simpler manner through the rate structure.[154]

Adopting a fixed percentage of includible benefits may overtax some Social Security recipients and undertax others relative to actual taxes paid. It may be appropriate to change the percentage over time as worker demographics change.[155]

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[153] If the private pension system were followed precisely, it might be possible to impose some of the computational burdens on the Social Security Administration, which could then be responsible for providing the information to the individual. Although such an approach would not avoid the complications associated with basing taxation on an individual's actual contributions, it would shift some of the burden to the Federal government. The Social Security Administration has already begun to provide workers information regarding payroll taxes credited to the individual.

[154] For further discussion of this issue, see Section II.C. of this Part, above.

[155] *See, e.g.,* Robert J. Meyers, *Is the 85-Percent Facts or for Taxing Social Security Benefits Perpetually Correct?* 58 Tax Notes 1545 (1993).

E. Tax Treatment of Individual Capital Gains and Losses

1. Adopt a uniform percentage deduction for capital gains in lieu of multiple tax rates

Present Law

In general, gain or loss reflected in the value of an asset is not recognized for income tax purposes until a taxpayer disposes of the asset. On the sale or exchange of a capital asset, any gain generally is included in income.[156] Any net capital gain of an individual is taxed at maximum rates lower than the rates applicable to ordinary income. Net capital gain is the excess of the net long-term capital gain for the taxable year over the net short-term capital loss for the year.[157] Gain or loss is treated as long-term if the asset is held for more than one year.[158]

Capital losses generally are deductible in full against capital gains. In addition, individual taxpayers may deduct capital losses against up to $3,000 of ordinary income in each year.[159] Any remaining unused capital losses of individuals may be carried forward indefinitely to another taxable year.[160]

A capital asset generally means any property except (1) inventory, stock in trade, or property held primarily for sale to customers in the ordinary course of the taxpayer's trade or business, (2) depreciable or real property used in the taxpayer's trade or business, (3) specified literary or artistic property, (4) business accounts or notes receivable, (5) certain U.S. publications, (6) certain commodity derivative financial instruments, (7) hedging transactions, and (8) business supplies.[161] In addition, the net gain from the disposition of certain property used in the taxpayer's trade or business is treated as long-term capital gain.[162] Gain from the disposition of depreciable personal property is not treated as capital gain to the extent of all previous depreciation allowances.[163] Gain from the disposition of depreciable real property is generally not treated as capital gain to the extent of the depreciation allowances in excess of the allowances that would have been available under the straight-line method of depreciation.[164]

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[156] Sec. 61(a)(3).

[157] Sec. 1222(11).

[158] Sec. 1222(1)-(4).

[159] Sec. 1211(b).

[160] Sec. 1212(b).

[161] Sec. 1221.

[162] Sec. 1231.

[163] Sec. 1245.

[164] Sec. 1250.

The maximum rate of tax on the adjusted net capital gain of an individual is 20 percent.[165] In addition, any adjusted net capital gain that otherwise would be taxed at a 15-percent rate is taxed at a 10-percent rate. These rates apply for purposes of both the regular tax and the alternative minimum tax.

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

The term "28-percent rate gain" means the amount of net gain attributable to long-term capital gains and losses from the sale or exchange of collectibles (as defined in section 408(m) without regard to paragraph (3) thereof)[166], an amount of gain equal to the amount of gain excluded from gross income under section 1202 (relating to certain small business stock),[167] the net short-term capital loss for the taxable year, and any long-term capital loss carryover to the taxable year.

"Unrecaptured section 1250 gain" means any long-term capital gain from the sale or exchange of section 1250 property (i.e., depreciable real estate) held more than one year to the extent of the gain that would have been treated as ordinary income if section 1250 applied to all depreciation, reduced by the net loss (if any) attributable to the items taken into account in computing 28-percent rate gain. The amount of unrecaptured section 1250 gain (before the reduction for the net loss) attributable to the disposition of property to which section 1231 applies shall not exceed the net section 1231 gain for the year.

The unrecaptured section 1250 gain is taxed at a maximum rate of 25 percent, and the 28-percent rate gain is taxed at a maximum rate of 28 percent. Any amount of unrecaptured section 1250 gain or 28-percent rate gain otherwise taxed at a 15-percent rate is taxed at the 15-percent rate.

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

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[165] Sec. 1(h).

[166] For this purpose, "collectible" means any work of art, any rug or antique, any metal or gem, any stamp or coin, any alcoholic beverage, or any other tangible property specified by the Secretary of the Treasury.

[167] This results in a maximum effective regular tax rate on qualified gain from small business stock of 14 percent.

Present law also provides for a 50-percent exclusion for certain stock in small businesses (60 percent if the small business is located in an enterprise zone);[168] and a 100-percent exclusion for certain stock and other property relating to the District of Columbia Enterprise Zone[169] and (with respect to acquisitions after 2001) relating to Renewal Communities.[170] These exclusions apply to property held more than five years.

Table 10., below, shows a breakdown of individual capital gain rates under present law for each individual marginal rate bracket and alternative minimum tax rate bracket.

Table 10.--Tax Rates Applicable Under Present Law to Capital Gains

	Regular Tax Rate Bracket					**Minimum Tax Rate Bracket**	
Category of gain	**15%**	**28%**	**31%**	**36%**	**39.6%**	**26%**	**28%**
Short-term capital gain[1]	15	28	31	36	39.6	26	28
Long-term capital gain[2]	10	20	20	20	20	Same as regular tax	
Section 1250 gain[3]	15	25	25	25	25	25	25
Collectible gain	15	28	28	28	28	26	28
Small business stock[4]	7.5	14	14	14	14	18.46[4]	19.88[6]
Small business stock for empowerment zone business[5]	6	11.2	11.2	11.2	11.2	14.768	15.904
5-year gain if acquired before 2001	8	20	20	20	20	Same as regular tax	
5-year gain if acquired after 2000	8	18	18	18	18	Same as regular tax	
D.C. Enterprise Zone stock and Renewal Community stock[6]	0	0	0	0	0	0	0

[1] Gain from assets held not more than one year.

[2] Gain from assets held more than one year not included in another category.

[3] Capital gain attributable to depreciation on section 1250 property (i.e., depreciable real estate).

[4] Effective rates after application of 50-percent exclusion for small business stock held more than five years.

[5] Effective rates after application of 50-percent exclusion for small business stock held more than five years.

[6] D.C Enterprise Zone stock issued after December 31, 1997, and before January 1, 2004, and Renewal Community stock issued after December 31, 2001, and before January 1, 2010. The stock must be held for more than five years.

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[168] Sec. 1202.

[169] Sec. 1400B.

[170] Sec. 1400F.

Legislative Background

Reduced tax rate for capital gains

Noncorporate capital gains were taxable at reduced rates from 1921 through 1987. The Revenue Act of 1921 ("1921 Act") provided for a maximum 12.5 percent tax on gain on property held for profit or investment for more than two years (excluding inventory or property held for personal use). Because of the relatively low tax rates on ordinary income during the 1920's and 1930's, this provision benefited only higher bracket taxpayers.

The system of capital gains taxation in effect prior to the Tax Reform Act of 1986 ("1986 Act") dated largely from the Revenue Act of 1942 ("1942 Act"). The 1942 Act provided for a 50-percent exclusion for noncorporate capital gains or losses on property held for more than six months. The 1942 Act also included alternative maximum rates on capital gains taxes for noncorporate and corporate taxpayers. The basic structure of the 1942 Act was retained under the Internal Revenue Code of 1954.

The Revenue Act of 1978 increased the exclusion for noncorporate long-term capital gains from 50 to 60 percent and repealed the alternative maximum rate. Together with concurrent changes in the noncorporate minimum tax, this had the effect of reducing the highest effective rate on noncorporate capital gains from approximately 49 percent[171] to 28 percent. The reduction in the maximum individual rate from 70 to 50 percent under the Economic Recovery Tax Act of 1981 reduced the maximum effective capital gains rate from 28 percent to 20 percent.

The 1986 Act repealed the provisions granting reduced rates for capital gains, fully effective beginning in 1988. The 1986 Act provided that the maximum rate on capital gains (i.e., 28 percent) would not be increased in the event the top individual rate was increased by a subsequent public law (unless that law specifically increased the capital gains tax). The Revenue Reconciliation Act of 1990 raised the maximum individual rate to 31 percent, and the Revenue Reconciliation Act of 1993 raised the top tax rate to 39.6 percent. Neither Act raised the maximum individual capital gains rate.

The current individual capital gains tax rate structure, described above, was enacted by the Taxpayer Relief Act of 1997 ("1997 Act") and was modified by the Internal Revenue Restructuring and Reform Act of 1998 ("IRS Reform Act").

The capital gain exclusion for small business stock was adopted in the Revenue Reconciliation Act of 1993, and the increased exclusion for enterprise zone business was adopted in the Community Renewal Tax Relief Act of 2000. The exclusion for D.C. Zone assets was adopted in the 1997 Act and the exclusion for Renewal Community assets was adopted in the Community Renewal Tax Relief Act of 2000.

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[171] The 49-percent rate resulted in certain cases where the taxpayer was subject to the individual "add-on" minimum and the maximum tax "earned income" limitation.

Holding period

Under the 1921 Act, the alternative maximum rate for capital gains applied to property held for more than two years. Since that time, Congress has, on several occasions, adjusted the holding period required for reduced capital gains taxation.

The Revenue Act of 1934 ("1934 Act") provided for exclusion of varying percentages of capital gains and losses depending upon the period for which an asset was held. Under that Act, 20 percent of capital gains was excludible if an asset was held for one to two years, 40 percent if an asset was held for two to five years, and 60 percent if the asset was held for between five and 10 years. Where an asset had been held for more than 10 years, 70 percent of capital gains was excluded.

The Revenue Act of 1938 ("1938 Act") provided for two classes of long-term capital gains. For assets held for 18 months to two years, a 33-percent exclusion was allowed. If assets were held for more than two years, a 50-percent exclusion was provided. No exclusion was allowed for assets held for 18 months or less. The 1938 Act also provided alternative ceiling rates applicable to the same holding periods as the capital gains exclusions.

The 1942 Act eliminated the intermediate holding period for capital gains purposes. The 1942 Act provided for two categories of capital assets: assets held for more than six months (long-term capital assets), for which a 50-percent exclusion was allowed; and assets held for six months or less (short-term capital assets), for which no exclusion was provided. The alternative tax rates on individual and corporate net capital gains (i.e., the excess of net long-term capital gains over short-term capital losses) were based upon the same six-month holding period.

A six-month holding period for long-term capital gains treatment remained in effect from 1942 through 1976. The Tax Reform Act of 1976 increased the holding period to nine months for 1977 and to one year for 1978 and all subsequent years. The Deficit Reduction Act of 1984 reduced the holding period to six months for property acquired after June 22, 1984 and before 1988. After 1988, the holding period has been one year. The 1997 Act provided for 5-year holding period beginning in the years 2001 and 2006, depending on the rate bracket of the individual taxpayer. The 1997 Act also provided a higher rate for assets held less than 18 months. That provision was repealed by the IRS Reform Act.

Treatment of gain and loss on depreciable assets and land used in trade or business

Depreciable property used in a trade or business was excluded from the definition of a capital asset by the 1938 Act, principally because of the limitation on deductibility of losses imposed by the 1934 Act. This step was motivated in part by the desire to remove possible tax deterrents to the replacement of antiquated or obsolete assets such as equipment, where depreciation would be fully deductible against ordinary income if the asset was retained, but lo ss would be subject to the capital loss limitations if the asset was sold.

The availability of capital gain treatment for gains from sales of depreciable assets stems from the implementation of excess profits taxes during World War II. Many depreciable assets, including manufacturing plants and transportation equipment, had appreciated substantially in value when they became subject to condemnation or requisition for military use. Congress

determined that it was unfair to tax the entire appreciation at the high rates applicable to wartime profits. Accordingly, in the 1942 Act, gains from wartime involuntary conversions were taxed as capital gains. The provision was extended to voluntary dispositions of assets because it was not practical to distinguish condemnations and involuntary dispositions from sales forced upon taxpayers by the implicit threat of condemnation or wartime shortages and restrictions.

The 1938 Act did not exclude land used in a trade or business from the capital asset definition. Because basis would have to be allocated between land and other property for purposes of depreciation in any event, the differing treatment of land used in a trade or business and depreciable property used in a trade or business was not viewed as creating serious allocation difficulties.

However, in the 1942 Act, Congress excluded land used in a trade or business from the definition of a capital asset and extended to such property the same special capital gain/ordinary loss treatment afforded to depreciable trade or business property.

The Revenue Act of 1962 required that depreciation on section 1245 property (generally, personal property) be recaptured as ordinary income on the disposition of the property. The Revenue Act of 1964 required that a portion of the accelerated depreciation on section 1250 property (generally, real property) be recaptured as ordinary income. Subsequent amendments have required that the entire amount of accelerated depreciation on section 1250 property be recaptured as ordinary income. However, any depreciation taken to the extent allowable under the straight-line method generally is not recaptured as ordinary income, but rather creates capital gain.

Sources of Complexity

Table 10., above, shows that 17 different rates of tax may apply to capital gain income. These different rates increase the complexity of the capital gain provisions for individual taxpayers. Individuals with net capital gain compute their tax liability by completing a 36-line tax computation on Schedule D of Form 1040 (or, if all the capital gain consists of capital gain distributions, a 15-line capital gain worksheet).[172] For taxable years beginning after 2000, additional lines will be needed to take into account five-year gains.

[172] Schedule D follows this Section II.E.

The next page is page 106

Recommendation for Simplification

The Joint Committee staff recommends that the current rate system for capital gains should be replaced with a deduction equal to a fixed percentage of the net capital gain. The deduction would be available to individuals whether itemized deductions or the standard deduction is claimed.

The proposal would replace the current 36-line tax computation with a simple one-line deduction equal to a fixed percentage of the net capital gain.[173] This would greatly reduce computational complexity. The recommendation would not change the exclusions for small business stock, D. C. Enterprise Zone stock, or Renewal Community stock.[174]

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[173] The deduction would be limited to the fixed percentage of the individual's taxable income determined without regard to this deduction.

[174] Thus, the recommendation would reinstate a deduction similar to the capital gain deduction in effect prior the 1986 Act.

SCHEDULE D (Form 1040)

Department of the Treasury
Internal Revenue Service (99)

Capital Gains and Losses

▶ Attach to Form 1040. ▶ See Instructions for Schedule D (Form 1040).

▶ Use Schedule D-1 for more space to list transactions for lines 1 and 8.

OMB No. 1545-0074

2000

Attachment Sequence No. **12**

Name(s) shown on Form 1040

Your social security number

Part I Short-Term Capital Gains and Losses—Assets Held One Year or Less

	(a) Description of property (Example: 100 sh. XYZ Co.)	(b) Date acquired (Mo., day, yr.)	(c) Date sold (Mo., day, yr.)	(d) Sales price (see page D-6)	(e) Cost or other basis (see page D-6)	(f) Gain or (loss) Subtract (e) from (d)
1						

2	Enter your short-term totals, if any, from Schedule D-1, line 2	2	
3	**Total short-term sales price amounts.** Add column (d) of lines 1 and 2	3	
4	Short-term gain from Form 6252 and short-term gain or (loss) from Forms 4684, 6781, and 8824	4	
5	Net short-term gain or (loss) from partnerships, S corporations, estates, and trusts from Schedule(s) K-1	5	
6	Short-term capital loss carryover. Enter the amount, if any, from line 8 of your 1999 Capital Loss Carryover Worksheet	6	( )
7	**Net short-term capital gain or (loss).** Combine column (f) of lines 1 through 6 ▶	7	

Part II Long-Term Capital Gains and Losses—Assets Held More Than One Year

	(a) Description of property (Example: 100 sh. XYZ Co.)	(b) Date acquired (Mo., day, yr.)	(c) Date sold (Mo., day, yr.)	(d) Sales price (see page D-6)	(e) Cost or other basis (see page D-6)	(f) Gain or (loss) Subtract (e) from (d)	(g) 28% rate gain or (loss) * (see instr. below)
8							

9	Enter your long-term totals, if any, from Schedule D-1, line 9	9	
10	**Total long-term sales price amounts.** Add column (d) of lines 8 and 9	10	
11	Gain from Form 4797, Part I; long-term gain from Forms 2439 and 6252; and long-term gain or (loss) from Forms 4684, 6781, and 8824	11	
12	Net long-term gain or (loss) from partnerships, S corporations, estates, and trusts from Schedule(s) K-1	12	
13	Capital gain distributions. See page D-1	13	
14	Long-term capital loss carryover. Enter in both columns (f) and (g) the amount, if any, from line 13 of your 1999 Capital Loss Carryover Worksheet	14	( ) ( )
15	Combine column (g) of lines 8 through 14	15	
16	**Net long-term capital gain or (loss).** Combine column (f) of lines 8 through 14 ▶ **Next:** Go to Part III on the back.	16	

* **28% rate gain or loss** includes **all** "collectibles gains and losses" (as defined on page D-6) and up to 50% of the eligible gain on qualified small business stock (see page D-4).

Part III Summary of Parts I and II

17	Combine lines 7 and 16. If a loss, go to line 18. If a gain, enter the gain on Form 1040, line 13 **Next:** Complete Form 1040 through line 39. Then, go to **Part IV** to figure your tax if: • Both lines 16 and 17 are gains **and** • Form 1040, line 39, is more than zero. Otherwise, **stop here.**	17	
18	If line 17 is a loss, enter here and as a (loss) on Form 1040, line 13, the **smaller** of these losses: • The loss on line 17 **or** • ($3,000) or, if married filing separately, ($1,500) **Next:** Skip **Part IV** below. Instead, complete Form 1040 through line 37. Then, complete the **Capital Loss Carryover Worksheet** on page D-6 if: • The loss on line 17 exceeds the loss on line 18 **or** • Form 1040, line 37, is a loss.	18	( )

Part IV Tax Computation Using Maximum Capital Gains Rates

19	Enter your taxable income from Form 1040, line 39			19	
20	Enter the **smaller** of line 16 or line 17 of Schedule D	20			
21	If you are filing Form 4952, enter the amount from Form 4952, line 4e	21			
22	Subtract line 21 from line 20. If zero or less, enter -0-	22			
23	Combine lines 7 and 15. If zero or less, enter -0-	23			
24	Enter the **smaller** of line 15 or line 23, but not less than zero	24			
25	Enter your unrecaptured section 1250 gain, if any, from line 17 of the worksheet on page D-8	25			
26	Add lines 24 and 25	26			
27	Subtract line 26 from line 22. If zero or less, enter -0-			27	
28	Subtract line 27 from line 19. If zero or less, enter -0-			28	
29	Enter the **smaller** of: • The amount on line 19 **or** • $26,250 if single; $43,850 if married filing jointly or qualifying widow(er); $21,925 if married filing separately; or $35,150 if head of household			29	
30	Enter the **smaller** of line 28 or line 29	30			
31	Subtract line 22 from line 19. If zero or less, enter -0-	31			
32	Enter the **larger** of line 30 or line 31 ▶	32			
33	Figure the tax on the amount on line 32. Use the Tax Table or Tax Rate Schedules, whichever applies			33	
	Note. If the amounts on lines 29 and 30 are the same, skip lines 34 through 37 and go to line 38.				
34	Enter the amount from line 29	34			
35	Enter the amount from line 30	35			
36	Subtract line 35 from line 34 ▶	36			
37	Multiply line 36 by 10% (.10)			37	
	Note. If the amounts on lines 19 and 29 are the same, skip lines 38 through 51 and go to line 52.				
38	Enter the **smaller** of line 19 or line 27	38			
39	Enter the amount from line 36	39			
40	Subtract line 39 from line 38 ▶	40			
41	Multiply line 40 by 20% (.20)			41	
	Note. If line 26 is zero or blank, skip lines 42 through 51 and go to line 52.				
42	Enter the **smaller** of line 22 or line 25	42			
43	Add lines 22 and 32	43			
44	Enter the amount from line 19	44			
45	Subtract line 44 from line 43. If zero or less, enter -0-	45			
46	Subtract line 45 from line 42. If zero or less, enter -0- ▶	46			
47	Multiply line 46 by 25% (.25)			47	
	Note. If line 24 is zero or blank, skip lines 48 through 51 and go to line 52.				
48	Enter the amount from line 19	48			
49	Add lines 32, 36, 40, and 46	49			
50	Subtract line 49 from line 48	50			
51	Multiply line 50 by 28% (.28)			51	
52	Add lines 33, 37, 41, 47, and 51			52	
53	Figure the tax on the amount on line 19. Use the Tax Table or Tax Rate Schedules, whichever applies			53	
54	**Tax on all taxable income (including capital gains).** Enter the **smaller** of line 52 or line 53 here and on Form 1040, line 40.			54	

2. Conform definition of "small business" for capital gain and loss provisions

Present Law

Gains on certain small business stock

Under section 1202 an individual may claim a 50-percent exclusion for gain from the sale of stock in certain small business corporations that was acquired at original issuance and was held for more than five years. For this purpose a qualified "small business" is a corporation that at the time of the issuance of the stock had aggregate gross assets of not more than $50 million. In addition, to constitute qualified stock, the corporation must be engaged in the active conduct of a qualified trade or business. Stock in certain businesses does not qualify for the exclusion: professional services; financial services; athletics; banking; insurance; investing; financing; leasing; farming; mineral extraction; hotels; and restaurants. An exception to the active trade or business requirement is provided for certain "specialized small business investment companies."[175] Forty-two percent of the excluded gain is a minimum tax preference.[176] The amount of gain eligible for the 50-percent exclusion is limited to the greater of (1) 10 times the taxpayer's basis in the stock or (2) $10 million gain from stock in that corporation (sec. 1202).

Losses on small business stock

An individual may treat as an ordinary loss up to $50,000 ($100,000 in the case of a joint return) on the loss from the disposition of small business corporation stock originally issued to the individual (or to a partnership having the individual as a partner).[177] For this purpose, a "small business" corporation is a corporation engaged in the active conduct of a trade or business whose equity capital does not exceed $1,000,000. In addition, during any of the five years preceding the loss, the business may have less than 50 percent of gross receipts from sources such as interest, dividends, rents, and royalties.

Losses on small business investment company stock

A loss on stock in any small business investment company[178] is treated as an ordinary loss, regardless of the size of the small business investment company (sec. 1242).

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[175] A "specialized small business investment company" is a corporation licensed to operate under section 301(d) of the Small Business Investment Act of 1958 as in effect on May 13, 1993.

[176] The Joint Committee staff recommends eliminating the alternative minimum tax. *See* Section I.A. of this Part.

[177] Sec. 1244, which was added to the Code in 1958. At that time, ordinary loss was permitted for $25,000 ($50,000 for joint returns). This amount was increased to $50,000 ($100,000 for joint returns) in 1978.

[178] A "small business investment company" is a corporation operating under the Small Business Investment Act of 1958.

Sources of Complexity

The different definitions of small business for the special gain and loss rules can create taxpayer confusion and uncertainty as to whether an investment qualifies for the special rules.

Recommendation for Simplification

The Joint Committee staff recommends that, for purposes of ordinary loss treatment under sections 1242 and 1244, the definition of "small business" should be conformed to the definition of "small business" under section 1202, regardless of the date of issuance of the stock.

The proposal would reduce complexity by providing the same definition of small business for purposes of the special rules for ordinary loss with respect to certain investments in small businesses. This would have the effect of expanding the $50,000 ($100,000 for joint returns) loss offset against ordinary income to the disposition of all stock that qualifies as small business stock under section 1202. The proposal would eliminate the special rule for small business investment companies (under section 1242), which would be covered by the proposed expansion of section 1244.

F. Two-Percent Floor On Miscellaneous Itemized Deductions

Present Law

Legislative background of the two-percent floor

In 1982, miscellaneous itemized deductions were disallowed for purposes of the individual alternative minimum tax.

A one-percent floor on miscellaneous itemized deductions was first advanced by the Treasury Department in 1984.[179] The floor was also contained in President Reagan's tax reform proposals in 1985.[180] President Reagan's proposal would have applied to employee business expenses (other than those reimbursed by an employer), miscellaneous itemized deductions, and State and local taxes (other than income taxes) incurred in carrying on an income-producing activity. Under the President's proposal, these deductions would have been allowed against gross income (i.e., above-the-line deductions), subject to a one-percent floor. The proposal was justified on the following basis: "disallowance of a deduction for a normal level of employee business expenses and miscellaneous itemized deductions would simplify recordkeeping, reduce taxpayer errors and ease administrative burdens for the Internal Revenue Service while still providing fair treatment for taxpayers who incur an unusually high level of such expenses."[181] Furthermore, the President's proposal noted that, in 1982, 50 percent of all taxpayers who itemized deductions claimed miscellaneous itemized deductions of less than one-half of one percent of their AGI and 93 percent of taxpayers claimed miscellaneous itemized deductions of less than 5 percent of AGI.

The Tax Reform Act of 1986 (the "1986 Act") added the two-percent floor on miscellaneous itemized deductions for regular tax purposes. Unlike the President's proposal, the floor applied only to miscellaneous itemized deductions, rather than to all miscellaneous deductions, whether itemized or above the line. The legislative history for the 1986 Act stated that the Congress concluded that the prior-law treatment of employee business expenses, investment expenses, and other miscellaneous itemized deductions had fostered significant complexity because taxpayers were required to keep extensive records for what were commonly small expenditures.[182] The legislative history also pointed out that the small amounts typically involved in the two-percent floor presented significant administrative problems for the IRS and that these problems were exacerbated because taxpayers commonly made errors of law with respect to the expenses that were deductible. The legislative history stated that the two-percent

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[179] *Tax Reform for Fairness, Simplicity, and Economic Growth*, Volume 2, General Explanation of the Treasury Department Proposals (November 1984).

[180] *The President's Tax Proposals to the Congress for Fairness, Growth, and Simplicity* (May 1985).

[181] *The President's Tax Proposals to the Congress for Fairness, Growth, and Simplicity* (May 1985), 105.

[182] H. Rep. 99-426 (December 7, 1985), at 109.

floor would relieve taxpayers of the burden of recordkeeping unless they expected to incur expenses in excess of the floor.

The legislative history for the 1986 Act also concluded that the two-percent floor was appropriate because some miscellaneous expenses were sufficiently personal in nature that they might be incurred apart from any business or investment activities of a taxpayer.

Itemized deductions

Under present law, an individual taxpayer may claim a standard deduction, the amount of which depends upon the taxpayer's filing status. The standard deduction is subtracted from adjusted gross income. In lieu of claiming the applicable standard deduction, an individual who has significant deductible expenses may elect to itemize deductions. The deductions that may be itemized include: charitable contributions; home mortgage interest; State and local income, real property, and certain personal property taxes; medical expenses (in excess of 7.5 percent of adjusted gross income); certain investment interest expenses; nonbusiness casualty and theft losses; gambling losses; and certain miscellaneous expenses.

Above-the-line deductions

In addition to either the standard deduction or itemized deductions, certain expenses of individual taxpayers are deductible in determining adjusted gross income (i.e., they are deductible as "above-the-line" expenses). These expenses include (1) the expenses attributable to a trade or business carried on by the taxpayer, other than a trade or business that consists of performing services as an employee; (2) reimbursed employee business expenses; (3) employee business expenses of performing artists meeting certain requirements; (4) certain expenses of State and local employees compensated on a fee basis; (5) losses from the sale or exchange of property; (6) deductions attributable to rents and royalties; (7) certain deductions of life tenants and income beneficiaries of property; (8) contributions to pension, profit-sharing, and annuity plans of self-employed individuals; (9) contributions to traditional Individual Retirement Arrangements; (10) penalties forfeited because of premature withdrawal of funds from time savings accounts or deposits; (11) alimony payments; (12) reforestation expenses; (13) certain required repayments of supplemental unemployment compensation benefits; (14) jury duty pay remitted to an employer; (15) deduction for clean-fuel vehicles and certain refueling property; (16) moving expenses; (17) contributions to Archer Medical Savings Accounts; and (18) interest on education loans.

Individuals (such as self-employed individuals) engaged in a trade or business (other than the trade or business of being an employee) are entitled to an above-the-line deduction for their ordinary and necessary business expenses.

Two-percent floor

In general

An individual may claim an itemized deduction for certain miscellaneous expenses only to the extent of such expenses in excess of two percent of the taxpayer's adjusted gross

income.[183] Miscellaneous expenses subject to the two-percent floor include certain unreimbursed employee business expenses[184] and expenses for the production or collection of income, for the management, conservation, or maintenance of property held for the production of income, and in connection with the determination, collection, or refund or any tax[185].

To be deductible, an unreimbursed employee business expense must be: (1) paid or incurred during the taxable year; (2) for carrying on the trade or business of being an employee; and (3) an ordinary and necessary business expense. Thus, unreimbursed employee business expenses are those expenses that would be deductible above the line if the employee were engaged in a trade or business (other than the trade or business of being an employee). Generally, the two-percent floor applies to unreimbursed employee business expenses after any other deduction limit (such as the 50-percent limit on expenses for business-related meals and entertainment). Unreimbursed employee expenses include such expenses as certain business and professional dues, uniform costs, home office deductions, business bad debts of an employee, employment related education expenses, licenses and regulatory fees, malpractice insurance premiums, medical examinations required by an employer, occupational taxes, publications and subscriptions, job search, employment and outplacement agency fees, and union dues and expenses.

The two-percent floor does not apply to the following itemized deductions: (1) otherwise deductible interest (sec. 163); (2) State and local income, real property, and certain personal property taxes (sec. 164); (3) casualty and theft losses (sec. 165(a)); (4) gambling losses to the extent of gambling winnings (sec. 165(d)); (5) charitable contributions (sec. 170); (6) medical expenses (sec. 213); (7) impairment-related work expenses of a disabled individual (sec. 67(d)); (8) the estate tax on income in respect to a decedent (sec. 691(c)); (9) any deduction allowable in connection with personal property used in a short sale; (10) certain adjustments occurring when a taxpayer restores amounts held under a claim of right (sec. 1341); (11) amortizable bond premium (sec. 171); (12) certain terminated annuity payments (sec. 72(b)(3)); and (13) deductions in connection with cooperative housing corporations (sec. 216).[186] The two-percent floor does not apply to deductions allowable to estates or trusts under sections 642(c), 651, and 661.

Issues relating to the application of the two-percent floor have led to litigation in two areas: attorneys' fees and expenses for investment advice for trusts and estates.

Attorneys' fees

Individuals may seek to recover damages for a variety of injuries. Damages (other than punitive damages) for physical injuries are generally excluded from income and expenses

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[183] Sec. 67.

[184] Sec. 162.

[185] Sec. 212.

[186] Sec. 67(b).

relating to the excluded income are not deductible[187]; other damages are generally included in income and related expenses to recover the damages are generally deductible.

In many of these disputes, the claimant will engage an attorney to represent the claimant on a contingent fee basis: that is, if the claimant recovers damages, a prearranged percentage of the damages will be paid to the attorney; if no damages are recovered, the attorney is not paid a fee. In some of these disputes, the attorney is paid instead on an hourly or flat-fee basis.

There has been a significant amount of litigation in recent years over the proper tax treatment of these arrangements. Some courts[188] have held that the entire amount of damages is income and the claimant is entitled to a miscellaneous itemized deduction subject to both the two-percent floor as an expense for the production of income for the portion paid to the attorney[189] and to the overall limitation on itemized deductions that applies above specified income levels.[190] In addition, because such amounts are not deductible for purposes of the alternative minimum tax, some taxpayers may be subject to tax at very high effective rates on their recoveries. Other courts have held that the portion of the recovery that is paid directly to the attorney is not income to the claimant, holding that the claimant has no claim of right to that portion of the recovery.[191]

Expenses for investment advice

For individuals, investment advice fees generally may be taken as a miscellaneous itemized deduction, subject to the two-percent floor. Such expenses are not allowable in calculating adjusted gross income for individuals.

Estates and trusts calculate their adjusted gross income in the same manner as individuals, however the following deductions are allowable in calculating adjusted gross income and are not subject to the two-percent floor: (1) the deductions for costs which are paid or incurred in connection with the administration of the estate or trust and which would not have

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[187] Secs. 104(a) and 265(a)(1).

[188] *Kenseth v. Commissioner*, 114 T.C. 399 (2000); *Coady v. Commissioner*, 213 F.3d 1187 (9th Cir. 2000); *Baylin v. United States*, 43 F.3d 1451 (Fed. Cir. 1995); *Benci-Woodward v. Commissioner*, 219 F.3d 941 (9th Cir. 2000).

[189] Sec. 67.

[190] Sec. 68.

[191] *Cotnam v. Commissioner*, 263 F.2nd 119 (5th Cir. 1959); *Foster v. United States*, 106 F. Supp. 2nd 1234 (N.D. Ala. 2000); *Estate of Arthur Clarks v. United States*, 202 F.3d 854 (6th Cir. 2000); *Srivastava v. Commissioner*, 220 F.3d 353 (5th Cir. 2000). In some of these cases, such as *Cotnam*, State law has been an important consideration in determining that the claimant has no claim of right to the recovery.

been incurred if the property were not held in such trust or estate, and (2) the personal exemptions of section 642(b) and distribution deductions of sections 651 and 661.[192]

A trustee is charged with exercising prudence and due care in carrying out his or her duties.[193] These duties include using reasonable care and skill to preserve the trust property,[194] while ensuring that the property is productive.[195] Indeed, the duty to preserve trust property can conflict with the duty to make trust property productive. For instance, the duty to preserve trust property requires investing with little risk, in order to preserve trust assets. Making assets productive, however, requires investing with some degree of risk, to ensure a reasonable return.[196] Indeed, many states have enacted a "prudent investor" rule, which places the trustee under a duty to invest and manage funds as a prudent investor would.[197]

Often, a trustee is not skilled in financial and investment matters, and may find it necessary to obtain expert assistance in fulfilling these duties. For example, a trustee may find it necessary to seek outside financial and investment advice. Thus, a trust may incur fees related to such advice.

The proper tax treatment of fees paid by a trust to investment advisors is unclear under present law. It can be argued that such expenses would not have been incurred if the property were not held in a trust or estate, and, thus, are allowable in calculating adjusted gross income. Conversely, it also can be asserted that such expenses are routine and would have been incurred regardless of whether the property were held in trust (i.e., if held by an individual) and, therefore, are subject to the two-percent floor.

In *O'Neill v. Commissioner*,[198] the U.S. Tax Court held that investment advisory fees paid by a trust are miscellaneous itemized deductions subject to the two-percent floor. In reaching its conclusion, the court ruled that "only those costs which are *unique* to the administration of an estate or trust are to be deducted from gross income without being subject to the 2-percent floor on itemized deductions set forth in section 67(a)."[199] Having found that individuals, like trusts, "routinely incur costs for investment advice as an integral part of their

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[192] Sec. 67(e).

[193] Restatement (Second) Trusts, sec. 174.

[194] Restatement (Second) Trusts, sec. 176.

[195] Restatement (Second) Trusts, sec. 181.

[196] *See* William P. Martin, II, *O'Neill v. Commissioner: Misplaced Trust,* 22 N. Ky. L. Rev. 841 (1995) at 843-844.

[197] Restatement (Third) Trusts, sec. 227 cmt. a.

[198] 98 T.C. 227 (1992).

[199] *Id.* at 230 (emphasis in original).

investment activities," the court ruled that fees paid by a trust for investment advice are not unique to the administration of a trust. Thus, such costs would not be costs that are "paid or incurred in connection with the administration of the estate or trust and which would not have been incurred if the property were not held in such trust or estate."[200] The taxpayer in *O'Neill* further argued that no trustee fees were paid to the co-trustees during the relevant periods, but if such fees were paid, they would be allowable in arriving at adjusted gross income. The court declined to hypothesize and, instead, ruled strictly on the facts of the case. Consequently, the deduction for investment fees was held subject to the two-percent floor.

The U.S. Court of Appeals for the Sixth Circuit, however, reversed the Tax Court.[201] The court of appeals found that certain expenses, such as trustee fees, costs of construction proceedings, and judicial accountings are "examples of expenses peculiar to a trust" and are therefore allowable in arriving at adjusted gross income. Moreover, the court of appeals noted that, had the investment expenses in *O'Neill* been paid to a trustee, such costs undoubtedly would have been peculiar to a trust and, thus, allowable in arriving at adjusted gross income. As the touchstone of its ruling, the court of appeals stressed that "[a] trustee is charged with the responsibility to invest and manage trust assets as a 'prudent investor' would manage his own assets." "If a trustee lacks experience in investment matters," the court found, "professional assistance may be warranted." Indeed, the court went further to observe that trust fiduciaries, occupying a position of trust on behalf of others, have an obligation to exercise skill and due care with respect to trust assets. Thus, the court of appeals held that investment expenses would not have been incurred if the property had not been held in trust, and were thus allowable in arriving at adjusted gross income.

The IRS declined to acquiesce to the court of appeal's ruling, noting that the Tax Court held that trust expenses are allowable in arriving at adjusted gross income only if they "are unique to the administration of an estate or trust."[202] Finding that "[f]ees for investment advice such as those at issue [in *O'Neill,*] are routinely incurred by individual investors," the IRS will continue to assert, outside the sixth circuit, that investment advice expenses are not peculiar to a trust and are, therefore, subject to the two-percent floor.[203]

In *O'Neill,* the court of appeals observed that the trustee in that case was held to the "prudent investor" standard, which required a degree of care and skill in investing on behalf of the trust.[204]

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[200] *Id.;* sec. 67(e)(1).

[201] *O'Neill v. Commissioner,* 994 F.2d 302 (6th Cir. 1993).

[202] AOD CC-1994-06.

[203] Although the IRS disagrees with the decision of the Court of Appeals for the Sixth Circuit, no petition for certiorari was filed because there is no intercircuit conflict. *Id.*

[204] See Ohio Rev. Code Ann. secs. 2109.37, 2109.371, and 2109.372 as cited in *O'Neill.*

Sources of Complexity

In general

The two-percent floor has (1) placed additional pressure on the distinction between employee and independent contractor status, because of the differing treatment of miscellaneous business expenses, (2) resulted in extensive litigation with respect to specific issues, (3) resulted in inconsistent treatment with respect to similar items of expense (such as donations by teachers of supplies to their schools), and (4) created pressure to enact above-the-line deductions that are not subject to the two-percent floor.

Employee vs. independent contractor

The two-percent floor has placed pressure on the distinction between an employee and an independent contractor. This pressure occurs because independent contractors can deduct as ordinary and necessary business expenses items that would be subject to the two-percent floor if they were paid by an employee. Thus, the two-percent floor creates an incentive for individuals to take the position that they are independent contractors for Federal tax purposes.

The facts and circumstances test to determine whether an individual is an employee is one of the most difficult issues under the Federal tax system. Since 1978, the IRS has been prohibited from issuing any formal guidance on the definition of an employee for Federal tax purposes.[205] Disputes between the IRS and taxpayers on this issue are often litigated. Thus, any provision that creates a distinction between the treatment of employees and independent contractors contributes to complexity of the Federal tax system.

Litigation

Attorneys' fees

There has been a significant amount of litigation in recent years over the proper tax treatment of attorneys' fees (i.e., whether attorneys' fees should be includible in income and deductible as a miscellaneous itemized deduction or should be excluded from income). The courts have reached very different results leading to substantial economic difference in the treatment of claimants. Claimants not allowed to exclude attorneys' fees from income do not receive a full deduction for payment of the fees because of the two-percent floor (and the operation of the individual alternative minimum tax). To avoid such an inequitable result, some courts have reached results that appear to be inconsistent with the applicable law.

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[205] This moratorium on the issuance of Treasury regulations and revenue rulings was contained in section 530 of the Revenue Act of 1978 (Pub. Law No. 95-600). Section 530 was initially scheduled to terminate at the end of 1979, but was temporarily extended twice and then permanently extended by the Tax Equity and Fiscal Responsibility Act of 1982 (Pub. Law No. 97-248).

Expenses for investment advice

The two-percent floor has the effect of increasing complexity with respect to the treatment of expenses for investment advice paid by a trust. The proper tax treatment of fees paid by a trust to investment advisors is unclear under present law. It can be argued that such expenses would not have been incurred if the property were not held in a trust or estate, and, thus, should be allowable in calculating adjusted gross income. Conversely, it can be asserted that such expenses would have been incurred regardless of whether the property was held in trust (i.e., if held by an individual) and, thus, are not unique to a trust and are subject to the two-percent floor. Because there is a significant difference in the tax treatment depending upon whether trust investment advice is deductible as an above-the-line deduction or as a miscellaneous itemized deduction, the two-percent floor places additional pressure on taxpayers to argue that these expenses are deductible above the line.

Inconsistent treatment of similar items of expense

The two-percent floor has created additional complexities by treating similar items of expenses differently. Consider the example of a teacher who purchases and donates supplies to a school. If the teacher donates supplies to the school with no expectation that the supplies will be available to that particular teacher in his or her classroom, then the supplies may constitute a charitable contribution that is fully deductible (subject to certain percentage of income limitations) under section 170. There is a question whether donated supplies that a teacher uses in his or her classroom constitutes a quid pro quo contribution for charitable deduction purposes.

On the other hand, if the teacher purchases supplies for use solely by the teacher in his or her classroom, then the cost of the supplies are miscellaneous itemized deductions subject to the two-percent floor.

Pressure to enact above-the-line deductions

As the Congress has become more aware of the inequities created by the two-percent floor, there has been more pressure to enact above-the-line deductions, rather than itemized deductions. This pressure occurs, at least in part, because the two-percent floor acts to deny many taxpayers the benefit of a deduction. As taxpayers bring to the attention of the Congress the inequity of disallowing deductions for legitimate expenses, Members of Congress have introduced legislation to redress these inequities by making expenses deductible above the line, rather than as miscellaneous itemized deductions. The addition of more above-the-line deductions increases complexity for individual taxpayers who must determine whether any particular expense is deductible above the line or as an itemized deduction.

Recommendation for Simplification

The Joint Committee staff recommends that the two-percent floor on miscellaneous itemized deductions should be eliminated.

Effects of the two-percent floor

The two-percent floor under miscellaneous itemized deductions was enacted in the 1986 Act to (1) reduce the complexity for individual taxpayers of extensive recordkeeping with respect to what commonly were small expenditures, (2) ease the administrative and enforcement burdens on the IRS to monitor compliance with the rules relating to miscellaneous itemized deductions, and (3) reduce the number of errors of law made by taxpayers in claiming improperly miscellaneous itemized deductions on their tax returns.

It can be argued that the two-percent floor did not reduce overall complexity of the Federal tax system, but rather shifted complexity to other issues relating to miscellaneous itemized deductions. The two-percent floor has shifted complexity by (1) creating pressure for individuals to claim to be independent contractors rather than employees; (2) encouraging litigation over the proper treatment of attorney's fees and leading courts to struggle to reach results that do not treatment taxpayers inequitably; and (3) increasing pressure to enact above-the-line deductions or create exceptions to the two-percent floor. In short, the Joint Committee staff believes that the two-percent floor contributes to complexity with respect to the treatment of miscellaneous itemized deductions and reaches a result that is inconsistent with the basic principle that individuals should be entitled to deduct their ordinary and necessary business expenses.

In addition, the two-percent floor adds complexity because it creates a separate category of deductions requiring taxpayers to make a determination of whether any specific expense is subject to the floor. Indeed, as is discussed below, the two-percent floor appears not to have reduced recordkeeping by taxpayers because of the uncertainty over whether any particular expense will be deductible or not and whether it will be subject to the two-percent floor or not.

Because it does not appear that the two-percent floor has achieved the intended goal of simplification for individuals, the Joint Committee staff believes it is appropriate to recommend that the two-percent floor should be eliminated. The Joint Committee staff believes that the complexity added by the two-percent floor is a direct result of the operation of the two-percent floor to deny deductions for legitimate expenses of individual taxpayers. As discussed above, for example, courts have struggled to reach an equitable result for individual taxpayers faced with the denial of a deduction for attorney's fees. The courts have found it unacceptable that the two-percent floor has the effect of requiring an individual to pay tax on income the individual did not receive. Indeed, in the case of some individuals winning a large award or settlement in a legal action, the combined effect of the individual alternative minimum tax and the two-percent floor could result in the Federal tax liability of an individual nearly equaling the individual's share of the award or settlement.

The two-percent floor operates to treat similarly situated taxpayers differently. As a result, the two-percent floor creates inequities within the Federal tax system and contributes to perceptions of unfairness by individual taxpayers. An individual taxpayer engaged in a trade or business as a sole proprietor may claim a deduction for expenses that the same individual could not deduct as an employee. Given that the two-percent floor has the effect of creating complexity due to this disparity of treatment of similarly situated taxpayers, the Joint Committee staff finds it appropriate to recommend that the two-percent floor should be eliminated.

Two-percent floor as a compliance tool

It has been argued that the two-percent floor under miscellaneous itemized deductions has accomplished certain of the goals articulated in the 1986 Act legislative history. For example, the two-percent floor has the effect of eliminating for many taxpayers the deduction for small items, such as bar association dues, newspaper and journal subscriptions, and other similar items. By eliminating these deductions, the 1986 Act reduced the administrative burden on the IRS to try to monitor compliance with small deductions. Indeed, the 1986 Act legislative history suggested that a reason for the two-percent floor was that taxpayers were improperly claiming certain expenses as miscellaneous itemized deductions. Thus, the two-percent floor can be viewed as a compliance tool for the IRS.

The Joint Committee staff considered whether the two-percent floor should be lowered to one percent or one-half of one percent. However, the arguments made with respect to small miscellaneous deductions of individuals who are employees applies equally to the small miscellaneous deductions of individual taxpayers with trade or business income. There is no reason to believe that an individual who is an employee is more likely to claim improper deductions than an individual with trade or business income. Thus, the Joint Committee staff believes that, although a lower floor under miscellaneous itemized deductions would take some of the pressure off of issues such as attorneys' fees, such a lowering of the floor would still perpetuate the disparity of treatment between employees and individuals with trade or business income. This disparity would perpetuate confusion about deductibility of business expenses and the perception of unfairness caused by the inequitable treatment of employees compared to individuals with trade or business expenses.

Recordkeeping burdens

The 1986 Act legislative history also stated that the two-percent floor would relieve taxpayers of the burdens of recordkeeping with respect to small miscellaneous expenses. However, taxpayers who are uncertain whether their miscellaneous deductions will exceed the two-percent floor still must keep records in case they may be entitled to claim a portion of their deductions. In addition, some taxpayer representatives advise individual taxpayers to continue to keep records of their miscellaneous expenses even if they do not expect to have expenses in excess of the two-percent floor. Thus, it would appear that this goal of the 1986 Act provision has not been realized.

Attorneys' fees

The staff of the Joint Committee on Taxation believes that two elements in present law work together to create the perceived inequities giving rise to litigation with respect to whether the portion of a damage award attributable to attorneys' fees paid by the taxpayer are income to the taxpayer. The most significant of these elements of present law is the effect of the alternative minimum tax. In a separate section of this report, the staff of the Joint Committee on Taxation has recommended elimination of the individual alternative minimum tax.

The second, less significant element of present law giving rise to this litigation is the two-percent floor. Removing the two-percent floor limitation from the deduction for attorney's fees

that are directly connected to the production of income would eliminate the need for continued litigation over this issue. Although other approaches to resolving this issue are possible, such as an exclusion from income for amounts assigned to the attorney, some commentators believe that this alternate approach could open the door for unintended consequences, such as with respect to attorneys' fees in connection with a capital expenditure.[206] The Joint Committee staff believes that the deduction approach is the superior approach to address this issue.

The Joint Committee staff considered an alternative recommendation to (1) retain the two-percent floor and (2) identify specific expenses, such as attorneys' fees and trust investment advice expenses, which would not be subject to the two-percent floor. However, the Joint Committee staff concluded that such a recommendation would not necessarily reduce complexity. Indeed, the Joint Committee staff concluded that addressing the specific problems with respect to attorneys' fees could result in greater complexity than present law. In addition, the Joint Committee staff felt that while the magnitude of the problem with respect to attorneys' fees that has generated the attention of commentators to this issue, the effect of the two-percent floor is no different with respect to all other miscellaneous itemized deductions.

Standard deduction

The Joint Committee staff notes that the standard deduction was increased in the 1986 Act to promote simplicity by reducing the number of taxpayers who itemize their deductions. Some would argue that the increases in the standard deduction mitigated some of the separate simplification benefit of the two-percent floor by increasing the number of individuals who claim the standard deduction in lieu of itemizing their deductions. Thus, some of the individuals for whom the two-percent floor could arguably have promoted simplification by eliminating the deduction for small miscellaneous itemized deductions were not affected by this simplification because they became non-itemizers due to the increase in the standard deduction.

It could also be argued that, in lieu of denying deductions for legitimate business expenses of individuals (such as unreimbursed employee business expenses subject to the two-percent floor), further increases in the standard deduction would achieve simplification in a more equitable manner. See the discussion in II.A., above, concerning structural issues relating to the individual income tax for a more complete discussion of this issue.

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[206] *See* Geier, "Some Meandering Thoughts on Plaintiffs and their Attorneys' Fees and Costs," Tax Notes, July 24, 2000, p. 549. Professor Geier points out "...an appropriate victory in one case could mean inappropriate victories in cases like *Baylin*, where 'exclusion' of attorneys' fees could result in effective deduction of an otherwise nondeductible capital expenditure."

G. Provisions Relating to Education

1. Overview of tax provisions relating to education

There are numerous provisions in the Code that allow taxpayers to reduce the cost of post-secondary education. Table 16, which follows at the end of this Section II.G., provides a summary of such provisions. In addition to the provisions noted in the table, there are special rules governing the tax treatment of qualified scholarships and fellowships, the forgiveness of certain student loans, and withdrawals from IRAs for educational expenses.[207]

The education incentives in the Code are structured in several different ways. Some provisions are structured as savings incentives (e.g., education IRAs and qualified state tuition programs), some are designed to reduce the cost of post-secondary education at the time educational expenses are incurred (e.g., the HOPE and Lifetime Learning credits), some provide exclusions from income for amounts used to pay for educational expenses (e.g., interest on education savings bonds), and some reduce the cost of borrowing money to pay for educational expenses (e.g., the student loan interest deduction). Although the existence of a variety of tax incentives for education may mean that more taxpayers are able to take advantage of one or more education incentives, understanding the tax benefits provided by the different provisions, the various eligibility requirements, the interaction between different incentives and provisions within each incentives, and as well as the recordkeeping and reporting requirements, may be time consuming and confusing for taxpayers who are interested in reducing their current educational expenses or saving for future expenses.

2. Definition of qualified higher education expenses

Present Law

Overview

Present law includes a variety of provisions that provide favorable tax treatment with respect to qualified higher education expenses, the definition of which varies from provision to provision.

Qualified state tuition programs

Present law provides tax-exempt status to "qualified State tuition programs," meaning certain programs established and maintained by a State (or agency or instrumentality thereof) under which persons may (1) purchase tuition credits or certificates on behalf of a designated beneficiary that entitle the beneficiary to a waiver or payment of qualified higher education expenses of the beneficiary, or (2) make contributions to an account that is established for the

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[207] For further explanation of the present-law tax provisions relating to education, *see* Joint Committee on Taxation, *Overview of Present Law and Economic Analysis Relating to Tax and Savings Incentives for Education* (JCX-1-01), February 12, 2001.

purpose of meeting qualified higher education expenses of the designated beneficiary of the account (a "savings account plan").

Contributions to a qualified State tuition program are not deductible. Earnings on such contributions generally are not includible in income until distributed. A qualified State tuition program is required to impose more than a de minimis penalty on the refund of earnings that are not (1) used to pay qualified higher education expenses; (2) made on account of the death or disability of the beneficiary; or (3) made on account of a scholarship received by the beneficiary.

The term "qualified higher education expenses" means expenses for tuition, fees, books, supplies, and equipment required for the enrollment or attendance of a designated beneficiary at an eligible educational institution,[208] regardless of whether the beneficiary is enrolled on a full-time, half-time or less than half-time basis. In addition, qualified higher education expenses include certain room and board expenses for any period during which the student is at least a half-time student.

Education IRAs

Section 530 provides tax-exempt status to education individual retirement accounts ("education IRAs"), meaning certain trusts (or custodial accounts) that are created or organized in the United States exclusively for the purpose of paying the qualified higher education expenses of a named beneficiary.[209] Contributions to education IRAs may be made only in cash and are not deductible. Annual contributions to education IRAs may not exceed $500 per designated beneficiary (except in cases involving certain tax-free rollovers, as described below), and may not be made after the designated beneficiary reaches age 18.[210] Moreover, an excise tax is imposed if a contribution is made by any person to an education IRA established on behalf of a beneficiary during any taxable year in which any contributions are made by anyone to a qualified State tuition program (defined under sec. 529) on behalf of the same beneficiary.

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

Amounts distributed from an education IRA are excludable from gross income to the extent that the amounts distributed do not exceed qualified higher education expenses of the designated beneficiary incurred during the year the distribution is made (provided that a HOPE

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[208] "Eligible educational institution" is defined the same for purposes of education IRAs and qualified State tuition programs.

[209] Education IRAs generally are not subject to Federal income tax, but are subject to the unrelated business income tax imposed by section 511.

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

credit or Lifetime Learning credit is not claimed with respect to the beneficiary for the same taxable year). To the extent that a distribution exceeds qualified higher education expenses of the designated beneficiary, an additional 10-percent tax is imposed on the earnings portion of such excess distribution, unless such distribution is made on account of the death or disability of, or scholarship received by, the designated beneficiary.

The term "qualified higher education expenses" is defined the same as under the provisions relating to qualified State tuition programs. In addition, qualified higher education expenses include amounts paid or incurred to purchase tuition credits (or to make contributions to an account) under a qualified State tuition program for the benefit of the beneficiary of the education IRA.

Savings bonds

Interest earned on qualified U.S. Series EE and Series I savings bonds issued after 1989 are excludable from gross income if the proceeds of the bond upon redemption do not exceed qualified higher education expenses paid by the taxpayer during the taxable year.[211] For 2001, the exclusion is phased out for married taxpayers filing joint returns with modified adjusted gross income between $83,650 and $113,650 for other taxpayers with modified adjusted gross income between $55,750 and $70,750.[212] These phaseout ranges are adjusted for inflation annually. To prevent taxpayers from effectively avoiding the income phaseout limitation through issuance of bonds directly in the child's name, the interest exclusion is available only with respect to U.S. Series EE savings bonds issued to taxpayers who are at least 24 years old.

"Qualified higher education expenses" are defined as tuition and fees required for the enrollment or attendance of the taxpayer, the taxpayer's spouse or any dependent of the taxpayer with respect to whom the taxpayer is entitled to a dependency exemption at an eligible education institution. Qualified higher education expenses do not include expenses with respect to any course or other education involving sports, games, or hobbies other than as part of a degree program. Qualified higher education expenses do not include any room and board expenses. Contributions to education IRAs and qualified State tuition programs made with the proceeds of savings bonds are qualified higher education expenses. "Eligible education institution" is defined the same as under qualified State tuition programs.

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

[212] The exclusion is not available to married taxpayers filing separate returns.

HOPE and Lifetime Learning credits

As described more fully below, present law includes two different tax credits, the HOPE credit and the Lifetime Learning credit, each with separate restrictions and requirements, with respect to "qualified tuition and related expenses." For purposes of these credits, the term "qualified tuition and related expenses" is defined the same as the term "qualified higher education expenses" for purposes of the exclusion for interest on education savings bonds, except that qualified tuition and related expenses do not include student activity fees, athletic fees, insurance expenses, or other expenses unrelated to an individual's academic course of instruction.

Withdrawals from IRAs

Subject to certain exceptions, a 10-percent additional income tax is imposed on taxable distributions from a traditional or Roth IRA prior to age 59-1/2.[213] One of the exceptions to this tax is for distributions for the "qualified higher education expenses" of the taxpayer, the taxpayer's spouse, or a child or grandchild of the taxpayer or the taxpayer's spouse. "Qualified higher education expenses" are defined as under the rules relating to qualified State tuition programs.

Sources of Complexity

As discussed more fully below, the numerous provisions relating to education create transactional complexity for taxpayers by making it difficult to determine which tax benefit is best for them. A specific factor contributing to this complexity (other than the number of different provisions) is the lack of a consistent definition of qualified higher education expenses.

Under present law, the definitions for qualified higher education expenses provide varying treatment with respect to the following:

- room and board expenses,
- expenses for books, supplies, and equipment,
- expenses relating to sports and hobbies,
- nonacademic fees, and
- the class of persons (e.g., certain relatives) whose expenses may be taken into account.

The differences between the definitions require taxpayers to keep track of certain expenses separately, thereby increasing recordkeeping burdens. In addition, the multiple definitions increase the likelihood of inadvertent errors by taxpayers. These errors may result in taxpayers claiming benefits for which they are not entitled or not claiming benefits for which they are entitled. The definitions may also increase taxpayer frustration with the Federal tax

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[213] For a description of the present-law rules relating to IRAs, see Section III.B. of this Part, below.

laws, particularly because the reasons for seemingly minor differences in the tax treatment of various expenses are unclear.

Recommendation for Simplification

The Joint Committee staff recommends that a uniform definition of qualifying higher education expenses should be adopted. The uniform definition would include expenses for tuition, books, fees, supplies, and equipment required for enrollment or attendance. It would not include expenses with respect to any course or other education relating to sports, games or hobbies other than as part of a degree program.

The Joint Committee staff recommendation generally follows the definition of qualified higher education expenses for purposes of the rules relating to qualified State tuition programs and education IRAs. Also, the Joint Committee recommendation would retain the current treatment of room and board expenses as they currently exist for the separate education tax incentives.

A uniform definition of education expenses would simplify reporting and recordkeeping with respect to educational expenses, particularly those that take advantage of more than one of the tax benefits for education provided in the Code, would simplify the calculation of the tax benefits for education, and make it easier for taxpayers and educational institutions to comply with the law. The principal simplification would stem from having a uniform definition of qualified education expenses, rather than from the particular definition recommended here. Although the Joint Committee staff recommendation does not alter the treatment of room and board expenses, uniform treatment of room and board expenses would further simply the definition. However, such a change would involve policy issues beyond the scope of this study. Allowing room and board expenses as qualified expenses for all education tax incentives would significantly expand the scope of the education tax incentives that do not currently cover such expenses. Similarly, excluding room and board expenses from the education tax incentives that allow such expenses would significantly reduce the benefits provided by those provisions.

3. Combine HOPE and Lifetime Learning credits

Present Law

HOPE credit

Individual taxpayers are allowed to claim a nonrefundable credit, the "HOPE" credit, against Federal income taxes up to $1,500 per student per year for qualified tuition and related expenses paid for the first two years of the student's post-secondary education in a degree or certificate program. The HOPE credit rate is 100 percent on the first $1,000 of qualified tuition and related expenses, and 50 percent on the next $1,000 of qualified tuition and related expenses. The qualified tuition and related expenses must be incurred on behalf of the taxpayer, the taxpayer's spouse, or a dependent of the taxpayer. The HOPE credit is available with respect to an individual student for two taxable years, provided that the student has not completed the first two years of post-secondary education before the beginning of the second taxable year. The HOPE credit amount that a taxpayer may otherwise claim is phased out ratably for taxpayers

with modified adjusted gross income between $40,000 and $50,000 ($80,000 and $100,000 for joint returns). For taxable years beginning after 2001, the $1,500 maximum HOPE credit amount and the adjusted gross income phase-out range will be indexed for inflation.

The HOPE credit is available in the taxable year the expenses are paid, subject to the requirement that the education is furnished to the student during that year or during the first three months of the next year. Qualified tuition and related expenses paid with the proceeds of a loan generally are eligible for the HOPE credit. The repayment of a loan itself is not a qualified tuition or related expense.

A taxpayer may claim the HOPE credit with respect to an eligible student who is not the taxpayer or the taxpayer's spouse only if the taxpayer claims the student as a dependent for the taxable year for which the credit is claimed. If a student is claimed as a dependent, the student is not entitled to claim a HOPE credit for that taxable year on the student's own tax return. If a parent (or other taxpayer) claims a student as a dependent, any qualified tuition and related expenses paid by the student are treated as paid by the parent (or other taxpayer) for purposes of determining the amount of qualified tuition and related expenses paid by such parent (or other taxpayer) under the provision. In addition, for each taxable year, a taxpayer may elect either the HOPE credit or the "Lifetime Learning" credit (described below) with respect to an eligible student.

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

Qualified tuition and related expenses generally include only out-of-pocket expenses. Qualified tuition and related expenses do not include expenses covered by employer-provided educational assistance and scholarships that are not required to be included in the gross income of either the student or the taxpayer claiming the credit. Thus, total qualified tuition and related expenses are reduced by any scholarship or fellowship grants excludable from gross income under section 117 and any other tax-free educational benefits received by the student (or the taxpayer claiming the credit) during the taxable year. The HOPE credit is not allowed with respect to any education expense for which a deduction is claimed under section 162 or any other section of the Code.

An eligible student for purposes of the HOPE credit is an individual who is enrolled in a degree, certificate, or other program (including a program of study abroad approved for credit by the institution at which such student is enrolled) leading to a recognized educational credential at an eligible educational institution. The student must pursue a course of study on at least a half-time basis. A student is considered to pursue a course of study on at least a half-time basis if the student carries at least one-half the normal full-time work load for the course of study the student is pursuing for at least one academic period that begins during the taxable year. To be eligible

for the HOPE credit, a student must not have been convicted of a Federal or State felony consisting of the possession or distribution of a controlled substance.

Eligible educational institutions generally are accredited post-secondary educational institutions offering credit toward a bachelor's degree, an associate's degree, or another recognized post-secondary credential. Certain proprietary institutions and post-secondary vocational institutions also are eligible educational institutions. In order to qualify as an eligible educational institution, an institution must be eligible to participate in Department of Education student aid programs.

Lifetime Learning credit

Individual taxpayers are allowed to claim a nonrefundable credit, the "Lifetime Learning" credit, against Federal income taxes equal to 20 percent of qualified tuition and related expenses incurred during the taxable year on behalf of the taxpayer, the taxpayer's spouse, or any dependents. For expenses paid after June 30, 1998, and prior to January 1, 2003, up to $5,000 of qualified tuition and related expenses per taxpayer return are eligible for the Lifetime Learning credit (i.e., the maximum credit per taxpayer return is $1,000). For expenses paid after December 31, 2002, up to $10,000 of qualified tuition and related expenses per taxpayer return will be eligible for the Lifetime Learning credit (i.e., the maximum credit per taxpayer return will be $2,000).

In contrast to the HOPE credit, a taxpayer may claim the Lifetime Learning credit for an unlimited number of taxable years. Also in contrast to the HOPE credit, the maximum amount of the Lifetime Learning credit that may be claimed on a taxpayer's return will not vary based on the number of students in the taxpayer's family -- that is, the HOPE credit is computed on a per-student basis, while the Lifetime Learning credit is computed on a family-wide basis. The Lifetime Learning credit amount that a taxpayer may otherwise claim is phased out ratably for taxpayers with modified adjusted gross income between $40,000 and $50,000 ($80,000 and $100,000 for joint returns).

The Lifetime Learning credit is available in the taxable year the expenses are paid, subject to the requirement that the education is furnished to the student during that year or during the first three months of the next year. Qualified tuition and related expenses paid with the proceeds of a loan generally are eligible for the Lifetime Learning credit (rather than repayment of the loan itself).

As with the HOPE credit, a taxpayer may claim the Lifetime Learning credit with respect to a student who is a dependent not the taxpayer or the taxpayer's spouse only if the taxpayer claims the student as a dependent for the taxable year for which the credit is claimed. If a student is claimed as a dependent by the parent or other taxpayer, the student may not claim the Lifetime Learning credit for that taxable year on the student's own tax return. If a parent (or other taxpayer) claims a student as a dependent, any qualified tuition and related expenses paid by the student are treated as paid by the parent (or other taxpayer) for purposes of the provision.

A taxpayer may claim the Lifetime Learning credit for a taxable year with respect to one or more students, even though the taxpayer also claims a HOPE credit for that same taxable year

with respect to other students. If, for a taxable year, a taxpayer claims a HOPE credit with respect to a student, then the Lifetime Learning credit is not be available with respect to that same student for that year (although the Lifetime Learning credit may be available with respect to that same student for other taxable years).

The Lifetime Learning credit is available for "qualified tuition and related expenses," which include tuition and fees required to be paid to an eligible educational institution as a condition of enrollment or attendance of a student at the institution. Charges and fees associated with meals, lodging, insurance, transportation, and similar personal, living or family expenses are not eligible for the credit. The expenses of education involving sports, games, or hobbies are not qualified tuition expenses unless this education is part of the student's degree program.

In contrast to the HOPE credit, qualified tuition and related expenses for purposes of the Lifetime Learning credit include tuition and fees incurred with respect to undergraduate or graduate-level (and professional degree) courses.[214]

As with the HOPE credit, qualified tuition and fees generally include only out-of-pocket expenses. Qualified tuition and fees do not include expenses covered by educational assistance that is not required to be included in the gross income of either the student or the taxpayer claiming the credit. Thus, total qualified tuition and fees are reduced by any scholarship or fellowship grants excludable from gross income under section 117 and any other tax-free educational benefits received by the student during the taxable year (such as employer-provided educational assistance excludable under section 127). The Lifetime Learning credit is not allowed with respect to any education expense for which a deduction is claimed under section 162 or any other section of the Code.

In addition to allowing a credit for the tuition and related expenses of a student who attends classes on at least a half-time basis as part of a degree or certificate program, the Lifetime Learning credit also is available with respect to any course of instruction at an eligible educational institution (whether enrolled in by the student on a full-time, half-time, or less than half-time basis) to acquire or improve job skills of the student.[215] Undergraduate and graduate students are eligible for the Lifetime Learning credit. Moreover, in contrast to the HOPE credit, the eligibility of a student for the Lifetime Learning credit does not depend on whether or not the student has been convicted of a Federal or State felony consisting of the possession or distribution of a controlled substance.

Sources of Complexity

Because the HOPE and Lifetime Learning credits have differing credit percentages applied to different base amounts of qualifying expenses, families eligible for both credits must complete separate calculations to calculate their total education credits. Additionally, beginning

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[214] The HOPE credit is available only with respect to the first two years of a student's post-secondary, i.e., undergraduate education.

[215] Eligible higher educational institutions are defined in the same manner for purposes of both the HOPE and Lifetime Learning credits.

in 2003, when the maximum qualifying expenses for the Lifetime Learning credit is increased to $10,000, certain families with a child eligible for the HOPE credit will need to calculate separately the value of the Lifetime Learning credit to see if it exceeds that of the value of the HOPE credit. (Currently, a student eligible for the HOPE credit will always receive a larger credit by claiming the HOPE rather than the Lifetime Learning credit.) The complexity involved in maximizing available credits is compounded for families with more than one student in college at the same time.

The complexities associated with multiple credits make it difficult for taxpayers to take into account the value of the credits in budgeting for college expenses.

The income-related phaseouts of the credits create both computational and transactional complexity for taxpayers.

Recommendation for Simplification

The Joint Committee staff recommends that the HOPE credit and Lifetime Learning credits should be combined into a single credit. The single credit would: (1) utilize the present-law credit rate of the Lifetime Learning credit; (2) apply on a per-student basis; and (3) apply to eligible students as defined under the Lifetime Learning credit. [216]

The HOPE and Lifetime Learning credits illustrate complexity in the Code that is caused by overlapping provisions with similar purposes but differing requirements. Although the credits offset post-secondary education expenses and thereby make education more affordable, the complexity of having two similar but separate credits, each with its own separate rules for similar types of expenses, undermines the objectives of the credits.

The proposal would eliminate the complexity of duplicative provisions by combining the two credits into a single credit. The specific aspects of the proposed single credit (i.e., the credit rate, application of the credit on a per-student basis, and definition of eligible student) blend aspects of the two present-law credits, and take into account a variety of factors, including simplification, fairness, and the pattern of typical education expenses. The Joint Committee staff recognizes that, depending on policy choices, a credit could be designed differently (e.g., a different credit rate) without unnecessarily compromising the goal of simplification.

4. Interaction among provisions

Present Law

Several of the tax provisions for education have restrictions based upon the taxpayer's use of other education provisions. An excise tax is imposed on contributions to an education

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[216] The Joint Committee staff has recommended separately that the income-related phaseouts of various tax benefits, including those applicable to the HOPE and Lifetime Learning credits, be repealed. The objectives sought to be achieved by the phaseouts can be achieved in a simpler manner through the rate structure. See Section II.C. of this Part, above.

IRA if, in the same year, a contribution is made on behalf of the beneficiary of the education IRA to a qualified State tuition plan.[217] If amounts distributed from an education IRA are excludable from gross income because they are used to pay the qualified higher education expenses of the beneficiary of the education IRA, then neither the HOPE nor the Lifetime Learning credit may be claimed for the same year with respect to the same individual. The individual may elect not to claim the exclusion, in which case a HOPE or Lifetime learning credit may be claimed.

Sources of Complexity

The interactions among various education provisions create transactional complexity for taxpayers. Although it is possible for taxpayers to take advantage of many or even all of the education tax benefits at some point, taxpayers must be careful about which incentives are selected in any particular year so as to avoid losing eligibility for other incentives.

The interactions may lead to inadvertent errors because more than one taxpayer may be involved. For example, an excise tax is triggered if a grandparent contributes to a State tuition plan on behalf of a grandchild whose father makes a contribution to an education IRA. In some cases, taxpayers may not be aware that others have taken action that results in denial of or penalty for using a benefit.

Recommendation for Simplification

The Joint Committee staff recommends that restrictions on the use of education tax incentives based on the use of other education tax should be eliminated and replaced with a limitation that the same expenses could not qualify under more than one provision.

This recommendation would allow taxpayers to fund an education IRA in the same year that a contribution to a State plan is made on their behalf. It would also permit taxpayers to exclude from income withdrawals from an education IRA in the same year that a HOPE or Lifetime learning credit is claimed, provided the exclusion is not used for the same expenses for which the HOPE or Lifetime learning credit is claimed.

The proposal would eliminate the transactional complexities associated with the present-law interactions, thus making it easier for taxpayers to take full advantage of the various provisions. The proposal would also eliminate inadvertent errors by taxpayers due to the provisions that trigger consequences as a result of actions by persons other than the taxpayer.

The proposal not only would provide simplification, but it may expand the use of various tax benefits for education by making it easier for taxpayers to claim the full benefit of the various tax provisions.

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[217] The excise tax is equal to 6 percent of the contributions to the education IRA. The excise tax applies each year in which the excess contribution remains in the education IRA. Sec. 4973(e).

5. Deduction for student loan interest

Present Law

Certain individuals may claim an above-the-line deduction for interest paid on qualified education loans, subject to a maximum annual deduction limit.[218] The deduction is allowed only with respect to interest paid on a qualified education loan during the first 60 months in which interest payments are required. Required payments of interest generally do not include voluntary payments, such as interest payments made during a period of loan forbearance. Months during which interest payments are not required because the qualified education loan is in deferral or forbearance do not count against the 60-month period.

Special rules apply in determining the 60-month period in the case of refinancings or other modifications of the loan. For example, under proposed Treasury regulations, a qualified education loan and all refinancings of that loan are treated as a single loan. The 60-month period runs from the date interest payments on the loan were first required.[219] However, if two or more loans are refinanced and consolidated into a single loan, then the 60-month period runs from the most recent date on which any of the loans entered repayment status.[220] Thus, the 60-month period may be extended if loans are consolidated.

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

The maximum allowable annual deduction is $2,500. The deduction is phased out ratably for single taxpayers with modified adjusted gross income between $40,000 and $55,000 and for married taxpayers filing joint returns with modified adjusted gross income between $60,000 and $75,000. The income ranges will be indexed for inflation after 2002.

Sources of Complexity

The present-law 60-month rule regarding deductibility of student loan interest presents complications because of the necessity of determining both the start and the end of the 60-month period in order to determine if the interest is properly deductible. The determination of the 60-month period is not straightforward because of special rules that extend the period if the loan is,

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[218] No deduction is allowed to an individual if that individual is claimed as a dependent on another taxpayer's return for the taxable year.

[219] Prop. Treas. Reg. sec. 1.221-1(h).

[220] *Id.*

or was ever, in a period of forbearance. Furthermore, special rules regarding loan consolidations require redetermining the 60-month period for the new consolidated loan. The new 60-month period begins on the most recent date that interest payments were required to begin being made on any of the underlying loans. This rule also effectively extends the period for which interest is properly deductible beyond 60 months for the older loans underlying the consolidated loan, which some might consider inequitable when unconsolidated loans are held to the 60-month limit.

Recommendation for Simplification

The Joint Committee staff recommends that the 60-month limit on deductibility of student loan interest should be eliminated.

The recommendation would make the student loan interest deduction easier for taxpayers to apply and eliminate the inconsistent treatment of loans. The recommendation would increase the amount of interest eligible for the deduction.

6. Exclusion for employer-provided educational assistance

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 does not apply with respect to graduate-level courses. The exclusion expires with respect to courses beginning on or after January 1, 2002.

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, and 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.[221] In general, education qualifies as a working condition fringe benefit if the employee could have deducted the education 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

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

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.[222]

Sources of Complexity

The temporary extensions and periods of lapse of the exclusion for employer-provided educational assistance creates complexity for employers, employees, and the IRS. Frequently, the exclusion expires and is subsequently retroactively extended. The uncertain state of the exclusion makes it difficult for employees to plan for their educational goals. For employers, retroactive extension of the exclusion causes severe administrative problems. When the exclusion expires, employers may be required to withhold on employer-provided educational assistance. Some employers withhold in such cases, which results in unnecessary administrative expenses and employee relation problems when the exclusion is reinstated. Some employers do not withhold, which exposes the employer to liability for failure to withhold. The IRS has similar problems, e.g., deciding what information to include on forms that may become out of date if the exclusion extended (after the forms have been printed). Further in the absence of the 127 exclusion, it may be difficult to determine whether employer-provided educational assistance is excludable from income because of the factual nature of the issues involved.

Recommendation for Simplification

The Joint Committee staff recommends that the exclusion for employer-provided educational assistance should be made permanent.

The section 127 exclusion was first enacted on a temporary basis in 1978. Since then, it has been extended numerous times, always on a temporary basis. As a result of these extensions, the exclusion has been in effect for over 20 years.

The section 127 exclusion was first established on a temporary basis by the Revenue Act of 1978 (through 1983). It subsequently was extended, again on a temporary basis, by Public Law 98-611 (through 1985), by the Tax Reform Act of 1986 (through 1987), by the Technical and Miscellaneous Revenue Act of 1988 (through 1988), by the Omnibus Budget Reconciliation Act of 1989 (through September 30, 1990), by the Omnibus Budget Reconciliation Act of 1990 (through 1991), by the Tax Extension Act of 1991 (through June 30, 1992), by the Omnibus Budget Reconciliation Act of 1993 (through December 31, 1994), by the Small Business Job Protection Act of 1996 (through May 31, 1997), by the Taxpayer Relief Act of 1997 (through May 31, 2000), and by the Tax Relief Extension Act of 1999 (through December 31, 2001).

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

Public Law 98-611 adopted a $5,000 annual limit on the exclusion, effective for taxable years beginning after December 31, 1983; this limit was subsequently raised to $5,250 in the Tax Reform Act of 1986. The Technical and Miscellaneous Revenue Act of 1988 made the exclusion inapplicable to graduate-level courses. The exclusion was reinstated with respect to graduate-level courses by the Omnibus Budget Reconciliation Act of 1990, effective for taxable years beginning after December 31, 1990. The exclusion was again made inapplicable to graduate-level courses by the Small Business Job Protection Act of 1997, effective for courses beginning after June 30, 1996.

Permanently extending the exclusion for employer-provided educational assistance will eliminate the problems that arise due to the expiring nature of the exclusion and will provide certainty for employers, employees, and the IRS. Providing a permanent exclusion will eliminate withholding and other issues that arise solely because of the (temporary) expiration of the exclusion. Providing a permanent exclusion will also provide a clear rule for determining whether employer-provided assistance is excludable. Without the special exclusion, a worker receiving educational assistance from his or her employer is subject to tax on the assistance, unless the education is related to the worker's current job. Because the determination of whether particular educational assistance is job-related is based on the facts and circumstances, it may be difficult to determine with certainty whether the educational assistance is excludable from income. This uncertainty may lead to disputes between taxpayers and the IRS.

7. Structural issues

In general, the present law education tax incentives generate complexity as a result of the numerous education tax provisions that may impact a given taxpayer. Each of the various provisions have their own eligibility criteria and definitions of qualified expenses. Because of this variation in the provisions with respect to definitions of qualified expenses and eligibility criteria (and interact with one another with regard to eligibility), taxpayers are confronted with a confusing array of choices with respect to Federal tax incentives for financing education.

With respect to saving for future education expenses, taxpayers are confronted with a choice of at least three tax-favored vehicles, as described above.[223] With respect to qualified State tuition programs, taxpayers may choose to purchase either tuition credits that entitle the beneficiary to the waiver or payment of qualified higher education expenses or to invest in accounts established for the purpose of meeting qualified higher education expenses of the beneficiary.

Multiple tax-favored savings vehicles present planning complexities for the taxpayer who seeks to maximize the likely after-tax economic return to savings. Because the savings vehicles differ with respect to the tax benefit offered and have differing rules on qualified expenses, contribution limits, income limits, and interactions with other education benefits, such as the HOPE credit, much complexity results in choosing the right approach to saving for education. A

[223] Additionally, taxpayers may choose other vehicles not specifically designated as education savings vehicles to save for education. For example, a taxpayer may choose to invest in IRAs or deferred annuities to save for education expenses.

taxpayer seeking tax-favored saving for education may choose to invest in only one vehicle, or choose to allocate funds among all the vehicles, provided, however, that investments in qualified State tuition programs and education IRAs are not made in the same year on behalf of the same beneficiary. Furthermore, once a saving plan is adopted, a taxpayer must be careful in how the savings are spent in order to get the intended tax result. For example, if the education IRA is used in a year in which a HOPE credit can be claimed, the value of the education IRA exclusion is lost. The well-advised taxpayer would use such funds for educational expenses after the HOPE credit is no longer available.

The exclusion for U.S. savings bond interest is especially complicated as a result of income limitations on the exclusion and the worksheets and forms necessary to determine income-related limitations on excludable interest. Due to these limitations, a 14-line form is required of all who claim the exclusion. Additionally, in order to complete the form, two of the lines of the form require separate worksheets of 5 and 6 lines respectively. One of the worksheets requires the adding up of 8 and then 13 lines of the Form 1040. A significant portion of the complexity of these forms and worksheets stems from the fact that the benefit takes the form of an exclusion combined with income eligibility limits. Because the exclusion needs to be determined before adjusted gross income is determined, adjusted gross income cannot be used as the basis for the phaseout, which necessitates the many separate calculations necessary to determine modified adjusted gross income. Additionally, the existence of other income exclusions or above-the-line deductions with phaseouts (Social Security benefits, IRA deduction, employer-provided adoption assistance, and student loan interest deduction) requires complicated ordering rules to calculate modified adjusted gross income for purposes of the phaseout.

As described above, the Joint Committee staff makes specific recommendations addressing certain aspects of present law that create complexity. In addition, the Joint Committee staff believes that combining the education savings programs into a single program would further simplify recordkeeping and reduce much of the financial and tax planning now required for meeting future education expenses. However, the Joint Committee staff makes no recommendation in this regard because of the policy considerations involved in creating such a single program.

For example, Congress would need to determine whether the benefit would consist of an exclusion from income of withdrawals for qualified expenses, as the present law education-IRA and Savings Bond programs permit, or whether the benefit would consist of deferral only, as State programs provide. Additionally, a balance between the low annual contribution limit of an education IRA and the higher aggregate State program-specific contribution limit (with no specific annual limitations) would need to be reached. Finally, a decision would have to be made whether the program would have income limits, as do the present law education IRA and Savings Bond programs, or not, as is the case with the present-law State programs.

Additionally, Congress would need to address transition issues with respect to outstanding education IRAs, State programs, and savings bond interest. If existing programs were grandfathered with respect to current assets, it is questionable how much, if any, simplification would be achieved. Taxpayers presently saving in one or more of the existing programs who wished to continue making contributions to a saving program would have to do so

in yet another program (i.e., the new program) with yet another set of rules. Alternatively, in order to achieve simplification for all savers, and not just those who have yet to begin saving for education, Congress could require that savings in existing programs be rolled over into the new program. But how it did so could create financial windfalls or losses to current savers, which would depend on the nature of the new program as well as the transition rules. For example, if the new saving program were to permit an exclusion from income, provisions that would allow rolling over existing State program funds would produce substantial windfalls. Alternatively, if the new saving program were to permit only deferral of income, provisions requiring the rolling over of existing education IRAs to the new program would result in future financial losses for such individuals because they would lose the benefit of the future exclusion.[224]

[224] However, since education IRAs have been in existence for only a few years and have had an annual contribution limit of $500, most education IRAs can be expected to have only small amounts of funds currently and the value of the future exclusion for the earnings on such funds is not likely to be large. If Congress were to require the rollover of education IRAs into a new saving program that permitted only deferral of income, it would be possible to grant an income exclusion on the rollover and a corresponding increase in the basis of the assets in the new saving program. This would effectively permit an exclusion on earnings of education IRAs to date, but only a deferral of income from the point of rollover.

Table 11.--Comparison of Certain Education Tax Incentives Available to Individuals Under Present Law

Provision	Tax Benefit	Dollar Limits on Amount Eligible for Tax Benefit	Eligible Contributors (for savings incentives)/ Eligible Claimants (for deductions, credits, and exclusions)	Eligible Beneficiaries	Qualified Education Expenses	Coordination with Other Education Provisions
1. Education IRA (sec. 530)	Earnings are not subject to tax until distributed. Distributions are not subject to tax if the amount distributed does not exceed the qualified higher education expenses of the beneficiary during the year. Earnings portion of distributions in excess of qualified expenses is subject to an additional 10-percent tax.	Annual contributions may not exceed $500 per designated beneficiary. No contributions permitted after beneficiary attains age 18.	Contribution limit phased out for contributors with modified AGI of $95,000 to $110,000 ($150,000 to $160,000 for joint returns).	Eligible distributee (i.e., student) can be enrolled on full-time, half-time, or less than half-time basis.	Includes tuition, fees, books, supplies, and equipment required for attendance at an eligible educational institution (defined in sec. 481 of the Higher Education Act of 1965). Also includes certain room and board expenses if student enrolled on at least a half-time basis. Does not include expenses covered by certain scholarships or other tax-free educational benefits. Includes amounts contributed to a QSTP for the benefit of the	No exclusion from income for a particular student if either the HOPE credit or LLC is claimed for the same year with respect to the same student. Beneficiary will incur a penalty excise tax if a contribution is made by any person to an education IRA if, in the same year, a contribution is made to a QSTP on behalf of the same beneficiary.

Table 11.--Comparison of Certain Education Tax Incentives Available to Individuals Under Present Law

Provision	Tax Benefit	Dollar Limits on Amount Eligible for Tax Benefit	Eligible Contributors (for savings incentives)/ Eligible Claimants (for deductions, credits, and exclusions)	Eligible Beneficiaries	Qualified Education Expenses	Coordination with Other Education Provisions
					beneficiary of the education IRA.	
2. Qualified State tuition program ("QSTP") (sec. 529)	Earnings are not subject to tax until distributed. Earnings not used for qualified higher education expenses are subject to an additional penalty.	QSTP must have adequate safeguards to prevent contributions in excess of amount needed for the beneficiary's higher education expenses.	No restrictions.	No restrictions.	Same as education IRA, although there is no restriction regarding expenses covered by tax-free educational assistance.	See education IRA discussion above. HOPE credit or LLC may be claimed in same year and with respect to same expenses for which a distribution from a QSTP is made.
3. HOPE credit (sec. 25A)	Credit against tax for qualified tuition and related expenses for first two years of post-secondary education.	Maximum credit is $1,500, computed on a per-student basis. Credit rate is 100% on first $1,000 of qualified expenses and 50% on next $1,000 of expenses	Credit amount is phased out for taxpayers with modified AGI between $40,000 and $50,000 ($80,000 and $100,000 for joint returns). Credit may be claimed by student or by	Eligible student must be enrolled on at least a half-time basis and must not have been convicted of Federal or State felony involving possession or distribution of a controlled substance.	Same as education IRA, except does not include books, supplies, equipment, charges or fees associated with room and board, athletics (unless part of student's degree program, and nonacademic fees	HOPE credit not available with respect to a particular student if, the student elects an exclusion from income for a distribution from an education IRA in the same year.

Table 11.--Comparison of Certain Education Tax Incentives Available to Individuals Under Present Law

Provision	Tax Benefit	Dollar Limits on Amount Eligible for Tax Benefit	Eligible Contributors (for savings incentives)/ Eligible Claimants (for deductions, credits, and exclusions)	Eligible Beneficiaries	Qualified Education Expenses	Coordination with Other Education Provisions
			another taxpayer if the taxpayer claims the student as a dependent.		(including insurance, transportation, and similar personal, living or family expenses).	HOPE credit and Lifetime Learning credit can not be claimed with respect to the same student in the same year. Also see QSTP discussion above.
4. Lifetime Learning credit ("LLC") (sec. 25A)	Credit against tax for qualified tuition and related expenses for undergraduate or graduate (and professional) courses. Unlike HOPE credit, LLC is available for an unlimited number of years.	For expenses paid between July 1, 1998 and December 31, 2002, maximum credit is $1,000. For expenses paid after December 31, 2002, maximum credit is $2,000. Credit rate is 20% of up to $5,000 ($10,000 beginning in 2003) of qualified expenses. Unlike HOPE credit, LLC is	AGI phase-out ranges are same as HOPE credit. As with HOPE credit, LLC may be claimed by student or by another taxpayer if the taxpayer claims the student as a dependent.	No restrictions.	Same as HOPE credit.	Same as HOPE credit.

Table 11.--Comparison of Certain Education Tax Incentives Available to Individuals Under Present Law

Provision	Tax Benefit	Dollar Limits on Amount Eligible for Tax Benefit	Eligible Contributors (for savings incentives)/ Eligible Claimants (for deductions, credits, and exclusions)	Eligible Beneficiaries	Qualified Education Expenses	Coordination with Other Education Provisions
		computed on family-wide basis, rather than per-student basis.				
5. Student loan interest deduction (sec. 221)	Taxpayer may claim an above-the-line deduction for interest paid on qualified education loans, subject to an annual deduction limit.	Deduction allowed with respect to interest paid on qualified education loans during the first 60 months in which interest payments are required. Maximum deduction is $1,500 in 1999, $2,000 in 2000, and $2,500 in 2001 and thereafter.	Deduction is phased out for taxpayers with modified AGI of $40,000 to $55,000 ($60,000 to $75,000 for joint returns).	No restrictions.	Includes tuition, fees, room and board, and related expenses, reduced by (1) any interest on education savings bonds excluded from income, (2) any distribution from an education IRA excluded from income, and (3) any educational benefits (e.g., scholarships, employer-provided educational assistance) excluded from income.	No restrictions.

Table 11.--Comparison of Certain Education Tax Incentives Available to Individuals Under Present Law

Provision	Tax Benefit	Dollar Limits on Amount Eligible for Tax Benefit	Eligible Contributors (for savings incentives)/ Eligible Claimants (for deductions, credits, and exclusions)	Eligible Beneficiaries	Qualified Education Expenses	Coordination with Other Education Provisions
6. Employer-provided educational assistance (sec. 127)	Exclusion from gross income and wages.	$5,250 per year.	Employers.	Employees.	Any education expenses, other than tools or supplies that may be retained by the employee after the course of instruction, meals, lodging, transportation, expenses related to sports, games, or hobbies, or graduate-level courses.	Otherwise allowable expenses under other provisions, e.g., HOPE and Lifetime Learning credits, are reduced by excludable amounts.
7. Education savings bonds (sec. 135)	Interest on certain savings bonds is not subject to tax if the proceeds of the bond upon redemption do not exceed qualified higher education expenses paid by the taxpayer during taxable year.	No limit on amount that may be excluded, but see income phase-out limitation.	For 2001, exclusion is phased out for taxpayers with modified AGI of $55,750 to $70,750 ($83,650 to $113,650 for joint returns). To prevent avoidance of the income phase-out limitation, bonds must be issued to	No restrictions.	Same as for HOPE credit and LLC, but without the restriction on nonacademic fees.	For purposes of computing excludable amount, taxpayer cannot include expenses taken into account in determining the HOPE credit or LLC claimed by the taxpayer, or the excludable

Table 11.--Comparison of Certain Education Tax Incentives Available to Individuals Under Present Law

Provision	Tax Benefit	Dollar Limits on Amount Eligible for Tax Benefit	Eligible Contributors (for savings incentives)/ Eligible Claimants (for deductions, credits, and exclusions)	Eligible Beneficiaries	Qualified Education Expenses	Coordination with Other Education Provisions
			taxpayer who is at least 24 years old.			amount of an education IRA distribution.

Note: AGI refers to adjusted gross income.

H. Taxation of Minor Children

Present Law

Filing requirements for children

Single unmarried individuals eligible to be claimed as a dependent on another taxpayer's return generally must file an individual income tax return if he or she had (1) earned income only over $4,550, (2) unearned income only over the minimum standard deduction amount for dependents ($750 in 2001), or (3) gross income of more than the larger of (a) $750, or (b) earned income plus $250.[225] Thus, if a dependent child has less than $750 in gross income, the child does not have to file an individual income tax return in 2001.

A child who cannot be claimed as a dependent on another person's tax return (e.g., because the support test is not satisfied by any other person) is subject to the generally applicable filing requirements. That is, such an individual generally must file a return if the individual's gross income exceeds the sum of the standard deduction and the personal exemption amounts applicable to the individual.

Taxation of unearned income of minor children

Special rules apply to the unearned income of a child under age 14. These rules, generally referred to as the "kiddie tax," tax certain unearned income of a child at the parent's rate, regardless of whether the child can be claimed as a dependent on the parent's return.[226] The kiddie tax applies if: (1) the child has not reached the age of 14 by the close of the taxable year, (2) the child's investment income was more than $1,500 (for 2001) and (3) the child is required to file a return for the year. The kiddie tax applies regardless of the source of the property generating the income or when the property giving rise to the income was transferred to or otherwise acquired by the child. Thus, for example, the kiddie tax may apply to income from property acquired by the child with compensation derived from the child's personal services or from property given to the child by someone other than the child's parent.

The kiddie tax is calculated by computing the "allocable parental tax." This involves adding the net unearned income of the child to the parent's income and then applying the parent's tax rate. A child's "net unearned income" is the child's unearned income less the sum of (1) the minimum standard deduction allowed to dependents ($750 for 2001), and (2) the greater of (a) such minimum standard deduction amount or (b) the amount of allowable itemized deductions that are directly connected with the production of the unearned income.[227] A child's net unearned income cannot exceed the child's taxable income.

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[225] Sec. 6012(a)(1)(C). Other filing requirements apply to dependents who are married, elderly, or blind. See, Internal Revenue Service, Publication 929, *Tax Rules for Children and Dependents,* at 3, Table 1 (2000).

[226] Sec. 1(g).

[227] Sec. 1(g)(4).

The allocable parental tax equals the hypothetical increase in tax to the parent that results from adding the child's net unearned income to the parent's taxable income. If a parent has more than one child subject to the kiddie tax, the net unearned income of all children is combined, and a single kiddie tax is calculated. Each child is then allocated a proportionate share of the hypothetical increase.

If the parents file a joint return, the allocable parental tax is calculated using the income reported on the joint return. In the case of parents who are married but file separate returns, the allocable parental tax is calculated using the income of the parent with the greater amount of taxable income. In the case of unmarried parents, the child's custodial parent is the parent whose taxable income is taken into account in determining the child's liability. If the custodial parent has remarried, the stepparent is treated as the child's other parent. Thus, if the custodial parent and stepparent file a joint return, the kiddie tax is calculated using that joint return. If the custodial parent and stepparent file separate returns, the return of the one with the greater taxable income is used. If the parents are unmarried but lived together all year, the return of the parent with the greater taxable income is used. [228]

Unless the parent elects to include the child's income on the parent's return (as described below) the child files a separate return. In this case, items on the parent's return are not affected by the child's income. The total tax due from a child is the greater of:

(1) the sum of (a) the tax payable by the child on the child's earned income plus (b) the allocable parental tax or;

(2) the tax on the child's income without regard to the kiddie tax provisions.

Parental election to include child's unearned income

Under certain circumstances, a parent may elect to report a child's unearned income on the parent's return. If the election is made, the child is treated as having no income for the year and the child does not have to file a return. The requirements for the election are that:

(1) the child has gross income only from interest and dividends (including capital gains distributions and Alaska Permanent Dividends);

(2) such income is more than the minimum standard deduction amount for dependents ($750 in 2001) and less than 10 times that amount;

(3) no estimated tax payments for the year were made in the child's name;

(4) no backup withholding occurred; and

(5) the child is required to file a return if the parent does not make the election.

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[228] Sec. 1(g)(5); Internal Revenue Service, Publication 929, *Tax Rules for Children and Dependents,* at 6 (2000).

Only the parent whose return must be used when calculating the kiddie tax may make the election. The parent includes in income the child's gross income in excess of twice the section minimum standard deduction amount for dependents. This amount is taxed at the parent's rate. The parent must also report an additional tax liability equal to the lesser of: (1) $112 in 2001, or (2) 15 percent of the child's gross income exceeding the child's standard deduction ($750 in 2001).

Including the child's income on the parent's return can affect the parent's deductions and credits that are based on adjusted gross income, as well as income-based phaseouts, limitations, and floors. In addition, certain deductions that the child would have been entitled to take on his or her own return are lost.[229] Further, if the child received tax-exempt interest from a private activity bond, that item is considered a tax preference of the parent for alternative minimum tax purposes.

Taxation of child's compensation for services

Compensation for a child's services, even though not retained by the child, is considered the gross income of the child, not the parent, even if the compensation is not received by the child (e.g. is the parent's income under local law).[230] If the child's income tax is not paid, however, an assessment against the child will be considered as also made against the parent to the extent the assessment is attributable to amounts received for the child's services.[231]

Sources of Complexity

The IRS instructions for the taxation of children span more than 20 pages with multiple worksheets to calculate the child's income and the appropriate amount of tax. The linkage among the returns of the child, parent, and siblings is also a source of complexity. If the parent's or a sibling's return is audited, the child's return must also be audited and adjusted. The rules are further complicated depending on whether the child's parents file jointly, separately, are married, unmarried, or remarried.

Recommendation for Simplification

The Joint Committee staff recommends that the tax rate schedule applicable to trusts should be applied with respect to the net unearned income of a child under age 14. The Joint Committee staff also recommends that the parental election to include a child's income on the parent's return should be available irrespective of (1) the amount and type of the child's income, and (2) whether there was withholding or estimated tax payments with respect to the child's income.

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[229] Sec. 1(g)(7)(B).

[230] Sec. 73(a).

[231] Sec. 6201(c).

Application of trust rate schedule

The Tax Reform Act of 1986 introduced the kiddie tax to combat the practice of high-income individuals transferring income-producing property to their children so that the income could be taxed at a lower rate.[232] The staff of the Joint Committee believes that the present-law rules can be simplified and still achieve the same goal.

By removing the linkage among the parent's, child's, and siblings' returns, the present-law kiddie tax rules could be simplified. The Joint Committee staff recommends that the current calculation of allocable parental tax be replaced with the tax rate schedule applicable to trusts.[233] Use of trust rates may result in the imposition of greater taxes than present law.[234] A rate schedule differing from that applicable to trusts could serve the same function under this proposal without compromising the goal of simplification. Like the trust rate schedule, such a schedule would need to be sufficiently compressed to discourage tax-motivated shifting of income between parent and child.

Under the Joint Committee staff proposal, information regarding the parent's or siblings' income would not be needed to complete the child's return. Further, it would eliminate the need

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[232] "The committee also desires to restrict a technique used by some high-income individuals with children to take undue advantage of the graduated rate schedules. . . ." H.R. Rep. No. 99-426, at 57 (1985). "The committee believes that the present law rules governing the taxation of minor children provide inappropriate tax incentives to shift income-producing assets among family members. In particular the committee is aware that the treatment of a child as a separate taxpayer encourages parents whose income would otherwise be taxed at a high marginal rate bracket to transfer income producing property to a child to ensure that the income is taxed at the child's lower marginal rates." *Id.* at 801.

[233] The Tax Section of the American Bar Association and the American Institute of Certified Public Accountants also have advocated the use of a compressed rate schedule in place of the allocable parental tax. See, American Institute of Certified Public Accountants, 10 Big Taxpayer Headaches That Could Be Cured Through A Little Tax Simplification, http://www.aicpa.org/members/div/tax/headache.htm (1999). See also, Leo L. Schmolka, *The Kiddie Tax Under the Tax Reform Act of 1986: A Need for Reform While the Ink is Still Wet*, 11 Rev. of Tax. of Indiv. 99, 117 (1987) (advocating application of trust and estate rates to every individual whom a dependency deduction is allowable to another taxpayer).

[234] The trust and estates tax rate schedule for 2001 is as follows:

If taxable income is:	**The tax is:**
Not over $1,800	15 percent of taxable income
Over $1,800 but not over $4,250	$270 plus 28 percent of the excess over $1,800
Over $4,250 but not over $6,500	$956.00 plus 31 percent of the excess over $4,250
Over $6,500 but not over $8,900	$1,653.50 plus 36 percent of the excess over $6,500
Over $8,900	$2,517.50 plus 39.6 percent of the excess over $8,900

to adjust the child's return if the return of the parent (or a sibling) is later adjusted. Each child's return would stand on its own.

Expansion of the parental election

Present law limits the ability of parents to elect to include a child's net unearned income on their returns. The Joint Committee staff recommends that these limitations be eliminated.

The Joint Committee staff recommends that the parental election be available regardless of the amount or type of the income (earned or unearned) received by the child.[235] The Joint Committee staff believes that the existence of earned income should not preclude the availability of the election. It is unlikely that a large number of children under the age of 14 would have substantial earned income. In the interest of simplicity, a parent should be able to report all the earned and unearned income of the child on the parent's return if the election is made. While this may result in higher taxes on the child's earned income, it would reduce the number of returns that need to be filed. Therefore, the staff of the Joint Committee recommends that the limitations on the amount and type of income should be removed.

Under present law, the election is not available if there are any withholding or estimated tax payments for the child under the child's social security number. The Joint Committee staff believes that this limitation should also be removed and that credit should be given for taxes withheld or paid in the name of the child.

Some may argue that it is inappropriate for a child's withholding to offset a parental liability, and possibly generate a refund. The Joint Committee staff, however, believes the utilization of the child's withholding is no different than the use of a spouse's withholding to offset the liability generated from the other spouse's income. The parent generally controls the child's finances. Thus, the family should be considered as a single economic unit under these circumstances.

This proposal would have an effect on IRS tax administration. Specifically, the proposal would require IRS computer systems to match and credit the child's income and withholding to the parents' account if the election is made. The inclusion of the child's social security number on the parent's return should alleviate any matching concerns; however, IRS computer systems would need reprogramming to properly administer the proposal.

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[235] Some argue that allowing an unlimited amount of the child's income to be included on the parents return results in a wealth transfer from parent to child through the payment of taxes. Specifically, the parent is paying the tax that would have been paid by the child and thus the child is financially better off. Further, it is argued that such an approach could encourage income shifting from child to parent in the event the parent is in a lower tax bracket than the minor child. The Joint Committee staff believes that the latter scenario would be a rare case. Further, these arguments ignore the premise underlying the kiddie tax, that the parent controls the family's assets, including those in the name of the child.

III. INDIVIDUAL RETIREMENT ARRANGEMENTS, QUALIFIED RETIREMENT PLANS, AND EMPLOYEE BENEFITS

A. Structural Issues Relating to Qualified Retirement Plans

1. General simplification issues

There are three potential sources of income for an individual after retirement--Social Security benefits, employer-provided qualified retirement plan benefits, and personal savings. These three sources of retirement income have traditionally been referred to as the "three-legged stool" of retirement income security. Taken together, these three sources of income ideally should provide an adequate replacement for preretirement income.

An employer's decision to establish or continue a qualified retirement plan for employees is voluntary. The Federal tax laws provide favorable tax treatment for amounts contributed to a qualified retirement plan to encourage the establishment and continuance of such plans.

The Federal laws and regulations governing employer-provided retirement benefits are recognized as among the most complex sets of rules applicable to any area of the tax law. Some have argued that this complexity has made it difficult, if not impossible, for employers, particularly small employers, to comply with the law. In addition, it is asserted that this complexity deters employers from establishing qualified retirement plans or forces the termination of such plans. If this assertion is accurate, then the complexity of the employee benefits laws is reducing the number of employees covered under employer-provided plans. Such a result requires Social Security and personal savings to assume more of the burden of replacing preretirement income.

Others assert that the complexity of laws and regulations governing qualified retirement plans is a necessary byproduct of attempts (1) to ensure that retirement benefits are delivered to more than just the most highly compensated employees of an employer; (2) to provide employers, particularly large employers, with the flexibility needed to recognize the differences in the way that employers do business; and (3) to ensure that retirement benefits generally are used for retirement purposes.

In this study, the Joint Committee staff makes a number of recommendations relating to the rules applicable to qualified retirement plans. In addition, the Joint Committee staff considered a number of proposals that would provide additional simplification, but would have fundamental policy implications. In some cases, proposals that would result in simplification prospectively would also require significant adjustment to existing plans, thus undermining the objectives of simplification. For example, the Joint Committee staff considered recommending that model plans be provided and that employers be able to adopt only the model plans. Although this would dramatically reduce the complexity of the qualified retirement plan rules, it would also change fundamental policy underlying those rules and require significant changes to many existing plans. Similarly, the Joint Committee staff considered recommending repeal of the rules relating to permitted disparity and providing a single elective deferral vechile. The

Joint Committee staff believes that such changes would add simplification, but would alter underlying policy.

The following discussion addresses broad sources of complexity relating to the qualified retirement plan rules, and issues that would arise if structural changes to the rules were made.

2. Reasons for complexity in qualified retirement plan laws

Volume and frequency of legislation

Many employers and practitioners in the qualified retirement plan area have argued that the volume of legislation affecting qualified retirement plans enacted since 1974 has contributed to complexity. In many cases, a particular substantive area of qualified retirement plan law may be dealt with legislatively almost every year. For example, the rules relating to the form and taxation of distributions from qualified retirement plans were significantly changed by the Tax Equity and Fiscal Responsibility Act of 1982, the Deficit Reduction Act of 1984, the Tax Reform Act of 1986, the Unemployment Compensation Amendments of 1992, the Retirement Protection Act of 1994, the Small Business Job Protection Act of 1996, and the Taxpayer Relief Act of 1997. In many cases, changes in the rules are lobbied for by employers and practitioners.

This constant change of the law has not only contributed to complexity for the employer, plan administrator, or practitioner who must understand the rules, but has also created problems for the IRS and Department of Labor. Regulations projects have at times been so backlogged at the IRS that employers may not have known what they must do to bring their qualified retirement plans into compliance with enacted legislative changes because the IRS has been unable to publish adequate guidance for employers.

The amount of legislation in the qualified retirement plan area in recent years hinders the ability of the IRS and the Department of Labor to monitor compliance with the law. Significant amounts of resources are required to be expended to educate government employees with respect to changes in the law. Time that is spent reviewing qualified retirement plan documents to determine whether they qualify under the tax laws in form takes time away from the auditing of plans to ensure that they qualify in operation.

The level of legislative and regulatory activity in the qualified retirement plan area has also created problems because inadequate time is available to consider the possible interaction of various provisions. The IRS may issue regulations that are immediately superseded by legislation. Legislation is enacted that does not consider the potential interaction problems created with other areas of employee benefits law.

Some people argue that the rules relating to qualified retirement plans should not be significantly altered in the context of an effort to simplify the rules. This argument assumes that additional changes in the employee benefits area will only contribute to complexity by legislating again in an area that some say has been overlegislated in the last 20 years.

On the other hand, legislative initiatives that merely repeal existing rules may not contribute to additional complexity of the rules unless the repeal of such rules leaves uncertainty as to the rule that applies in place of the repealed rule.

The structure of the workplace

Some argue that the complexity of the rules relating to qualified retirement plans stems from a problem that is not unique to the employee benefits area--that is, the way in which the workplace has developed has created inherent complexities in legislation enacted to apply in the workplace. The way in which employers do business affects the complexity of qualified retirement plan legislation.

Large employers tend to have complex structures. These complex structures may include the division of employees among various subsidiaries that are engaged in different types of businesses. Rules are required to deal with the issues that arise because a business is operated in many tiers. For example, questions arise as to which employees are required to be taken into account in determining whether an employer is providing qualified retirement plan benefits on a nondiscriminatory basis. To what extent are employees of various subsidiaries that are engaged in completely different activities required to be aggregated? If these employees must be aggregated for testing purposes, what kind of recordkeeping burdens are imposed on the employer? How are headquarters employees treated and how does the treatment of such employees differ from the treatment of subsidiary employees? If an employer retains temporary workers, to what extent are such workers required to be taken into account? Should employees covered by collective bargaining agreements be treated differently than other employees? Employers face these issues every day because of the way in which their businesses are operated, rather than simply because the laws governing qualified retirement plans are complex.

Flexibility and complexity

Employers and employees generally want to be able to tailor their compensation arrangements, including qualified retirement plans, to fit their particular goals and circumstances. Present law accommodates these desires by providing for various tax-favored retirement savings vehicles, including qualified retirement plans, individual retirement arrangements ("IRAs"), simplified employee pensions, SIMPLE plans, and tax-sheltered annuities. There are many different types of qualified retirement plans, different ways of funding such plans, and different ways of providing benefits under such plans.

The number of different tax-favored retirement arrangements increases complexity in the qualified retirement plan rules because different rules are needed for each type of arrangement. A great deal of simplicity could be achieved, for example, if employers were permitted to choose from only one or two model qualified retirement plans. However, this would also greatly reduce the flexibility provided employers and employees under present law.

To some extent, the complexity of present law is elective. For example, employers who wish to reduce complexity can adopt a master or prototype plan. Similarly, an employer may adopt for all of its employees a simple profit-sharing plan that involves a minimum of administrative work. However, many employers choose more complicated compensation arrangements.

Complexity and certainty

Although employers and practitioners often complain about the complexity of the rules relating to qualified retirement plans, some of that complexity is, in fact, attributable to the desire of employers or the Congress to have certainty in the rules. For example, the general nondiscrimination rule relating to qualified retirement plans merely requires that a plan not discriminate in either contributions or benefits in favor of highly compensated employees. This rule is easy to articulate; however, determining whether or not the rule is satisfied is not a simple task. The most obvious problem is determining what the word "discriminate" means. If it means that there may be no difference in contributions or benefits between those provided to highly compensated employees and those provided to rank-and-file employees, then the rule may be fairly straightforward. However, because the rules permit employers some flexibility to provide more contributions or benefits for highly compensated employees, it is necessary to determine how much of a difference in the contributions or benefits is permitted.

Rules that provide greater certainty for employers tend, on their face, to appear to be more complex. A case in point are the nondiscrimination rules for employee benefits added in the 1986 Act (Code sec. 89).[236] Employers complained vigorously about the calculations and recordkeeping requirements imposed by section 89. However, these rules developed during the legislative consideration of the 1986 Act in large measure in response to employers' complaints about the uncertainty of a general rule prohibiting nondiscrimination in favor of highly compensated employees.

A more mechanical rule will often appear to be more complex, but will also provide more certainty to the employers, plan administrators, and practitioners who are required to comply with the rule. Thus, any attempts to reduce complexity of the employee benefits laws must balance the desire for simplicity against the perceived need for certainty. In addition, it should be recognized that simplicity in legislation does not preclude complexity in regulation.

Retirement policy vs. tax policy

Another source of complexity in the development of qualified retirement plan laws and regulations is the use of the Federal income tax system to encourage the delivery of retirement benefits by employers. This approach tends to create conflicts between retirement income policy and tax policy.

Retirement income policy has as its goal the delivery of adequate retirement benefits to the broadest possible class of workers. Because the decision to maintain a retirement plan for employees is voluntary, retirement income policy would argue for laws and regulations that do not unduly hinder the ability or the willingness of an employer to establish a retirement plan. Such a policy might also encourage the delivery of more retirement benefits to rank-and-file employees by adopting a rule that prohibits discrimination in favor of highly compensated employees, but does not otherwise limit the amount of benefits that can be provided to such employees. Thus, an employer whose principal objective was to provide large retirement

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[236] Section 89 was repealed in 1989 (Pub. Law No. 101-140).

benefits to highly compensated employees (e.g., management) could do so as long as the employer also provided benefits to rank-and-file employees.

On the other hand, tax policy will be concerned not only with the amount of retirement benefits being delivered to rank-and-file employees, but also with the extent to which the Federal Government is subsidizing the delivery of such benefits. Thus, Federal tax policy requires a balancing of the tax benefits provided to an employer who maintains a qualified retirement plan in relation to all other tax subsidies provided by the Federal tax laws. This balancing has led the Congress (1) to limit the total amount of benefits that may be provided to any one employee by a qualified retirement plan and (2) to adopt strict nondiscrimination rules to prevent highly compensated employees from receiving a disproportionate amount of the tax subsidy provided with respect to qualified retirement plans.

Jurisdiction of qualified retirement plan legislation

When the Employee Retirement Income Security Act ("ERISA") was enacted in 1974, the Congress concluded that Federal qualified retirement plan legislation should be developed in a manner that limited the Federal tax subsidy of employer-provided retirement benefits and that provided adequate safeguards for the rights of employees whose employers maintained qualified retirement plans. Accordingly, the rules adopted in ERISA included changes in the tax laws governing qualified retirement plans (Title II of ERISA) and also included labor law requirements applicable to employer-provided plans (Title I of ERISA). In many cases, these labor law requirements mirrored the requirements of the tax laws and created a civil right of action for employees. Thus, ERISA ensured that compliance with the Federal employee benefits laws could be monitored by the Federal Government (through the IRS and the Department of Labor) and by employees (through their civil right of action under the labor laws).

Although many of the qualified retirement plan laws enacted in ERISA had mirror provisions in the labor laws and in the Internal Revenue Code, subsequent legislation has not always followed the same form. For example, the top-heavy rules that were enacted as part of the 1982 Act were only included in the Internal Revenue Code and did not contain a corresponding provision in Title I of ERISA. Some have argued that such a piecemeal approach to employee benefits legislation can lead to inconsistencies between the Federal tax law and Federal labor law and can contribute to the overall complexity of the rules governing qualified retirement plans.

In addition, the enforcement of rules relating to qualified retirement plans is shared by the IRS and the Department of Labor. Thus, there is no single agency of the Federal Government that is charged with the development and implementation of regulations and with the operational enforcement of the rules relating to qualified retirement plans.

Although the authority of each applicable agency has been clarified, complexity can occur because of the manner in which the agencies interact. An employer must determine the agency with which it must consult on an issue and may find that the goals of each agency are different. For example, the Pension Benefit Guaranty Corporation views the funding of a defined benefit pension plan from its goal of assuring solvency of the plan when benefit payments are due. On the other hand, the IRS is concerned that employers should not be

permitted to overfund defined benefit pension plans as a mechanism by which the employer can shelter income from taxation. Without careful coordination of the goals of these two Federal agencies, employers may receive inconsistent directives.

Transition rules

When the Congress enacts tax legislation altering the tax treatment of qualified retirement plans or distributions from such plans, transition relief is often provided to specific employers or individual taxpayers or to a class of employers or taxpayers. Transition relief generally delays temporarily or permanently the application of the enacted rule to the applicable taxpayer. Sometimes, transition relief will apply a modified rule that is a compromise between present law and the enacted rule.

The adoption of transition rules for a taxpayer or a class of taxpayers contributes to the actual and perceived complexity of employee benefits laws.

B. Individual Retirement Arrangements

Present Law

In general

Present law provides tax-favored treatment for individual retirement arrangements ("IRAs"). There are two broad categories of IRAs: traditional IRAs, to which both deductible and nondeductible contributions may be made, and Roth IRAs. The Federal income tax rules applicable to IRAs differ depending on whether an IRA is a traditional IRA or a Roth IRA. In addition, the rules relating to traditional IRAs depend on whether an individual makes deductible or nondeductible contributions. As discussed more fully below, the economic benefit of the tax provisions relating to deductible and Roth IRAs is similar--exemption of earnings from tax--except that Roth IRAs effectively have a higher contribution limit. The economic benefit of making nondeductible contributions to an IRA is different. Deductible IRAs and Roth IRAs effectively exempt earnings on invested sums from tax, while the nondeductible IRA taxes earnings, but on a deferred basis.

Traditional IRAs

Deductible contributions

Under present law, the maximum permitted annual deductible IRA contribution generally is the lesser of $2,000 or the individual's compensation includible in gross income for the year. In the case of a married couple, deductible IRA contributions of up to $2,000 can be made for each spouse (including, for example, a homemaker who does not work outside the home), if the combined compensation of both spouses is at least equal to the contributed amount. If the individual for whom the contribution is made is an active participant in an employer-sponsored retirement plan, the $2,000 deduction limit is phased out for taxpayers with adjusted gross income over certain levels for the taxable year.

The adjusted gross income phase-out limits for a single individual who is an active participant in an employer-sponsored retirement plan are as follows: for 2001, $33,000 to $43,000; for 2002, $34,000 to $44,000; for 2003, $40,000 to $50,000; for 2004, $45,000 to $55,000; and for 2005 and thereafter, $50,000 to $60,000.

The adjusted gross income phase-out limits for a married taxpayer filing a joint return who is an active participant in an employer-sponsored plan are as follows: for 2001, $53,000 to $63,000; for 2002, $54,000 to $64,000; for 2003, $60,000 to $70,000; for 2004, $65,000 to $75,000; for 2005, $70,000 to $80,000; for 2006, $75,000 to $85,000; and for 2007 and thereafter, $80,000 to $100,000.

In the case of married taxpayers filing separate returns, the contribution limit is phased out for modified adjusted gross income between $0 and $10,000.

If an individual is not an active participant in an employer-sponsored retirement plan, but the individual's spouse is, the $2,000 deduction limit is phased out over adjusted gross income between $150,000 and $160,000.

Nondeductible contributions

To the extent an individual cannot or does not make deductible contributions to an IRA or contributions to a Roth IRA, the individual may make nondeductible contributions to an IRA. Nondeductible contributions must be reported on the individual's tax return for the year (even if the individual is not otherwise required to file a return). If nondeductible contributions are not reported, then those contributions will be includible in income when distributed, unless the individual can show with other satisfactory evidence that nondeductible contributions were made. In no event can the total IRA contributions for an individual for a year exceed the lesser of $2,000 or the individual's compensation (or the total compensation of both spouses includible in gross income for the year).

Taxation of distributions

Amounts held in a traditional IRA are includible in income when withdrawn (except to the extent the withdrawal is a return of nondeductible contributions) under the rules applicable to taxation of annuities. If an individual has not made nondeductible contributions to a traditional IRA, then all distributions from the individual's traditional IRAs are taxable. If an individual has made nondeductible IRA contributions, then a portion of each distribution is nontaxable. In general, the amount of a distribution that is not taxable is determined by multiplying the amount of the distribution by the ratio of the remaining nondeductible contributions to the total IRA balance. In making this calculation, all traditional IRAs of an individual are treated as one IRA.

Includible amounts withdrawn from an IRA prior to attainment of age 59-1/2 are subject to an additional 10-percent early withdrawal tax, unless the withdrawal is due to death or disability, is made in the form of certain periodic payments, is used to pay medical expenses in excess of 7.5 percent of adjusted gross income, is used to purchase health insurance of an unemployed individual, is used for education expenses, or is used for first-time homebuyer expenses of up to $10,000.

Roth IRAs

Individuals with adjusted gross income below certain levels may make nondeductible contributions to a Roth IRA.[237] The maximum annual contribution that may be made to a Roth IRA is the lesser of $2,000 or the individual's compensation includible in gross income for the year. The contribution limit is reduced to the extent an individual makes contributions to any other IRA for the same taxable year. As under the rules relating to IRAs generally, a contribution of up to $2,000 for each spouse may be made to a Roth IRA provided the combined compensation of the spouses is at least equal to the contributed amount. The maximum annual contribution that can be made to a Roth IRA is phased out for single individuals with adjusted

[237] Roth IRAs were established by the Taxapyer Relief Act of 1997, effective for taxable years beginning after December 31, 1998.

gross income between $95,000 and $110,000, and for married individuals filing joint returns with adjusted gross income between $150,000 and $160,000.

In the case of married taxpayers filing separate returns, the contribution limit is phased out for modified adjusted gross income between $0 and $10,000.

Taxpayers with modified adjusted gross income of $100,000 or less generally may convert a traditional IRA into a Roth IRA. Married taxpayers filing separate returns may not convert a traditional IRA into a Roth IRA.

The amount converted from a traditional IRA into a Roth IRA is includible in income as if a withdrawal had been made, except that the 10-percent early withdrawal tax does not apply and, if the conversion occurred in 1998, the income inclusion may be spread ratably over 4 years.

Amounts held in a Roth IRA that are withdrawn as a qualified distribution are not includible in income, nor subject to the additional 10-percent tax on early withdrawals. A qualified distribution is a distribution that is made (1) after the five-taxable-year period beginning with the first taxable year for which the individual made a contribution to a Roth IRA, and (2) after attainment of age 59-1/2, on account of death or disability, or for first-time homebuyer expenses of up to $10,000.

To the extent attributable to earnings, a distribution from a Roth IRA that is not a qualified distribution is includible in income and subject to the 10-percent early withdrawal tax (unless an exception applies).[238]

The same exceptions to the early withdrawal tax that apply to regular IRAs apply to Roth IRAs. The early withdrawal tax will apply, however, to any portion of a distribution attributable to a conversion from a deductible or nondeductible IRA if the distribution occurs within the five-taxable-year period beginning with the taxable year in which the conversion occurs (unless an exception applies).

Economic comparison of tax benefits of IRAs

Deductible contributions to traditional IRAs

Subject to the rules described above, a taxpayer is allowed to deduct contributions to a traditional IRA from income in the year contributed; upon withdrawal, the entire amount withdrawn is includible in income. There are two potential advantages of making deductible IRA contributions over saving in fully taxable vehicles. First, taxpayers earn a tax-free rate of return on IRA investments. Second, taxpayers postpone taxation of the contribution until the contributions are withdrawn, at which time they may be taxed at a lower rate than when the contribution is made.

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[238] Early distribution of converted amounts may also accelerate income inclusion of converted amounts that are taxable under the four-year rule applicable to 1998 conversions.

The following example illustrates why a deductible IRA investment receives a tax-free rate of return. Assume a taxpayer with a marginal tax rate of 28 percent makes a $1,000 deductible contribution to a traditional IRA. The initial savings from the contribution is $280, the tax that would have been paid on the $1,000. For the purpose of this example, assume that the taxpayer withdraws the funds after one year (without imposition of the 10-percent early withdrawal tax). If the annual rate of return on the IRA assets is 10 percent, the value of the IRA is $1,100, total tax due is $308, and the taxpayer is left with $792. Notice that if the taxpayer had paid the initial tax of $280 and invested the remaining $720 at 10 percent, then the taxpayer would have had $792 after one year. If the income had not been invested in a taxable savings account, the taxpayer would have to pay tax on $72 dollars of earnings (a tax of $20.16), and would be left with $771.84 after payment of taxes. The value of the IRA is that the taxpayer does not have to pay the additional $20.16 tax. Thus, the deductible IRA contribution allows the taxpayer to get a tax-free rate of return on an investment of $720.

This analysis is independent of the number of years the IRA investment is held. The value of the tax exemption, however, increases with the number of years the IRA is held. For instance, if in the above example, the taxpayer holds the IRA for 10 years, the IRA would be worth $1,867, whereas a fully taxed investment would be worth $1,443 after 10 years.

The deductible IRA investment can be viewed as an investment that is jointly shared by the government and the taxpayer. The government's share is equal to the tax rate (28 percent in the above example). When the IRA funds are withdrawn, the government receives its share of the funds. In the above example, when the funds are withdrawn after one year, the government receives 28 percent of $1,100 ($308), and the taxpayer receives 72 percent of $1,100 ($792). The taxpayer pays no tax on the earnings attributable to the taxpayer's share of the investment, and thus receives a tax-free rate of return on the investment. This is one advantage of investing through deductible IRA contributions.

A second advantage of deductible IRA contributions arises if the taxpayer's marginal tax rate in the year the funds are withdrawn is lower than the marginal tax rate in the year of the contribution. Because the government's share of the investment is equal to the taxpayer's tax rate in the year the funds are withdrawn, the lower the tax rate prevailing at that time, the smaller the government's share. In the example above, for instance, if the tax rate when the funds are withdrawn is 15 percent, then the tax paid after one year would be $165. Not only does the taxpayer receive a tax-free rate of return on the taxpayer's share of the investment, but the taxpayer's share of the investment is 85 percent rather than 72 percent.

Tax rates might be lower at the time the funds are withdrawn because the IRA owner may be receiving untaxed Social Security benefits and reduced taxable income from other sources. However, the marginal tax rate could be lower or higher because tax rate schedules may change over time.

Roth IRAs

From an economic perspective, contributions to Roth IRAs are similar to deductible IRA contributions. With a Roth IRA, the taxpayer does not deduct the contribution from income, but pays no tax when the funds are withdrawn assuming applicable requirements are satisfied. In

other words, the government takes its share before the funds are invested. The taxpayer is never taxed on the interest earned on the investment, and thus earns a tax-free rate of return on the IRA investment. This is the same tax benefit provided to deductible IRAs.

However, in the case of a Roth IRA, the tax is paid on the initial contribution at the time of contribution, and in the case of deductible IRA contributions, the tax is paid on the initial contribution at the time of withdrawal. In effect, the government's share of the Roth IRA is equal to the taxpayer's marginal tax rate at the time the funds are contributed, whereas the government's share of the deductible IRA is equal to the taxpayer's marginal tax rate at the time the funds are withdrawn. Whether the deductible IRA and Roth IRA are economically equivalent depends on the difference between the taxpayer's marginal tax rate in the year the contribution is made and the taxpayer's marginal tax rate in the year the IRA funds are withdrawn.

If these two marginal tax rates are equal, then the Roth IRA provides the same overall benefits as deductible IRA contributions. For example, if a taxpayer earns $1,000 and contributes it to a Roth IRA, the taxpayer first pays tax on the $1,000. If the taxpayer's marginal tax rate is 28 percent, the taxpayer will have $720 to invest. After one year earning interest at 10-percent per year, the taxpayer has $792, the same amount that the taxpayer has in the deductible IRA contribution example above.

If the tax rate in the year the contribution is made is different from the tax rate in the year the funds are withdrawn, then the deductible IRA contribution and the Roth IRA are no longer equivalent. When tax rates decrease over time (either because tax rates change or taxpayers fall into lower tax brackets), deductible IRA contributions are more advantageous, because taxpayers defer payment of tax until tax rates are lower. When tax rates increase over time, a Roth IRA is more tax favored.

One source of difference between the deductible IRA and the Roth IRA arises from the imposition of a common annual limitation on contributions. Under present law, the contribution limit applied to Roth IRAs is the same as that currently applicable to deductible IRAs, $2,000. Contributions to a deductible IRA are limited to $2,000 of pre-tax income, whereas contributions to a Roth IRA are limited to $2,000 of after-tax income. The $2,000 Roth IRA contribution limit effectively increases the amount of tax-free saving that can be invested in the Roth IRA relative to the deductible IRA. The following example illustrates this difference. In the case of a taxpayer with a marginal tax rate of 28 percent who contributes $2,000 to a deductible IRA earning 10 percent per year, the IRA balance will be $2,200 after one year. The taxpayer will owe $616 in tax, leaving $1,584. This is equivalent to the taxpayer having paid an initial tax of $560, or 28 percent of $2,000, and investing the remaining $1,440 at an after-tax return of 10 percent. Thus, the $2,000 limit on pre-tax income is like a limit of $1,440 on after-tax income for a taxpayer with a 28-percent marginal tax rate. If instead the investor had contributed $2,000 to a Roth IRA, the funds available to the taxpayer after one year would be the full $2,200,

because no additional tax would be due.[239] The difference in the limits is only valuable to taxpayers who want to invest more than $2,000 of pre-tax income in an IRA.

Nondeductible IRAs

Present law permits taxpayers to make nondeductible contributions to traditional IRAs to the extent that a taxpayer may not make deductible IRA contributions or Roth IRA contributions because of the applicable income phase-outs (or chooses not to make such contributions). Unlike earning on Roth IRA contributions, earnings on nondeductible contributions to traditional IRAs are includible in income when withdrawn. The tax advantage of such contributions is that taxes on earnings are deferred, rather than assessed annually. This permits the earnings to compound faster than with annual taxation of earnings. This advantage is the same advantage implicit in the tax treatment of the earnings on deferred annuities, which are taxed when the annuities are paid rather than when the earnings accrue.

For example, compare the accumulation of income for an investor with a 28-percent marginal tax rate on $720 which is invested for a period of 10 years at a 10-percent annual rate of return. If the earnings are taxed annually, the total available funds at the end of 10 years would be $1,443.05. The investor's annual after-tax return is 7.2 percent. If the tax is deferred for 10 years and assessed on the accumulated interest at the end of the 10-year period at a 28-percent marginal tax rate, the value of the taxpayer's investment would be $1,344.60, which represents an annual return of 7.9 percent. Unlike the deductible contributions and Roth IRA contributions discussed above, the after-tax rate of return of investment on traditional nondeductible IRA contributions increases as the holding period increases; as the holding period increases, accumulated earnings increase, and thus the value of deferring tax on the accumulated earnings increases.

Summary

Table 12., below, compares the funds available after 10 years to a taxpayer who saves $1,000 of pre-tax income through deductible contributions to a traditional IRA, Roth IRA contributions, and nondeductible contributions to a traditional IRA, assuming that no early withdrawal tax applies and that the rate of return on the IRA assets is 10 percent per year. The tax rate in the year contributed is labeled t_0, and the tax rate in the year the funds are withdrawn is labeled t_{10}. Table 18., below, summarizes the timing of the Federal government's tax receipts under the various IRA options.

As was noted above, the difference in the funds available to the taxpayer investing $1,000 of pre-tax income through deductible IRA contributions compared to Roth IRA contributions depends only on the difference between the marginal tax rate the taxpayer faces in the year the funds are contributed, t_0, and the marginal tax rate in the year the funds are withdrawn, t_{10}. The funds available through traditional nondeductible IRA contributions are always smaller than

[239] More generally, for a taxpayer facing a marginal tax rate of t, the equivalent contribution limit for a deductible IRA is C/(1-t) where C is the contribution limit for the Roth IRA.

those in the Roth IRA. Both of these IRAs tax the contribution at a tax rate t_o, but the Roth IRA effectively exempts earnings from additional tax, whereas traditional nondeductible IRA contributions result only in deferral of tax on earnings.

Table 12.--Funds Available to Taxpayer and Pattern of Tax Receipts With Respect to Deductible IRA, Roth IRA, and Traditional Nondeductible IRA Contributions

Funds Available to Taxpayer After 10 Years

Type of IRA Contribution	Funds contributed to IRA	Funds available after 10 years	Taxes due in year 10	Funds available after tax in year 10
Deductible IRA	\$1,000	\$2,594	$\$2,594\cdot(t_{10})$	$\$2,594\cdot(1-t_{10})$
Roth IRA	$\$1,000\cdot(1-t_0)$	$\$2,594\cdot(1-t_0)$	0	$\$2,594\cdot(1-t_0)$
Traditional Nondeductible IRA	$\$1,000\cdot(1-t_0)$	$\$2,594\cdot(1-t_0)$	$\$(2,594-1,000)\cdot(1-t_0)t_{10}$	$\$2,594\cdot(1-t_0) - \$1,594\cdot(1-t_0)t_{10}$

Table 18.--Pattern of Income Tax Payments With Respect to Deductible IRA, Roth IRA, and Traditional Nondeductible IRA Contributions

Type of IRA Contributions	Tax payments in —		
	Current year	Year 1-9	Year 10
Deductible IRA	0	0	$\$2,594\cdot(t_{10})$
Roth IRA	$\$1,000\cdot(t_0)$	0	0
Traditional Nondeductible IRA	$\$1,000\cdot(t_0)$	0	$\$1,594\cdot(1-t_0)\,t_{10}$

Assumptions:
Taxpayer has \$1,000 of pre-tax income to invest in IRA, and the annual rate of return on IRA assets is 10 percent.
t_0 = marginal tax rate in year of IRA contribution.
t_{10} = marginal tax rate in year of IRA withdrawal (year 10).

Sources of Complexity

The existence of multiple IRA options creates transactional complexity. A major source of this complexity is the differing eligibility rules for each type of IRA contribution, particularly the income-based eligibility restrictions. Any given taxpayer may be eligible to make only nondeductible contributions, both nondeductible contributions and Roth IRA contributions, or all three types of IRA contributions (nondeductible, Roth IRA, and deductible). Thus, a taxpayer wishing to make IRA contributions may need to understand three different sets of rules both to determine eligibility to make contributions and to determine which type of contribution the taxpayer wishes to make (if eligible for more than one type).

The adjusted gross income limits create additional complexities for taxpayers who make IRA contributions before they file their tax return for the year.[240] Such taxpayers must estimate their adjusted gross income to determine IRA eligibility. If the taxpayer underestimates his or her adjusted gross income, the taxpayer may in fact be ineligible for the IRA contribution he or she has made. In such a case, the taxpayer must withdraw the contribution (with earnings) or face excise taxes on excess contributions.[241]

The adjusted gross income limits also create computational complexity. For a further discussion of the complexity caused by adjusted gross income phase-outs, see Section II.C. of this Part, above.

Recommendation for Simplification

The Joint Committee staff recommends that the income limits on eligibility to make deductible IRA contributions, Roth IRA contributions, and conversions of traditional IRAs to Roth IRAs should be eliminated. Further, the Joint Committee staff recommends that the ability to make nondeductible contributions to traditional IRAs should be eliminated.

The Joint Committee recommends staff that the age restrictions on eligibility to make IRA contributions should be the same for all IRAs.

Taken together, the Joint Committee staff recommendations will reduce the number of IRA options and conform eligibility criteria for remaining IRAs, thus simplifying taxpayers' savings decisions.[242] Taxpayers will no longer need to apply various rules to determine

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[240] IRA contributions may be made for a taxable year until the time for filing the taxpayer's Federal tax return for the year, generally April 15th of the following year.

[241] The excise tax is equal to six percent of the excess contributions and applies annually to accumulated excess contributions that have not been withdrawn from the IRA by a specified date. Sec. 4973.

[242] The Joint Committee staff has made separate recommendations relating to the minimum distribution rules and basis recovery rules applicable to qualified employer retirement plans and IRAs. *See* Sections III.C.7. and D. of this Part, below. If adopted, these

eligibility. Instead, taxpayers will be able to focus on what tax-favored savings vehicle, if any, they consider most appropriate for their circumstances.[243]

The Joint Committee staff is recommending that the adjusted gross income limits relating to IRAs be repealed as part of its general recommendation relating to income-based phase-outs, which is discussed in Section II.C. of this Part, above. As explained therein, the Joint Committee staff believes that certain adjusted gross income phase-outs, including those relating to IRAs, are intended to achieve progressivity, and that progressivity can be more simply achieved through the rate structure.

Some argue that the adjusted gross income phase-outs relating to IRAs serve purposes other than or in addition to progressivity. In particular, it is argued that eliminating the income limits on deductible IRA contributions and Roth IRAs will have an effect on employer-sponsored retirement plan coverage. In determining whether to adopt a tax-qualified pension plan for its employees, one of the factors an employer may consider, particularly in the case of a small business, is the tax-favored savings opportunities available to the owners of the business outside of the qualified plan. The greater such opportunities, the less likely the business may be to undertake the burdens and expense of a qualified plan. Thus, if all individuals, regardless of income, are permitted to make deductible IRA or Roth IRA contributions, some businesses may not adopt broad-based qualified plans. Although all employees would be eligible to make IRA contributions under the proposal, IRA participation has traditionally been lower among lower-income individuals. Thus, there is a concern that if fewer employers adopt qualified retirement plans as a result of broadening IRA eligibility, lower-income individuals will not have adequate retirement saving. Others argue that providing universal availability of IRAs is not likely to have much of an impact on an employer's decision to establish a qualified plan given the relatively low IRA contribution limit under present law ($2,000 per year) compared to the tax-favored savings opportunities under qualified plans (as much as $35,000 per year, depending on the type of plan adopted).

As a corollary to the Joint Committee staff recommendation that the income limits applicable to IRAs be repealed, the Joint Committee staff recommends that the ability to make nondeductible contributions to traditional IRAs be repealed. Nondeductible contributions were initially adopted when the income limits on deductible IRAs were enacted in 1986 in order to provide a tax incentive for discretionary retirement savings for all taxpayers.[244] If the income limits on the ability to make deductible IRA contributions and Roth IRA contributions are repealed, then permitting nondeductible contributions to traditional IRAs is no longer necessary--

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recommendations would further conform the rules relating to deductible IRA contributions and Roth IRAs.

[243] As mentioned above, Roth IRAs and deductible IRA contributions provide a similar tax benefit--exemption of the earnings. However, Roth IRAs effectively have a higher contribution limit. To make the two vehicles economically more equivalent, the contribution limit for deductible IRAs could be increased.

[244] S. Rep. 99-313 (May 29, 1986), at 543.

both deductible IRAs and Roth IRAs provide better economic benefits than nondeductible contributions to traditional IRAs.

The Joint Committee staff recommends that the age restrictions on IRA contributions be the same for all types of IRAs. There does not appear to be a strong policy reason for applying different rules to different types of IRAs, and eliminating this difference would make it easier for taxpayers to choose which IRA vehicle is best.

C. Qualified Retirement Plans

1. Adopt uniform definition of compensation for qualified retirement plans

Present Law

In general

Present law prescribes different required definitions of employee[245] compensation for different qualified retirement plan purposes.[246] These purposes include: (1) application of the limits on contributions and benefits; (2) application of the limits on deductions for qualified retirement plan contributions; (3) determination of highly compensated employees and key employees; (4) determination of minimum benefits required under top-heavy plans; and (5) application of the nondiscrimination and minimum coverage rules. Each definition of compensation, and the purposes for which it is used, are described in detail below and summarized in Table 13, following the Joint Committee staff's recommendation for simplification.

Qualified retirement plans generally provide benefits based on employees' compensation. Accordingly, a qualified retirement plan usually contains a definition of compensation that is used to determine benefits under the plan. A qualified retirement plan may, but generally is not required to, use one of the prescribed definitions of compensation to determine benefits.[247] If the plan does not base benefits on one of these definitions, compensation must be recalculated using a prescribed definition in order to apply the qualified retirement plan requirements.

Section 415 compensation

Definition

Limits apply to the amount of contributions and benefits that can be provided under a qualified retirement plan (sec. 415). The maximum contribution or benefit depends on the type of plan and is the lesser of a specific dollar amount or a percentage of compensation.

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[245] In the case of a self-employed individual who is treated as an employee under section 401(c)(1), compensation generally means the individual's earned income as defined in section 401(c)(2). No changes are recommended with respect to the definition of compensation of self-employed individuals.

[246] The annual compensation that may be taken into account for qualified plan purposes, including determining benefits under a plan, must also be limited to a specified amount ($170,000 for 2001). Secs. 401(a)(17) and 404(l).

[247] Some plans must use a prescribed definition of compensation in determining benefits. For example, plans that satisfy the nondiscrimination requirements on a safe-harbor basis must use compensation as defined in the regulations. *See* Treas. Reg. secs. 1.401(a)(4)-2(b) and 1.401(a)(4)-3(b). *See also*, the discussion of SIMPLE plans in this Part.

Compensation is generally defined for this purpose as the compensation from the employer that is includible in the income of the participant for the year, plus certain elective contributions that are not included in gross income.[248] Under Treasury regulations, the general definition of compensation includes amounts that are currently included in gross income and excludes amounts that are not. However, the regulations deviate from that general definition for certain types of compensation such as restricted stock and moving expense reimbursements.[249] The regulations also provide alternative definitions of compensation based on compensation that is subject to income tax withholding or for which the employer must provide a written statement to the employee.[250] Form W-2 is the means by which the employer provides the employee with a written statement.[251]

Other purposes for which section 415 compensation is used

The amount of an employee's compensation is used to determine status as a highly compensated employee for purposes of various nondiscrimination provisions or status as a key employee for purposes of the top-heavy provisions.[252] If a plan is top heavy, the plan must provide each non-key employee with a minimum benefit of a specified percentage of compensation.[253] In addition, the employer's deduction for contributions to one or more qualified retirement plans for a year is limited to a certain percentage of total compensation of all participants for the year.[254]

The definition of compensation that applies for purposes of the limits on contributions and benefits applies also for purposes of the determination of highly compensated employee or key employee status, and the calculation of top-heavy minimum benefits.[255] Thus, the various

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[248] Sec. 415(c)(3)(D). The limit that applies to a defined contribution plan is based on a percentage of the employee's compensation for the year. The limit that applies to a defined benefit plan is based on a percentage of the employee's highest average compensation for any three consecutive years.

[249] Treas. Reg. sec. 1.415-2(d)(2) and (3).

[250] Treas. Reg. sec. 1.415-2(d)(11).

[251] In general, the employer must provide a written statement to the employee showing the compensation from the employer that is included in the employee's income for the calendar year. The employer must also provide the employee with a written statement showing the cost of group-term life insurance coverage included in the employee's income for the calendar year. Form W-2 is used for these purposes.

[252] Secs. 414(q) (highly compensated employee) and 416(i)(1) (key employee).

[253] Sec. 416(c).

[254] Sec. 404(a)(3)(A)(i) and (a)(7).

[255] *See* sec. 414(q)(4), which cross references sec. 415(c)(3), sec. 416(i)(1)(D), which cross references sec. 414(q)(4), and Treas. Reg. sec. 1.416-1, T-21, M-2, and M-7.

definitions of compensation under the regulations are available also for those other purposes. In addition, elective contributions are included in compensation for those purposes. The same definition of compensation generally applies for purposes of the limits on deductions; however, elective contributions are not included in compensation for deduction limitation purposes.

Section 414(s) definition of compensation

Definition

The qualified retirement plan rules include a definition of compensation for purposes of the application of the various nondiscrimination requirements.[256] This definition generally is based on the definition of compensation that applies for purposes of the limits on contributions and benefits, but the employer may elect not to include elective contributions.[257] In addition, the use of alternative methods of determining compensation is authorized to the extent that the use of an alternative method does not discriminate in favor of highly compensated employees.[258]

Treasury regulations permit as safe harbors (1) the use of the general definition or any of the alternative definitions of compensation prescribed for purposes of the limits on contributions and benefits (for example, compensation subject to income tax withholding) or (2) the use of one of those definitions reduced by all of the following: expense reimbursements and allowances, fringe benefits, moving expenses, deferred compensation and welfare benefits.[259] In addition, any of those permissible definitions may be modified to include particular types of contributions and deferrals or to exclude any portion of the compensation of some or all of the highly compensated employees.[260]

As an alternative to the safe harbor definitions, the regulations permit the use of any definition that (1) does not by design favor highly compensated employees, (2) is reasonable within the meaning of the regulations, and (3) satisfies the nondiscrimination requirement in the regulations.[261] The nondiscrimination requirement generally involves a comparison of the average percentage of total compensation included in the alternative definition for the employer's highly compensated employees as a group with the average percentage of total compensation included for the nonhighly compensated employees as a group.

Subject to certain requirements and limitations, the regulations permit the use of an employee's "rate of compensation," i.e., the employee's compensation according to a pay scale

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[256] Sec. 414(s).

[257] Sec. 414(s)(1) and (2).

[258] Sec. 414(s)(3).

[259] Treas. Reg. sec. 1.414(s)-1(c)(2) and (3).

[260] Treas. Reg. sec. 1.414(s)-1(c)(4) and (5).

[261] Treas. Reg. sec. 1.414(s)-1(d).

or schedule, rather than the employee's actual compensation, as well as an employee's compensation from a prior employer or imputed compensation under a defined benefit plan.

Purposes for which section 414(s) compensation is used

The definition of compensation prescribed in section 414(s) applies for purposes of provisions that specifically refer to that statutory definition. For example, in addition to the nondiscrimination requirements, the minimum coverage requirements refer to the statutory definition. [262]

Definition of compensation for SIMPLE plans[263]

Definition

SIMPLE plans automatically satisfy certain qualification requirements by using a statutorily prescribed plan design, including a prescribed definition of compensation. For this purpose, compensation of an employee means amounts that are subject to income tax withholding, elective deferrals, and amounts deferred under an eligible deferred compensation plan.[264] These amounts are generally shown on the employee's Form W-2.

Purposes for which the SIMPLE definition is used

Employee compensation is relevant for purposes of several aspects of the prescribed design of a SIMPLE plan. An employee must be able to choose between elective contributions to the plan and receiving cash, and the amount of elective contributions must be expressed as a percentage of the employee's compensation. The employer must also make matching contributions to the plan, which may not exceed a specified percentage of compensation. As an alternative to matching contributions, the employer may make nonelective contributions of a specified percentage of compensation.

In order to be eligible to maintain a SIMPLE plan, the employer must have no more than 100 employees who received compensation of at least $5,000 in the preceding year. In addition, participation in the plan must be available to all employees who received compensation of at least $5,000 in any two preceding years and are reasonably expected to receive compensation of at least $5,000 during the year.

The definition of compensation described above must be used in applying all of these SIMPLE plan requirements.

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[262] *See, e.g.*, secs. 401(a)(5)(B) and 410(b)(2)(C)(i).

[263] Secs. 408(p) and 401(k)(11).

[264] Sec. 408(p)(6)(A)(i). This definition applies also for purposes of a SIMPLE section 401(k) plan under section 401(k)(11)(D)(i).

Periods for determining compensation

Compensation for qualified retirement plan purposes is generally determined on the basis of a twelve-month period. Although typically the calendar year is used, a different twelve-month period may be permitted or required. For example, if a qualified retirement plan uses a plan year other than the calendar year, or if the employer uses a taxable year other than the calendar year, the plan year or the employer's taxable year may be the relevant period for determining compensation. In addition, different periods may apply for different purposes, so that, even if the same basic definition of compensation is used, compensation would have to be recalculated using the appropriate period.

Sources of Complexity

Present law is complex in that it contains different definitions of compensation for different purposes and minor variations within each definition that have little substantive effect. In addition, some of the items that are included or not included under a particular definition are not reflected on the employee's Form W-2, and the amount of those items is not easily ascertainable. The use of different definitions for purposes of applying the qualified retirement plan requirements and for determining benefits under the plan and the use of different periods for determining compensation create further complexity.

Recommendation for Simplification

The Joint Committee staff recommends the use of a single definition of compensation for all qualified retirement plan purposes, including determining plan benefits. The uniform definition would be all compensation provided to an employee by the employer for which the employer is required to furnish the employee a written statement on Form W-2, plus elective contributions.[265]

Under the Joint Committee staff's recommendation, the uniform definition would be used in determining whether a plan meets the qualification requirements, in applying other qualified retirement plan rules, such as deduction limits, and in determining contributions or benefits under the plan.[266] Use of the amounts shown on Form W-2, which are based on the calendar year, would mean that compensation would be determined by reference to the calendar year. If a different period applies for a particular purpose, such as the plan year or the employer's taxable

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[265] Elective contributions include employee elective contributions to a section 401(k) plan, a SIMPLE plan, a salary reduction simplified employee pension, a tax-sheltered annuity plan, an eligible deferred compensation plan, or a cafeteria plan, as well as amounts that are used at the election of the employee to provide qualified transportation fringe benefits. Most of these amounts are listed on the employee's Form W-2 under present law.

[266] It may be appropriate to permit an employee's compensation from a prior employer or imputed compensation to be used under a defined benefit plan in certain cases as currently permitted under the regulations.

year, the amount of compensation to be used would be compensation for the calendar year ending within the relevant period.

The recommendation would eliminate the need to determine different amounts of compensation for different purposes or different periods. In addition, benefits would be based on the same amount of compensation used in applying the qualified retirement plan rules. Moreover, because the definition is based on the amount of compensation for which the employer provides the employee a written statement on Form W-2 (and a copy of which is filed with the employee's tax return), the proper amount of compensation can be easily ascertained.

Requiring the use of a statutory definition of compensation in determining benefits under a qualified retirement plan would in some cases limit the flexibility available under present law. For example, qualified retirement plans sometimes base benefits on the employees' compensation under a pay scale or pay schedule rather than on actual compensation. In such a case, the plan would have to be amended to include the uniform definition, and additional changes could be required to maintain the same level of benefits. However, the loss of flexibility would be offset by reduced complexity in qualified retirement plan compliance and administration. In addition, eliminating differences between the amount of compensation shown on an employee's Form W-2 and the amount of compensation used to determine benefits could have the ancillary effect of making it easier for employees to understand the benefits to which they are entitled.

Table 13.--Definitions Of Compensation For Qualified Retirement Plan Purposes

DEFINITION	USE
415 compensation: • Current includible with elective contributions. • Modified current includible with elective contributions. • W-2 with elective contributions. • Modified W-2 with elective contributions. • Wages for income tax withholding with elective contributions.	Must be used to determine sec. 415 benefit and contribution limits, minimum top heavy benefits, HCE status and key employee status. May be used for benefit accrual purposes.
404 compensation (415 compensation without elective contributions): • Current includible without elective contributions. • Modified current includible without elective contributions. • W-2 without elective contributions. • Modified W-2 without elective contributions. • Wages for income tax withholding without elective contributions.	Must be used to determine deduction limit. May be used for benefit accrual purposes.
414(s) compensation: • Current includible with elective contributions and fringe benefits. • Current includible without elective contributions and fringe benefits. • Current includible without elective contributions and with fringe benefits. • Current includible with elective contributions and without fringe benefits. • Modified current includible with elective contributions and fringe benefits. • Modified current includible without elective contributions and fringe benefits. • Modified current includible without elective contributions and with fringe benefits. • Modified current includible with elective contributions and without fringe benefits. • W-2 with elective deferrals and fringe benefits. • W-2 without elective contributions and fringe benefits. • W-2 without elective contributions and with fringe benefits. • W-2 with elective contributions and without fringe benefits. • Modified W-2 with elective contributions and fringe benefits. • Modified W-2 without elective contributions and fringe benefits. • Modified W-2 without elective contributions and with fringe benefits. • Modified W-2 with elective contributions and without fringe benefits.	Must be used for application of nondiscrimination requirements and average benefits test for minimum coverage compliance. May be used for benefit accrual purposes.

Table 13.--Definitions Of Compensation For Qualified Retirement Plan Purposes (continued)	
DEFINITION	USE
• Wages for income tax withholding with elective contributions and fringe benefits. • Wages for income tax withholding without elective contributions and fringe benefits. • Wages for income tax withholding without elective contributions and with fringe benefits. • Wages for income tax withholding with elective contributions and without fringe benefits. • Any 415 definition modified with respect to a category that is applied consistently to all employees (e.g., bonuses, overtime) if the average included percentage of compensation for the HCEs is not more than a de minimis amount greater than the same percentage for the NHCEs. • Regular or basic rate of pay (rather than actual pay) if the average included percentage of compensation for the HCEs is not more than a de minimis amount greater than the same percentage for the NHCEs.	
408(p) (SIMPLE) compensation • Wages for income tax withholding with elective deferrals and section 457 deferrals.	Must be used for SIMPLE plan purposes.

2. Modifications to minimum coverage and nondiscrimination rules

Present Law

In general

The requirements for qualified retirement plans are aimed generally at providing retirement security. Many of the requirements serve to protect the benefits that are provided to employees.[267] In addition, because lower-income individuals typically save less than higher-income individuals, several of the qualified retirement plan requirements are designed to assure that benefits provided under qualified retirement plans are not weighted too heavily in favor of highly compensated employees. Specifically, the minimum coverage rules, the general rule prohibiting discrimination in contributions or benefits, and the top-heavy rules measure different, but interrelated aspects of a qualified retirement plan's delivery of benefits.[268]

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[267] For example, the vesting, accrual, and anticutback requirements (sec. 411) or the minimum funding requirements (sec. 412).

[268] *See* sec. 410(b) (minimum coverage rules), sec. 401(a)(4) (requiring that the contributions or benefits under a plan not discriminate in favor of highly compensated

The minimum coverage rules seek to assure that the group of employees benefiting under a plan is an acceptable combination of highly compensated employees and nonhighly compensated employees. The prohibition against discrimination in contributions or benefits ("general nondiscrimination rule") seeks to assure that the benefits provided to nonhighly compensated employees for a year is roughly comparable to the benefits provided to highly compensated employees for that year.[269] The top-heavy rules seek to assure that, if too much of the cumulative benefits under a plan are provided to key employees, other employees receive at least a minimum benefit.

Minimum coverage

In general

The group of employees covered under a qualified retirement plan must include a minimum percentage of the employer's nonhighly compensated employees.[270] The minimum percentage is generally determined by reference to the percentage of highly compensated employees who benefit under the plan. Two tests are available for satisfying the minimum coverage requirement: the ratio percentage test and the average benefits test.

Ratio percentage test

Under the ratio percentage test, the percentage of the employer's nonhighly compensated employees who benefit under the plan and the percentage of the employer's highly compensated employees who benefit under the plan are determined. The ratio of the two percentages ("ratio percentage") is determined by dividing the nonhighly compensated employee percentage by the highly compensated employee percentage. If the ratio percentage is at least 70 percent, the plan satisfies the ratio percentage test and, therefore, the minimum coverage requirement.

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employees), and sec. 416 (top-heavy rules). The term "nondiscrimination requirements" is sometimes used to refer to all these requirements as a group. Various other provisions are aimed at ensuring that plans are nondiscriminatory or otherwise relate to the nondiscrimination rules, including the limit on annual compensation (sec. 401(a)(17)), the minimum participation requirements (sec. 401(a)(26)), the permitted disparity rules (sec. 401(l)), the special nondiscrimination rules for 401(k) plans (sec. 401(k)(3)), the rules for matching contributions and employee contributions (sec. 401(m)), the definition of highly compensated employee (sec. 414(q)), the separate line of business rules (sec. 414(r)), and the definition of compensation (sec. 414(s)).

[269] The relationship between the minimum coverage rules and the prohibition on discrimination in contributions or benefits is discussed further in S. Rep. 99-313 (May 29, 1986), at 592.

[270] For purposes of the nondiscrimination requirements, all the employees of members of a controlled group or an affiliated service group are treated as employed by a single employer, and leased employees are treated as employees of the business to which they are leased. *See* sec. 414(b), (c), (m) and (n).

The ratio percentage test can be most easily understood using an example of a plan that covers all the employer's highly compensated employees. In that case, the percentage of highly compensated employees covered is 100 percent. As long as the plan covers at least 70 percent of the employer's nonhighly compensated employees, the plan's ratio percentage will be at least 70 percent and the plan will satisfy the ratio percentage test. However, if a plan covering 100 percent of the highly compensated employees covers less than 70 percent of the nonhighly compensated employees, the plan will not satisfy the minimum coverage requirements by means of the ratio percentage test.

Average benefits test

If a plan does not satisfy the ratio percentage test, it must satisfy the average benefits test, which includes several components. First, the classification of employees covered by the plan (such as hourly employees or employees of a particular division) must be reasonable and reflect objective business criteria. In addition, the ratio percentage of the plan must exceed a threshold established under regulations. The threshold depends on the percentage of nonhighly compensated employees in the employer's workforce as a whole ("nonhighly compensated employee concentration percentage"). The higher the nonhighly compensated employee concentration percentage, the lower the required ratio percentage for the plan.[271] In some cases, additional facts and circumstances must be considered. The last component, called the "average benefit percentage test" under the regulations, requires an analysis of the benefits provided to employees under the employer's qualified retirement plans.

The average benefit percentage test involves three determinations: (1) individual benefit percentages for the employees, that is, the employee's benefits as a percentage of the employee's compensation; (2) average benefit percentages for the group of nonhighly compensated employees and the group of highly compensated employees; and (3) the ratio of the average percentages for the groups. For this purpose, benefits provided under all of the employer's plans and all of the employees in the workforce, even those not covered by any plan, are taken into account. The test requires that the average benefit percentage of the nonhighly compensated employees must be at least 70 percent of the average benefit percentage of the highly compensated employees.

General nondiscrimination rules

In general

The contributions or benefits provided under a qualified retirement plan must not discriminate in favor of highly compensated employees. Treasury regulations provide detailed and exclusive rules for determining whether a plan satisfies the general nondiscrimination rules.[272] Under the regulations, the amount of contributions or benefits provided under the plan, all benefits, rights and features offered under the plan, and the timing of plan amendments must

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[271] *See* Treas. Reg. sec. 1.410(b)-4(c)(4)(iv) for a table of nonhighly compensated employee concentration percentages and related ratio percentages.

[272] Treas. Reg. secs. 1.401(a)(4)-1 through 1.401(a)(4)-13.

be tested. The regulations provide that both the form of the plan and the effect of the plan in operation determine whether the plan is nondiscriminatory.

Safe harbors and general tests

The regulations offer several plan designs that satisfy the general nondiscrimination rules on a safe-harbor basis so that little or no testing is required. Safe harbors are available for defined contribution plans, defined benefit plans, target benefit plans, and cash balance plans.[273] The safe harbors for defined contribution plans and defined benefit plans involve plan designs that generally provide contributions or benefits that are a uniform percentage of compensation, taking into account permitted disparity (discussed below).[274] The requirements of the safe harbors are very detailed.

If a plan does not satisfy one of the safe harbors, it is subject to the general tests provided in the regulations.[275] These general tests are very complicated. Like the average benefit percentage test, they involve a determination of individual contribution or benefit rates for employees in the plan and a comparison of the rates of the highly compensated employees and the nonhighly compensated employees.[276] Although average benefit rates for the two groups are compared under the average benefit percentage test, the general nondiscrimination tests compare the rates for individual employees. A plan passes the general test if, for each contribution or benefit rate that applies to a highly compensated employee, the same rate (or a higher rate) applies to a sufficient number of nonhighly compensated employees to make up a group that satisfies the minimum coverage requirements. In the case of a defined benefit plan, the general test applies twice, once on the basis of the normal retirement benefits provided under the plan and again on the basis of the other benefits (such as early retirement benefits) that are actuarially the most valuable benefits provided under the plan.

Generally, the general test for contribution rates applies to a defined contribution plan, and the general test for benefit rates applies to a defined benefit plan. However, the regulations also permit a defined contribution plan to be tested on an equivalent benefits basis or a defined benefit plan to be tested on an equivalent contributions basis. The regulations also provide rules for the case where a defined contribution plan and a defined benefit plan are aggregated for purposes of the minimum coverage requirements and, as a result, are tested as a single plan for nondiscrimination purposes, as discussed below.

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[273] *See* Treas. Reg. secs. 1.401(a)(4)-2(b), 1.401(a)(4)-3(b), 1.401(a)(4)-8(b)(3), and 1.401(a)(4)-8(c)(3).

[274] *See* secs. 401(a)(5)(B) and (C).

[275] *See* Treas. Reg. secs. 1.401(a)(4)-2(c) and 1.401(a)(4)-3(c).

[276] Under the regulations, the rules for determining employees' contribution and benefit rates under the general tests apply also for purposes of the average benefit percentage test. The average benefit percentage test takes into account all employees in the workforce, even those who do not benefit under any plan.

Permitted disparity

The general nondiscrimination rules generally prohibit a plan from providing contributions or benefits that discriminate in favor of highly compensated employees. The permitted disparity rules provide an exception under which higher contributions or benefits can be provided to higher-paid employees without violating the general nondiscrimination rules.[277]

The rationale for permitted disparity lies in the design of the Social Security system, under which an employer pays Social Security taxes on an employee's compensation and, as a result, is considered to provide a portion of the employee's Social Security benefits.[278] Because Social Security taxes and benefits are based on an employee's compensation only up to the wage base, permitted disparity allows the employer to provide higher (that is, disparate) contributions or benefits with respect to the portion of an employee's compensation that is not taken into account under the Social Security system.[279]

The permitted disparity provisions contain separate rules for defined contribution plans and defined benefit plans. The amount of disparity that is permitted under a defined contribution plan is based roughly on the rate at which the employer pays Social Security taxes; the amount of disparity that is permitted under a defined benefit plan is based roughly on the rate at which Social Security benefits replace earnings.

Treasury regulations provide rules under which permitted disparity can be incorporated into the design of a defined contribution plan or a defined benefit plan that uses a safe harbor under the general nondiscrimination rules.[280] The general nondiscrimination regulations also provide rules for imputing permitted disparity as part of the general nondiscrimination tests.[281] Permitted disparity may be imputed also in conjunction with cross-testing (discussed below) and in determining benefit rates for purposes of the average benefit percentage test.

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[277] Secs. 401(a)(5)(C) and 401(l).

[278] The employee also pays Social Security taxes on his or her compensation, at the same rate as the employer.

[279] Before the Tax Reform Act of 1986, the methods by which contributions or benefits under a qualified retirement plan were integrated with the Social Security system were provided in Rev. Rul. 71-446, 1971-2 C.B. 187. The Tax Reform Act of 1986 amended section 401(l) to provide permitted disparity rules for defined contribution and defined benefit plans, in place of the integration rules. For the history of integration and permitted disparity and a discussion of the Social Security system as a rationale for these rules, see Patricia A. Dilley, *The Evolution of Entitlement: Retirement Income and the Problem of Integrating Private Pensions and Social Security*, 30 Loy. L.A. L. Rev. 1063 (April 1997).

[280] Treas. Reg. secs. 1.401(l)-1 through 1.401(l)-6.

[281] Treas. Reg. sec. 1.401(a)(4)-7. These regulations provide formulas that mimic the maximum disparity that could be provided under the plan and that are used in determining contribution or benefit rates under the general test.

Rules common to minimum coverage and general nondiscrimination rules

Because of the interaction between the minimum coverage requirements and the general nondiscrimination rules, some aspects of the rules are relevant for both purposes.

Excludable employees

An employer is permitted to exclude from a plan employees who either are under age 21 or have been employed for less than a year ("excludable employees").[282] Alternatively, the employer may use a lower age or service requirement, or none at all, to determine eligibility for the plan. For example, the employer may cover all employees age 21, regardless of their service, or the employer could cover all employees who have been employed for 6 months, regardless of their ages.

If the employer does not cover excludable employees in the plan, they are disregarded in applying the minimum coverage requirements and the general nondiscrimination rules. If the employer covers any excludable employees in the plan, two options apply. First, the plan may be tested by taking into account all employees in the workforce who meet the plan's eligibility requirements. Second, the portion of the plan covering nonexcludable employees may be tested, taking into account all the nonexcludable employees in the workforce, and the portion of the plan covering excludable employees is tested separately, taking into account all the excludable employees in the workforce who meet the plan's eligibility requirements.

Separate line of business

Under a special rule, an employer that operates separate lines of business may apply the minimum coverage requirements to a plan separately with respect to the employees in each separate line of business if the plan satisfies a "gateway" requirement that takes into account the ratio percentage of the plan determined by reference to the entire workforce.

Aggregation of plans

Separate plans may be aggregated and treated as a single plan in applying the minimum coverage requirements. For example, an employer with different divisions might have separate plans for the employees in each division. If a disproportionate number of the highly compensated employees work in one division, the plan for that division might not satisfy the minimum coverage requirements, so the plans may be aggregated and tested together. Plans that are aggregated for purposes of the minimum coverage requirements must also be aggregated and tested together for purposes of applying the general nondiscrimination rules.

If the plans being aggregated are all defined contribution plans, the amount of contributions under the plans is easily determined. Similarly, if all are defined benefit plans, the amount of benefits under the plans is easily determined. However, if the aggregated plans include both defined contribution plans and defined benefit plans, a mechanism is needed to equate contributions and benefits. This mechanism is needed also to apply the average benefit

[282] Sec. 410(a).

percentage test in cases where the employer maintains both a defined contribution plan and a defined benefit plan. The cross-testing rules, discussed below, provide this mechanism.

Cross-testing

The regulations provide a mechanism, called "cross-testing," by which amounts allocated to employees under a defined contribution plan are converted to equivalent benefits or amounts accrued for employees under a defined benefit plan are converted to equivalent contributions.[283] Cross-testing can be used in testing the amount of contributions or benefits provided under a plan or in applying the average benefit percentage test under the minimum coverage rules.

The cross-testing rules were developed in the early 1990's in conjunction with the implementation of changes made to the qualified retirement plan provisions under the 1986 Act. Before 1986, the IRS had issued administrative guidance for determining whether contributions under a defined contribution plan and benefits under a defined benefit plan were comparable.[284] The comparability procedures applied when a defined contribution and a defined benefit plan were aggregated for purposes of applying the minimum coverage and the nondiscrimination requirements, but the guidance did not specifically limit their applicability to that situation. Similarly, the legislative history of the 1986 Act discusses the use of comparability procedures (with certain modifications) for purposes of the average benefit percentage test and in applying the nondiscrimination requirements to two or more plans that are aggregated for purposes of the minimum coverage requirements.[285]

Under the current regulations, cross-testing is not limited to cases in which a defined contribution plan and a defined benefit plan are aggregated for minimum coverage and nondiscrimination purposes. Accordingly, cross-testing may be used to apply the general test to a single defined contribution plan on an equivalent benefits basis or to a single defined benefit plan on an equivalent contributions basis.

As a result of the actuarial computations and assumptions used in cross-testing, if the same amount of contributions is provided to a younger employee and to an older employee, the equivalent benefits at normal retirement age for the younger employee are considered greater than those for the older employee. Similarly, a smaller contribution for a younger employee and a larger contribution for an older employee are considered to result in the same (or comparable) equivalent benefits at normal retirement age. Because the highly compensated employees in a business tend to be older, cross-testing can allow an employer to provide higher contributions for highly compensated employees without failing the nondiscrimination requirements. Employee benefit advisors have developed a plan design, called a "new comparability plan," that uses the

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[283] For testing purposes, the regulations consider allocations, that is, the particular amounts of the employer's contributions to the plan that are allocated to employees' individual accounts. For ease of reference, the term "contributions" is used in this discussion.

[284] Rev. Rul. 81-202, 1981-2 C.B. 93.

[285] *See* H. Rep. 99-841 (September 18, 1986), at II-411, II-413-414, II-415, and S. Rep. 99-313 (May 29, 1986), at 577, 582.

cross-testing rules to provide maximum contributions to highly compensated employees while providing fairly small contributions to nonhighly compensated employees.[286]

The use of cross-testing with respect to a single defined contribution plan has been debated off and on since the cross-testing rules were issued in proposed form in 1990. The Treasury Department and the IRS considered whether to limit the use of cross-testing in the final regulations, but decided not to do so. After final regulations were issued, the possibility of legislative restrictions on the use of cross-testing was raised, but none were enacted.

In February 2000, the Treasury Department and the IRS announced the initiation of a review of issues related to the use of cross-testing by new comparability plans and requested public comments.[287] Proposed regulations dealing with cross-tested plans were issued in October 2000.[288] In order for a defined contribution plan to be cross-tested under the proposed regulations, the plan must provide broadly available allocation rates (as defined in the regulations) or must satisfy a gateway requirement. Under the gateway requirement, nonhighly compensated employees must receive contributions at a rate at least 1/3 of the highest rate applicable to a highly compensated employee or at a rate of at least five percent. The regulations also provide new rules for situations in which a defined contribution plan and a defined benefit plan are aggregated for testing purposes to assure that the requirements for cross-testing defined contribution plans are not circumvented.

Top-heavy requirements

In general

Under present law, a top-heavy plan is a qualified retirement plan under which cumulative benefits are provided primarily to key employees.[289] More precisely, a defined benefit plan is top-heavy if more than 60 percent of the cumulative accrued benefits under the plan are for key employees. A defined contribution plan is top heavy if the sum of the account balances of key employees is more than 60 percent of the total account balances under the plan.

A qualified retirement plan that is top-heavy must provide (1) minimum employer contributions or benefits for plan participants who are nonkey employees and (2) more rapid vesting for plan participants who are nonkey employees. All qualified retirement plans must provide that more rapid vesting will apply and minimum contributions or benefits will be provided to employees if the plan becomes top-heavy.

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[286] An Internet search of the term "new comparability plan" generates links to the Web sites of various employee benefit companies promoting new comparability plans on this basis.

[287] Notice 2000-14, 2000-10 I.R.B. 737.

[288] Prop. Tres. Reg. sec. 1.401(a)(4)-8(b)(1).

[289] The definition of key employee is discussed in detail in Part III.C.4.

Sources of Complexity

Complexity results from having multiple nondiscrimination requirements with similar purposes, i.e., assuring appropriate benefit delivery to all employees of an employer. Complexity also results because there are many possible ways to satisfy each of the separate nondiscrimination rules. Although simple plan designs will automatically satisfy all nondiscrimination rules without the need for testing, e.g., a plan that covers all nonexcludable employees and that provides the top-heavy minimum benefit and vesting schedule, many employers do not wish to adopt a simple plan design or find it economically impractical.

For example, an employer's business may include different divisions in different geographical locations or in different lines of business. In such cases, a simple plan structure for all employees of the employer may not reflect business considerations, including benefit costs and market conditions. An employer's business may also include different divisions acquired through mergers, acquisitions, or similar transactions. In such cases, a plan maintained by the predecessor employer may not be the same as the employer's plan. In these types of circumstances, employers will not find it feasible to adopt a simple plan design, and will generally use individually designed plans, necessitating the use of complicated testing rules.

Some employers may wish to favor highly compensated employees more than would be possible under simpler plan designs that reduce testing requirements. Thus, in some cases, employers may prefer to take advantage of the ability to provide a greater disparity of benefits that more complicated nondiscrimination testing permits.

In other cases, employers may wish to take advantage of safe harbor rules, but find that they may not. The requirements of safe harbors are detailed, and even minor variations from the prescribed design will preclude an employer from relying on the safe harbor.

Particular aspects of the rules have led to the development of other complicated rules. For example, the ability to aggregate different plans for testing purposes and has led to the development of the cross-testing rules, which involve complex computations requiring the use of sophisticated actuarial principles and assumptions.

The nondiscrimination tests generally involve complicated calculations, particularly for plans that do not use the ratio percentage test. Use of the ratio percentage test avoids the need to calculate benefit and contribution percetnages, and possibly convert benefits to contributions or vice versa, as is necessary when the average benefits test is used to show compliance with the minimum coverage requirements.

Complexity also arises because many of the nondiscrimination rules are provided in regulations. Thus, the rules are subject to change. For example, as described above, the extent to which cross-testing may be used has been the subject of debate and changing rules.

Recommendation for Simplification

The Joint Committee staff recommends that the ratio percentage test under the minimum coverage rules should be modified to allow more plans to use the test. In addition, the Joint Committee staff recommends that excludable

employees should be disregarded in applying the minimum coverage and general nondiscrimination rules. Finally, the Joint Committee staff recommends that the extent to which cross-testing may be used should be specified in the Code.

Minimum coverage

Modification of ratio percentage test

Under the Joint Committee staff recommendation, if the nonhighly compensated employee concentration percentage is at least 60 percent, the plan covers a reasonable classification of employees (under present law rules), and the plan's ratio percentage exceeds a certain threshold, the plan would satisfy the ratio test without the need to apply the average benefit percentage test. The necessary ratio percentage would depend on the nonhighly compensated employee concentration percentage as shown in the following table.

Nonhighly Compensated Employee Concentration	Ratio Percentage
Less than 60%	70% *
60-79%	65%
80-99%	60%

* This is the ratio percentage required to satisfy the ratio percentage test under present law, which would not change under the recommendation.

The Joint Committee staff recommendation would enable more plans to satisfy the minimum coverage requirements without the need to perform the complex computations and analysis involved in the average benefit percentage test. At the same time, eliminating the average benefit percentage test only if the nonhighly compensated employee concentration percentage and the plan's ratio percentage meet certain thresholds will limit the change to plans that are likely to satisfy the average benefit percentage test under present law.

Disregard of excludable employees

The Joint Committee staff recommends that excludable employees should be disregarded in applying the minimum coverage and general nondiscrimination requirements even if some or all of them are covered by the plan. Under the recommendation, excludable employees would not be taken into account in testing the plan as a whole and the portion of the plan covering excludable employees would not be subject to separate testing.

Excludable employees who are covered by a plan tend to be a small portion of a plan's coverage and generally do not affect the results of minimum coverage and nondiscrimination testing. Requiring excludable employees to be tested thus generally serves simply to make the testing process more complicated. In addition, offering two testing options further complicates the testing by making it necessary in some cases for the test to be applied twice in order to determine which is more beneficial. The recommendation would simplify the testing by disregarding excludable employees in all cases.

Codification of the cross-testing rules

Besides the complexity inherent in the cross-testing rules, there continue to be questions about the extent to which cross-testing should be permitted, particularly in the context of a single plan. As discussed above, the 1986 legislative history could be read to suggest that cross-testing should apply only in the case of combined plans or average benefits testing. Moreover, to the extent that cross-testing appears to be used in some cases merely to provide better benefits to highly compensated employees, cross-testing could be considered not only complicated, but also contrary to the policy behind the nondiscrimination requirements. These issues and the resulting uncertainty about the ongoing validity of the cross-testing rules makes it difficult for employers and their advisors to make decisions about proper plan designs.

The Joint Committee staff recommends that the cross-testing rules be codified. The Joint Committee staff also recommends that, in connection with codifying the cross-testing rules, the purposes for which the cross-testing rules may be used should be clarified. This will provide certainty and stability in the design of qualified retirement plans that are based on the cross-testing rules by eliminating questions as to whether the rules will continue to be available.

Structural issues

The Joint Committee staff believes that further simplification could be achieved by eliminating some nondiscrimination rules or making significant changes to the rules. For example, in the course of this study, the Joint Committee staff considered proposals to eliminate the ability to provide disparate benefits under the permitted disparity rules and to eliminate the top-heavy rules. However, all the nondiscrimination rules are based on separate policy rationales as reflected in the legislative history for each provision. In addition, radical changes to the rules could affect benefit levels for various employees. Thus, such changes would involve policy ramifications that are beyond the scope of this study.

3. Apply uniform vesting requirements to all qualified retirement plans

Present Law

In general

Under present law, a plan is not a qualified retirement plan unless a participant's employer-provided benefit vests at least as rapidly as under one of two alternative minimum vesting schedules.[290] A plan satisfies the first schedule if a participant acquires a nonforfeitable right to 100 percent of the participant's accrued benefit derived from employer contributions upon the completion of five years of service. A plan satisfies the second schedule if a participant has a nonforfeitable right to at least 20 percent of the participant's accrued benefit derived from employer contributions after three years of service, 40 percent after four years of service, 60 percent after five years of service, 80 percent after six years of service, and 100 percent after seven years of service.

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[290] Sec. 411(a).

If an employee terminates employment before being fully vested and later returns to employment with the same employer or of a member of the employer's controlled group, special rules apply to determine the employee's period of service for vesting purposes. The rules depend on whether the employee was nonvested or partially vested before termination and how long the employee was absent from service. In some cases, years of service before the termination must be taken into account for vesting purposes when the employee returns.

Top-heavy vesting

If a qualified retirement plan is top-heavy, the plan must provide more rapid vesting for plan participants who are nonkey employees, under one of two alternative minimum vesting schedules.[291] Under the first schedule, a participant acquires a nonforfeitable right to 100 percent of the participant's accrued benefit derived from employer contributions upon the completion of three years of service. Under the second schedule, a participant has a nonforfeitable right to at least 20 percent of the participant's accrued benefit derived from employer contributions after two years of service, 40 percent after three years of service, 60 percent after four years of service, 80 percent after five years of service, and 100 percent after six years of service.

Qualified retirement plans, even those that are not top-heavy, must contain provisions that will take effect if the plan becomes top-heavy. Those provisions must include the top-heavy vesting schedule that will apply if the plan becomes top-heavy.

Sources of Complexity

Having special vesting schedules for top-heavy plans increases the complexity of the vesting rules, particularly because the top-heavy vesting schedules must be reflected in the plan document.

Recommendation for Simplification

The Joint Committee staff recommends that the vesting requirements for all qualified retirement plans should be made uniform by applying the top-heavy vesting schedules to all plans.

A single set of vesting rules will provide consistency among plans, will reduce complexity in plan documents and will eliminate the possibility that different portions of an employee's benefit will be subject to different vesting schedules, depending on whether the plan was top-heavy when the benefits accrued. Applying the top-heavy vesting schedule to all plans will assure that this change does not undercut the effectiveness of the top-heavy rules. It will also reduce the number of partially vested participants, making the rules for terminated employees easier to apply.

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[291] Sec. 416(b).

4. Conform requirements for SIMPLE IRAs and SIMPLE 401(k) plans

Present Law

In general

Under certain salary reduction arrangements, an employee may elect to have the employer make payments as contributions to a qualified retirement plan or similar arrangement on behalf of the employee, or to the employee directly in cash. Contributions made to the plan at the election of the employee are called elective deferrals. Elective deferrals (and earnings thereon) generally are not includible in a participant's gross income until distributed from the plan.

Present law provides two different types of employer-sponsored arrangements to which elective deferrals can be made that are specifically designed for small employers: SIMPLE 401(k) plans and SIMPLE IRAs (collectively referred to as "SIMPLE plans").[292] Both of these arrangements are intended to encourage the establishment of retirement plans by small employers by providing simpler rules and reduced administrative burdens compared to typical qualified retirement plans. As the names suggest, SIMPLE IRAs use individual retirement arrangements ("IRAs") as the funding vehicle, and SIMPLE 401(k) plans use a qualified cash or deferred arrangement ("401(k) plan") as the funding vehicle.

The rules applicable to SIMPLE IRAs and SIMPLE 401(k) plans are similar, but not identical. SIMPLE plans are deemed to satisfy the nondiscrimination requirements applicable to qualified retirement plans and are deemed to satisfy the top-heavy rules.

In addition to SIMPLE plans, present law provides two additional plans to which elective deferrals may be made: 401(k) plans and tax-sheltered annuities. All employers, other than State or local government employers, may maintain a 401(k) plan.[293] Tax-sheltered annuities ("section 403(b) annuities") may be maintained by certain tax-exempt employers and educational institutions. These arrangements are subject to different sets of rules, including limits on contributions, eligibility requirements, and nondiscrimination rules.

Eligible employers

Both SIMPLE IRAs and SIMPLE 401(k) plans are available to employers with 100 or fewer employees who do not maintain a qualified retirement plan. However, SIMPLE IRAs may

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[292] Secs. 401(k)(11) and 408(p).

[293] Present law generally prohibits State and local government employers from establishing 401(k) plans. This prohibition does not apply in the case of a 401(k) plan adopted by a State or local government before May 6, 1986.

be established by State or local government employers, whereas SIMPLE 401(k) plans generally may not be established by State or local government employers.[294]

Contribution requirements

All employees eligible to participate in a SIMPLE IRA or SIMPLE 401(k) must be permitted to make elective deferrals under the plan, up to a maximum of $6,500 (for 2001). In addition, the employer must match employees' elective deferrals on a dollar-for-dollar basis up to three percent of compensation, or the employer must make a two-percent nonelective contribution for all eligible employees. In the case of SIMPLE IRAs, but not SIMPLE 401(k) plans, the employer may make matching contributions at a rate of less than three percent, but not less than one percent and may not make a reduced matching contribution for more than two years in the five-year period ending in the current year.

No contributions may be made to a SIMPLE plan other than required contributions.

Eligible employees

In the case of a SIMPLE IRA, the group of eligible employees must include any employee who has received at least $5,000 in compensation from the employer in any two preceding years and is reasonably expected to receive $5,000 in the current year. The employer may choose to exclude certain nonresident aliens and collectively bargained employees. The group of employees eligible to participate in a SIMPLE 401(k) plan must satisfy the coverage requirements generally applicable to qualified retirement plans under section 410(b). These coverage requirements allow employers greater flexibility in determining which employees are eligible for a SIMPLE 401(k) than do the eligibility rules for SIMPLE IRAs.

Sources of Complexity

The existence of multiple structures and multiple rules for elective deferral arrangements requires employers to consider each structure and its particular rules to determine which arrangements are available to the employer and which to adopt for its employees. Small employers are faced with an even greater array of options than other employers; they have available elective deferral arrangements available to employers regardless of size, plus the SIMPLE IRA and SIMPLE 401(k) plans available only to small employers. The difficulty of determining what type of plan to establish is complicated by the fact that there are small differences between the two plans specifically designed for small employers. The confusion the different rules create may be exacerbated by the lack of clear policy rationales for some of the differences.

Recommendation for Simplification

The Joint Committee staff recommends that the rules relating to SIMPLE IRAs and SIMPLE 401(k) plans should be conformed by (1) allowing State

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[294] A State or local government with a pre-May 6, 1986, grandfathered 401(k) plan may adopt a SIMPLE 401(k) plan.

and local government employers to adopt SIMPLE 401(k) plans, (2) applying the same contribution rules to SIMPLE IRAs and SIMPLE 401(k) plans, and (3) applying the employee eligibility rules for SIMPLE IRAs to SIMPLE 401(k) plans.

Under the proposal, all small employers would be eligible to adopt a SIMPLE plan. This would simplify the decision-making process for State and local government employers; moreover, there does not appear to be a policy rationale for allowing such governmental employers to adopt one type of SIMPLE plan but not another. The Joint Committee staff is making a separate recommendation to allow State and local governmental plans to adopt 401(k) plans.[295] Even if that recommendation is not adopted, the Joint Committee staff believes that employer eligibility for SIMPLE plans should not be different for SIMPLE IRAs and SIMPLE 401(k) plans.

The Joint Committee staff recommends that the contribution requirements for all SIMPLE plans should be the same. This recommendation could be implemented by either extending the option to lower the required match to SIMPLE 401(k) plans or by eliminating the option for SIMPLE IRA plans. Eliminating options generally increases simplification. However, the ability to elect a lesser contribution in some years provides flexibility to employers and therefore may make it more likely that an employer will adopt a plan for its employees. Thus, maintaining the option may further pension policy objectives.

The Joint Committee staff recommends that SIMPLE IRA employee eligibility rules be applied to all SIMPLE plans. The SIMPLE IRA rules are less flexible that the SIMPLE 401(k) rules, but are easier to apply.

During the course of this study, it was suggested to the Joint Committee staff that greater simplification could be achieved by eliminating the SIMPLE 401(k) alternative. It is argued that the SIMPLE IRA is overall a simpler approach, and that the existence of a choice of plans itself is a complicating factor. The Joint Committee staff agrees that options add complexity. However, the Joint Committee staff decided not to recommended eliminating SIMPLE 401(k) plans. For employers who intend to adopt a SIMPLE plan only on a temporary basis and eventually to adopt a regular qualified retirement plan, the ability to adopt a SIMPLE 401(k) plan may provide greater simplification in the longer term by making easier the transition from a SIMPLE plan to a regular 401(k) plan.

The Joint Committee staff believes that further simplification could be achieved by conforming all the rules for the various elective deferral arrangements available to all employers. Such simplification would involve policy issues that would need to be resolved apart from simplification.

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[295] *See* Section III.C.8. of this Part, below.

5. Conform definitions of highly compensated employee and owner

Present Law

In general

The employee benefit and qualified retirement plan provisions of the Code prohibit discrimination in favor of certain groups of employees, including owners, officers, and highly paid employees. In addition, certain employees are subject to restrictions or other special treatment. Different terms and definitions apply to these groups for different purposes.

Highly compensated employee

Highly compensated employee status is relevant for the nondiscrimination requirements applicable to qualified retirement plans and to other employee benefits.[296] For most purposes, a highly compensated employee is an employee (1) who was a five-percent owner during the year or the preceding year, or (2) who had compensation of $85,000 (for 2001) or more for the preceding year.[297] An employer may elect to limit the employees treated as highly compensated employees based upon their compensation in the preceding year to the highest paid 20 percent of employees in the preceding year. Five-percent owner is defined by cross-reference to the definition of key employee (see below).

Some employee benefit provisions use slightly different terms with slightly different definitions. A self-insured health plan must not discriminate in favor of a "highly compensated individual," defined as (1) one of the five highest paid officers, (2) a 10-percent shareholder, or (3) an individual among the highest paid 25 percent of all employees.[298] A cafeteria plan must not discriminate in favor of a "highly compensated individual" with respect to eligibility to participate in the cafeteria plan or in favor of a "highly compensated participant" with respect to benefits under the plan.[299] For cafeteria plan purposes, a "highly compensated individual" is (1) an officer, (2) a five-percent shareholder, (3) an individual who is highly compensated, or (4) the spouse or dependent of any of the preceding categories.[300] A "highly compensated participant"

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[296] These benefits include qualified tuition reductions under section 117(d), educational assistance under section 127, dependent care assistance under section 129, certain fringe benefits under section 132, and adoption assistance under section 137.

[297] Sec. 414(q).

[298] Sec. 105(h)(5).

[299] Sec. 125(b)(1).

[300] Sec. 125(e). Although sole proprietors and partners are treated as employees for qualified retirement plan purposes, they are not treated as employees for all employee benefit purposes. In addition, a 2-percent owner of a subchapter S corporation is treated as a partner for employee benefit purposes.

is a participant who falls in any of those categories. "Highly compensated" is not defined for this purpose.

Key employee

Key employee status is relevant for purposes of the top-heavy rules that apply to qualified retirement plans and to cafeteria plans.[301] Key employee status applies also for purposes of the nondiscrimination requirements applicable to group term life insurance.[302] A key employee is an employee who, at any time during the year or the preceding four years, is (1) a five-percent owner of the employer, or (2) a one-percent owner with compensation of more than $150,000, (3) one of the 10 employees with compensation more than $35,000 (for 2001) and owning the largest interests in the employer, or (4) an officer with compensation more than $70,000 (for 2001).[303] The $35,000 and $70,000 figures are determined by cross-reference to other provisions of the Code; $150,000 is a fixed amount. A special rule limits the number of officers treated as key employees. If the employer is a corporation, a five-percent owner is a person who owns more than five percent of the outstanding stock or stock possessing more than five percent of the total combined voting power of all stock. If the employer is not a corporation, a five-percent owner is a person who owns more than five percent of the capital or profits interest. A one-percent owner is defined by substituting one percent for five percent in the preceding definitions. Attribution applies in determining ownership.[304]

Special owner rules

For qualified retirement plan purposes, various special rules apply to employees who own a five-percent or 10-percent interest in the employer.[305]

An owner-employee is an employee who (1) owns the entire interest in an unincorporated trade or business or (2) owns more than 10 percent of either the capital interest or the profits interest in a partnership.[306] Contributions to a qualified retirement plan for an owner-employee

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[301] Secs. 416 and 125(b)(2).

[302] Sec. 79(d).

[303] Sec. 416(i).

[304] The attribution rules that apply for qualified retirement plan purposes are discussed in Section III.C.10. of this Part.

[305] Under the present-law requirements for minimum distributions, a five-percent owner must begin receiving distributions after age 70½, even if still working. For this purpose, five-percent owner is defined by cross-reference to the definition of key employee. For further discussion of the minimum distribution rules, see Section III.C.7.a of this Part, below, which includes a recommendation to eliminate required distributions during the life of the employee.

[306] Sec. 401(c)(3).

may be based only on the employee's earned income from the trade or business for which the qualified retirement plan is established.[307]

A qualified retirement plan is prohibited from engaging in certain transactions, such as a property sale, with disqualified persons.[308] A disqualified person includes a shareholder owning 10 percent or more of the employer, a highly compensated employee (defined as earning 10 percent or more of the yearly wages of the employer), or a partner or joint venturer owning a 10-percent or more capital or profits interest in the employer.[309] The Secretary of the Treasury, after consultation and coordination with the Secretary of Labor, may by regulation prescribe a percentage lower than 10 percent for this purpose.

In some cases, transactions that otherwise would be prohibited are exempt from the prohibition. However, most prohibited transaction exemptions do not apply to owner-employees. For this purpose, a shareholder-employee is treated as an owner-employee. A shareholder-employee is an employee or officer of an S corporation who owns more than five percent of the outstanding stock of the S corporation, and attribution from family members applies in determining ownership.[310]

A principal owner is a person who owns (1) in the case of a corporation, five percent or more of the total combined voting power of all stock or five percent or more of the total value of the stock, (2) in the case of a partnership, five percent or more of the capital or profits interest, or (3) in the case of a trust or estate, an actuarial interest of five percent or more.[311] In certain circumstances, a principal owner's interest is disregarded in determining whether two or more trades or businesses are under common control for employee benefit purposes. In addition, if a qualified retirement plan covers a principal owner and the total number of employees of the employer (or the employer's controlled group, if applicable) is 100 or less, all of the employees are interested parties who must receive notice of an application for an IRS determination of the qualified status of the plan.[312]

An individual who owns more than five percent of the stock or of the capital or profits interests in an employer is a principal owner or shareholder for purposes of an employer-provided educational assistance, dependent care assistance, or adoption assistance program.[313]

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[307] Sec. 401(d).

[308] Sec. 4975(c).

[309] Sec. 4975(e)(2).

[310] Sec. 4975(f)(6)(C).

[311] Treas. Reg. sec. 1.414(c)-3(d)(2).

[312] Treas. Reg. sec. 1.7476-1(b)(2).

[313] Secs. 127(b)(3), 129(d)(4) and 137(c)(2).

Benefits provided to the group of principal owners or shareholders and their spouses and dependents under these programs are subject to special limits.

Sources of Complexity

Requiring an employer to apply various definitions and criteria for different employee benefit purposes makes compliance excessively burdensome. In many respects the various definitions and criteria overlap or contain only minor differences and therefore produce complexity without meaningful policy distinctions.

Recommendation for Simplification

The Joint Committee staff recommends that uniform definitions of highly compensated employee and owner should be used for all qualified retirement plan and employee benefit purposes. Accordingly, the Joint Committee staff recommends that many of the statutory terms and definitions be repealed.

Under the Joint Committee staff's recommendation, a five-percent owner would be a person who owns (1) in the case of an employer that is a corporation, more than five percent of the outstanding stock or stock possessing more than five percent of the total combined voting power of all stock and (2) in the case of an employer that is not a corporation, more than five percent of the capital or profits interest. In determining the employer's highly compensated employees, five-percent owner status for the current year or preceding year would be relevant. In determining the employer's key employees, five-percent (or one-percent) owner status for the current year or four preceding years would be relevant. Attribution would continue to apply in determining ownership. Five-percent owner status would be relevant for purposes of any special rules applying to owners. All other owner-related terms and their definitions would be repealed.

The statutory definition of highly compensated employee[314] would apply for purposes of the nondiscrimination requirements applicable to any tax-favored employee benefit. Therefore, as under present law, highly compensated employees would include five-percent owners, as well as employees with compensation of more than $80,000[315] (indexed) for the preceding year, with an optional rule to limit the latter group to the 20 percent highest paid employees. Any other terms or definitions for highly compensated status would be eliminated.

The recommendation would simplify the application of special rules for owners in that all special rules would apply to the same group of owners. Similarly, the same group of highly compensated employees would apply for all nondiscrimination purposes. The employer would no longer have to determine different groups of owners or different highly compensated groups for different purposes.

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[314] Sec. 414(q).

[315] Under present law, an employee with compensation of $80,000 or more is a highly compensated employee. The change to more than $80,000 would provide consistency with the standard for five-percent owner and key employee status.

6. Conform contribution limits for tax-sheltered annuities to contribution limits for qualified retirement plans

Present Law

Present law imposes limits on the contributions that may be made to tax-favored retirement plans.

Defined contribution plans

In the case of a tax-qualified defined contribution plan, the limit on annual additions that can be made to the plan on behalf of an employee is the lesser of $35,000 (for 2001) or 25 percent of the employee's compensation (sec. 415(c)). Annual additions include employer contributions, including contributions made at the election of the employee (i.e., employee elective deferrals), after-tax employee contributions, and any forfeitures allocated to the employee. For this purpose, compensation means taxable compensation of the employee, plus elective deferrals and similar salary reduction contributions. A separate limit applies to benefits under a defined benefit plan.

For years before January 1, 2000, an overall limit applied if an employee was a participant in both a defined contribution plan and a defined benefit plan of the same employer.

Tax-sheltered annuities

In the case of a tax-sheltered annuity (a "section 403(b) annuity"), the annual contribution generally cannot exceed the lesser of the exclusion allowance or the section 415(c) defined contribution limit. The exclusion allowance for a year is equal to 20 percent of the employee's includible compensation, multiplied by the employee's years of service, minus excludable contributions for prior years under qualified plans, tax-sheltered annuities, or section 457 plans of the employer.

In addition to this general rule, employees of nonprofit educational institutions, hospitals, home health service agencies, health and welfare service agencies, and churches may elect application of one of several special rules that increase the amount of the otherwise permitted contributions. The election of a special rule is irrevocable. In addition, an employee may not elect to have more than one special rule apply.

Under one special rule, in the year the employee separates from service, the employee may elect to contribute up to the exclusion allowance, without regard to the 25 percent of compensation limit under section 415. Under this rule, the exclusion allowance is determined by taking into account no more than 10 years of service.

Under a second special rule, the employee may contribute up to the lesser of: (1) the exclusion allowance; (2) 25 percent of the participant's includible compensation; or (3) $15,000.

Under a third special rule, the employee may elect to contribute up to the section 415(c) limit, without regard to the exclusion allowance. If this option is elected, then contributions to other plans of the employer are also taken into account in applying the limit.

For purposes of determining the contribution limits applicable to section 403(b) annuities, includible compensation means the amount of compensation received from the employer for the most recent period that may be counted as a year of service under the exclusion allowance. In addition, includible compensation includes elective deferrals and similar salary reduction amounts.

Treasury regulations include provisions regarding application of the exclusion allowance in cases in which the employee participates in a section 403(b) annuity and a defined benefit plan. The 1997 Act directed the Secretary of the Treasury to revise these regulations, effective for years beginning after December 31, 1999, to reflect the repeal of the overall limit on contributions and benefits.

Sources of Complexity

The contribution limits for section 403(b) annuities create complexity because of the recordkeeping necessary to apply the limits, complicated calculations, and the existence of multiple options. In addition, the differences between the section 403(b) limits and the qualified retirement plan limits create confusion for taxpayers and make the comparison of different plans more difficult, thus adding complexity to the employer's decision as to what type of plan to adopt.

Recommendation for Simplification

The Joint Committee staff recommends that the contribution limits applicable to tax-sheltered annuities should be conformed to the contribution limits applicable to comparable qualified retirement plans.

The Joint Committee staff recommendation would repeal the exclusion allowance applicable to contributions to tax-sheltered annuities. Thus, such annuities would be subject to the contribution limits applicable to qualified retirement plans. The differences between the limits on contributions to qualified retirement plans and tax-sheltered annuities are largely historical. The qualified retirement plan limits are easier to apply than the present-law section 403(b) limits. Conforming the limits will reduce recordkeeping and computational burdens, a well as eliminate the confusion resulting from differences between tax-sheltered annuities and qualified retirement plans.

7. Simplification of distribution rules applicable to qualified retirement plans

(a) Simplify minimum distribution rules

Present Law

In general

Minimum distribution rules apply to all types of tax-favored retirement plans, including qualified retirement plans, individual retirement arrangements ("IRAs"), tax-sheltered annuities ("section 403(b) plans"), and eligible deferred compensation plans of tax-exempt and State and local government employers ("section 457 plans"). In general, under these rules, distribution of minimum benefits must begin no later than the required beginning date. Minimum distribution rules also apply to benefits payable with respect to a plan participant who has died. Failure to comply with the minimum distribution rules results in an excise tax imposed on the payee equal to 50 percent of the required minimum distribution not distributed for the year. The excise tax may be waived if the payee establishes to the satisfaction of the Secretary that the shortfall in the amount distributed was due to reasonable error and reasonable steps are being taken to remedy the shortfall. The excise tax will be automatically waived for certain beneficiaries in the event of the death of the participant prior to the participant's required beginning date. In addition to the imposition of the excise tax on the payee, the failure of a qualified retirement plan to provide for compliance with the minimum distribution rules results in disqualification of the plan.

Distributions prior to the death of the individual

In the case of distributions prior to the death of the plan participant, the minimum distribution rules are satisfied if either (1) the participant's entire interest in the plan is distributed by the required beginning date, or (2) the participant's interest in the plan is to be distributed (in accordance with regulations), beginning not later than the required beginning date, over a permissible period. The permissible periods are (1) the life of the participant, (2) the lives of the participant and a designated beneficiary, (3) the life expectancy of the participant, or (4) the joint life and last survivor expectancy of the participant and a designated beneficiary. For purposes of calculating minimum required distributions, the life expectancies of the participant and the participant's spouse may be recalculated annually.

In the case of qualified retirement plans, tax-sheltered annuities, and section 457 plans, the required beginning date is April 1 of the calendar year following the later of (1) the calendar year in which the employee attains age 70-1/2 or (2) the calendar year in which the employee retires. However, in the case of a five-percent owner of the employer, distributions are required to begin no later than April 1 of the calendar year following the year in which the five-percent owner attains age 70-1/2. If commencement of benefits is delayed beyond age 70-1/2, then the accrued benefit of the employee must be actuarially increased to take into account the period after age 70-1/2 in which the employee was not receiving benefits under the plan. In the case of distributions from an IRA other than a Roth IRA, the required beginning date is April 1 following the calendar year in which the IRA owner attains age 70-1/2. The pre-death minimum distribution rules do not apply to Roth IRAs.

Distributions after the death of the plan participant

The minimum distribution rules also apply to distributions to beneficiaries of deceased participants. In general, if the participant dies after minimum distributions have begun, the remaining interest must be distributed at least as rapidly as under the minimum distribution method being used as of the date of death. If the participant dies before minimum distributions have begun, then the entire remaining interest must generally be distributed within five years of the participant's death. The five-year rule does not apply if (1) the terms of the plan do not provide that the entire remaining interest must be distributed within five years of the participant's death, and (2) distributions begin within one year of the participant's death and are payable over the life of a designated beneficiary or over the life expectancy of a designated beneficiary. A surviving spouse beneficiary is not required to begin distribution until the date the deceased participant would have attained age 70-1/2. In addition, a surviving spouse who receives an eligible rollover distribution from a tax-favored retirement plan may roll over the distribution to an IRA.

Sources of Complexity

The minimum distribution requirement is widely viewed as not only one of the most complex set of rules affecting tax-favored retirement plans, but also one of the most likely to provide a trap for the millions of individuals who participate in such plans and arrangements. Unlike most of the rules relating to qualified retirement plans, the minimum distribution rules impose the primary responsibility for compliance, and the resulting administrative burdens, on plan participants. In some cases the plan administrator may help participants to determine the required minimum distribution, and annuity distributions from a defined benefit plan will generally satisfy the rules. However, in many cases the individual will not have such assistance.

As a result of the minimum distribution requirement, an individual who has attained age 70-1/2, who continues to work and participate in an employer-sponsored retirement arrangement, and who owns an IRA, is required to begin receiving distributions of retirement benefits from the IRA at the same time as the individual contributes to or accrues benefits under the employer-sponsored retirement arrangement.[316]

The minimum distribution requirement is another example of the different treatment of IRAs and qualified retirement plans. In addition to the different definitions of required beginning date, different minimum distribution rules apply to owners of multiple IRAs and participants in multiple qualified retirement plans. An individual who owns more than one IRA is permitted to withdraw from only one IRA the aggregate amount of required minimum distributions. However, if an employee is a participant in more than one qualified retirement plan, the plans in which the employee participates may not be aggregated for purposes of satisfying the minimum distribution requirements.

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[316] The same situation arises for an individual who continues to work and participate in an employer-sponsored retirement arrangement after attaining age 70-1/2 and either has an accrued benefit under a tax-favored retirement savings plan maintained by a prior employer or is currently or was previously a five-percent owner of the individual's employer.

Some would argue that the minimum distribution requirements are illogical and inconsistent with the stated purpose of the requirements, i.e., to ensure that benefits accumulated or accrued under tax-favored retirement plans are used to provide replacement of an individual's preretirement income at retirement rather than for indefinite deferral of tax on a participant's accumulation under the arrangements. For example, if an amount greater than the required minimum distribution is made for a particular year, the participant may not reduce the required distribution for the next year by the amount of the excess payment. In addition, a qualified retirement plan participant's entire benefit under the plan, whether vested or non-vested, must be included in the minimum distribution calculation.

The minimum distribution rules result in complexity and administrative burdens not only for plan participants, but also for beneficiaries of such individuals. The manner in which a beneficiary must comply with the minimum distribution requirements following the death of a plan participant depends upon (1) whether the beneficiary is the spouse of the participant, or an individual other than the spouse of the participant, or a beneficiary of a spousal beneficiary who dies after the participant but before distributions have begun to the surviving spouse, (2) whether the participant had reached the participant's required beginning date prior to the participant's death, (3) whether the beneficiary is designated prior to the end of the year following the year in which the participant dies, (4) whether the plan is an individual account plan or a defined benefit pension plan, (5) whether the plan has adopted a provision specifying that the entire remaining interest must be distributed within five years of the participant's death if the participant dies before minimum distributions have begun, and (6) whether distributions to the beneficiary commence within the year following the year of the participant's death.

Recommendation for Simplification

The Joint Committee staff recommends that the minimum distribution rules should be simplified by providing that (1) no distributions are required during the life of a participant; (2) if distributions commence during the participant's lifetime under an annuity form of distribution, the terms of the annuity will govern distributions after the participant's death; and (3) if distributions either do not commence during the participant's lifetime or commence during the participant's lifetime under a nonannuity form of distribution, the undistributed accrued benefit must be distributed to the participant's beneficiary or beneficiaries within five years of the participant's death.[317]

The minimum distribution rules were applied to all qualified retirement plans by the 1982 Act as part of a broader set of changes to the qualification rules. Prior to the 1982 Act, more strict qualification requirements, and lower contribution limits, applied to plans of unincorporated businesses (called "H.R. 10 plans" or "Keogh plans") than to plans maintained by corporations. The 1982 Act repealed some of the special rules relating to Keogh plans,

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[317] As under present law, a surviving spouse who receives an eligible rollover distribution from a tax-favored retirement plan would be permitted to roll over the distribution to an IRA.

modified some of the special rules, and applied the modified rules to plans maintained by all employers. These changes were made because the Congress believed that the level of tax incentives made available to encourage an employer to provide retirement benefits to employees should generally not depend upon whether the employer is an incorporated or unincorporated enterprise. In addition, the Congress believed that the rules that were needed to assure that the tax incentives available under qualified retirement plans are not abused should generally apply without regard to whether the employer maintaining the plan is incorporated or unincorporated.

The minimum distribution rules reflect the perspective that the primary purpose of the special tax benefits for qualified retirement plans is retirement savings and that tax-favored retirement plans should not primarily be used as a means of estate planning. The minimum distribution rules do not impose any additional taxes; they merely determine when tax will be imposed on retirement plan benefits. Thus, the minimum distribution rules limit the tax benefits for retirement savings after the plan participant reaches age 70-1/2 or retires. Some commentators have argued that recent Federal tax law changes, including the elimination of an excise tax on excess distributions from and an additional estate tax on excess accumulations under qualified retirement plans, threaten to significantly increase the use of qualified retirement plans as estate planning rather than retirement savings vehicles. They suggest that the minimum distribution rules should be simplified in a manner that would ensure the use of qualified retirement plan benefits during a participant's lifetime.[318]

On the other hand, some view the minimum distribution requirement as a penalty for saving. They argue that saving is beneficial to the U.S. economy as a whole and that an individual should not be penalized merely because the plan participant has sufficient assets or resources to provide for his or her retirement and does not need to draw down his or her tax-favored retirement plans until after age 70-1/2 (or at all during his or her lifetime). Others argue that if the participant does not need tax-favored savings for retirement income, then the tax-favored treatment may not be necessary to encourage the participant to save, and thus is not an efficient use of tax incentives.

The elimination of the rules that require minimum distributions during the life of the plan participant and the establishment of a uniform rule for post-death distributions would significantly simplify a complex requirement that imposes burdens on plan participants and their beneficiaries, as well as plan sponsors and administrators who assist such individuals in complying with the rules.[319]

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[318] *See, e.g.,* Jay A. Soled and Bruce A. Wolk, *The Minimum Distribution Rules and Their Critical Role in Controlling the Floodgates of Qualified Plan Wealth,* 2000 B.Y.U. L. Rev. 587 (2000).

[319] The recommendation would not affect the incidental death benefit limitation that applies to qualified retirement plans. *See*, e.g., Treas. Reg. sec. 1.401-1(b)(1)(i).

(b) Adopt uniform early withdrawal rules

Present Law

Early withdrawal tax

A distribution of benefits from a tax-favored retirement plan generally is includible in gross income in the year it is paid under the rules relating to taxation of annuities, unless the amount distributed represents the individual's investment in the contract (i.e., basis). Special rules apply in the case of Roth IRAs, distributions that are rolled over into another tax-favored retirement plan, distributions of employer securities, and certain other situations.

Taxable distributions made before age 59-1/2, death, or disability generally are subject to an additional 10-percent income tax. This early withdrawal tax applies to all taxable distributions from tax-favored retirement plans, except that the tax does not apply to benefits under an eligible retirement plan of a tax-exempt or State or local government employer (a "section 457 plan"). A number of exceptions apply to the early withdrawal tax, depending on the specific type of arrangement from which the distribution is made. For example, there is an exception to the early withdrawal tax for distributions from IRAs for first-time home purchase and certain educational expenses; however, this exception does not apply to distributions from employer-sponsored qualified retirement plans, such as qualified cash or deferred arrangements ("section 401(k) plans"). Table 14., below, lists the exceptions to the early withdrawal tax that apply to each type of plan.

Table 14.--Comparison Of The Exceptions To The 10-Percent Early Withdrawal Tax

EXCEPTION TO EARLY WITHDRAWAL TAX	IRAS	QUALIFIED RETIREMENT PLANS	TAX-SHELTERED ANNUITY (403(b)) PLANS
1. Distributions Made After Age 59-1/2	Yes	Yes	Yes
2. Distributions Made After Death	Yes	Yes	Yes
3. Distributions Attributable To Disability	Yes	Yes	Yes
4. Periodic Payments	Yes	Yes	Yes
5. Distributions After Separation From Service After Age 55	No	Yes	Yes
6. Distributions for Extraordinary Medical Expenses	Yes	Yes	Yes
7. Distributions To Unemployed Individuals For Health Insurance Expenses	Yes	No	No
8. Distributions for Higher Education Expenses	Yes	No	No

Distributable events

Present law limits the circumstances under which plan participants may receive preretirement distributions from qualified retirement plans. The permissible circumstances vary by plan type. Elective deferrals under a section 401(k) plan (and earnings thereon) may be distributed only on account of separation from service, death, or disability, or attainment of age 59-1/2. Elective deferrals (but not earnings thereon) may also be distributed on account of a hardship of the employee.

Sources of Complexity

Present law creates complexities for taxpayers because the differing exceptions to the early withdrawal tax make it more difficult for taxpayers to determine their tax liability and to plan transactions appropriately. For example, an individual with both an IRA and an employer-sponsored retirement plan must take into account the possible imposition of the tax in deciding from which plan to make the withdrawal. An individual who is unaware of the differences may be subject to the tax, whereas a more informed individual would be able to avoid the tax by making the withdrawal from a different plan.

The different exceptions to the early withdrawal tax also may make it more difficult for taxpayers to understand the consequences of and to make decisions regarding rollovers of distributions from one type of plan to another. For example, if an individual retires under a qualified retirement plan at age 55, distributions from that plan are not subject to the early withdrawal tax. However, if the individual rolls his or her benefit over into an IRA, and then begins distributions before age 59-1/2, the distributions would be subject to the early withdrawal tax (unless another exception to the tax applies).

The different exceptions to the early withdrawal tax also create complexities due to enforcement problems. For example, the different exceptions have resulted in the enactment of a provision prohibiting the rollover of certain hardship distributions from a section 401(k) plan to prevent avoidance of the early distribution tax on distributions from such plans.[320] These additional rules create confusion for taxpayers, as well as for plan administrators who must administer the rules. In some cases, imposition of the early withdrawal tax still may be avoided by rolling over a distribution from one type of plan to another.

Recommendation for Simplification

The Joint Committee staff recommends that the exceptions to the early withdrawal tax should be uniform for all tax-favored retirement plans and that the applicable age requirements for the early withdrawal tax and permissible distributions from section 401(k) plans should be changed from 59-1/2 to 55.

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[320] S. Rep. 105-174 (April 22, 1998), at 145-46.

The early withdrawal tax reflects the concern that the tax incentives for retirement savings are inappropriate if the savings are diverted to nonretirement uses. The early withdrawal tax discourages early withdrawals and also recaptures a measure of the tax benefits that had been provided.[321] While some view exceptions to the early withdrawal tax as undermining the purposes of the tax benefits for retirement savings, others argue that allowing exceptions for certain types of expenses will encourage more individuals to save in a tax-favored retirement plan. Without the exceptions, some individuals may be discouraged from saving due to concerns that the funds will not be readily available if needed for other purposes. Some also argue that certain exceptions to the tax directly further the goal of retirement saving. For example, some argue that an exception for first-time home purchase may encourage more individuals to purchase a home, thus reducing their retirement income needs.

It is unclear why certain exceptions to the tax should apply to certain types of tax-favored retirement plans and not others. The fact that IRAs have additional exceptions for first-time home purchase and educational expenses may reflect a view that IRAs are intended to encourage saving generally, or saving for purposes other than retirement, whereas employer-sponsored retirement plans are intended to encourage saving for retirement. However, it is difficult to make such distinctions. Some argue that the exceptions for distributions from employer-sponsored qualified retirement plans should be more favorable than the exceptions for other tax-favored retirement plans to provide an incentive for employers to establish such plans. On the other hand, some argue that limiting the exceptions from other vehicles, such as IRAs, would be unfair to individuals who are not covered by an employer-sponsored plan.

The Joint Committee staff's recommendation would provide the same exceptions to the early withdrawal tax for all tax-favored retirement plans.[322] There are four exceptions to the tax that would be affected by the proposal: the exceptions for first-time homebuyer expenses, educational expenses, and health insurance expenses of unemployed individuals that currently apply only to IRAs, and the exception for distributions made to an employee after separation from service after attaining age 55 that currently applies only to qualified retirement plans. In all four cases, the rules could be simplified by either extending the exception to all plans or by eliminating the exception with respect to all plans. Exceptions to the tax create complexities that would not exist if the exceptions did not exist. Thus, more simplification would be achieved by eliminating the exceptions. However, the Joint Committee staff believes that the existence of the

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[321] *See, e.g.,* Joint Committee on Taxation, *General Explanation of the Tax Reform Act of 1986 (JCS-10-87), May 4, 1987,* at 713-14.

[322] Certain exceptions that are relevant only to particular types of plans because of the rules applicable to such plans would not be changed. For example, the early withdrawal tax does not apply to distributions of excess deferrals under a section 401(k) plan or similar arrangement. This exception to the tax is relevant only with respect to plans to which elective deferrals can be made. The proposal also would not extend the early withdrawal tax to plans not currently subject to the tax, in particular, section 457 plans. However, if pending legislative proposals to permit rollover of benefits between governmental section 457 plans and other tax-favored arrangements are enacted, then conforming the treatment of such plans under the early withdrawal tax should be considered.

exceptions represents a policy decision on the part of the Congress that certain limited exceptions to the tax are appropriate. The Joint Committee staff believes it is more consistent with this policy decision to extend the exceptions to all types of plans. Thus, under the recommendation, the early withdrawal tax would not apply to distributions for first-time homebuyer expenses, educational expenses, or health insurance expenses of unemployed individuals. In addition, in order to extend the age 55 exception to IRAs in a simple manner and to establish a uniform age at which distributions are permitted and do not trigger additional taxation, the age at which the early withdrawal tax applies and at which distributions of elective deferrals from a section 401(k) plan are permitted would be reduced from age 59-1/2 to age 55.

8. Make 401(k) plans available to all governmental employers

Present Law

Legislative background

Section 401(k), which permits employees to elect to have a portion of their pay contributed to a qualified retirement plan rather than received in cash, was enacted in 1978.[323] At that time, there was no restriction on the type of employer that could establish a 401(k) plan.

The 1986 Act enacted an express prohibition on the maintenance of 401(k) plans by State and local government and tax-exempt employers.[324] The legislative history explains that the Congress was concerned that the proliferation of 401(k) plans was unduly shifting the burden of retirement savings to employees and believed that such plans should be supplemental retirement savings, not primary retirement plans. Restricting the types of employers that could adopt such plans was one way to limit the expansion of 401(k) plans.[325] The 1986 Act provided that the prohibition on the maintenance of 401(k) plans did not apply to plans of State or local governments adopted before May 6, 1986. Later legislative changes clarified that a State or local government that had adopted a 401(k) plan before such date could amend the plan after such date, including to add classes of employees and could also adopt a new 401(k) plan.[326]

The 1996 Act allowed tax-exempt employers to maintain 401(k) plans. The 1996 Act also provided for SIMPLE IRAs, which is a simplified plan that, like 401(k) plans, allows

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[323] Sec. 131(a) of the Revenue Act of 1978, Pub. Law No. 95-600. An arrangement that satisfies the requirements of section 401(k) is a qualified cash or deferred arrangement ("401(k) plan"). For a description of the law relating to cash or deferred arrangements before the enactment of section 401(k), *see,* Joint Committee on Taxation, *General Explanation of the Revenue Act of 1978* (JCS-7-79), March 12, 1979, at 82-83.

[324] Secs. 1116 and 1136 of Pub. Law No. 95-600.

[325] H. Rep. 99-426 (1985), at 687; S. Rep. 99-313 (1986), at 549.

[326] Sec. 1011(k)(8) of the Technical and Miscellaneous Revenue Act of 1988, Pub. Law No. 647. *See* S. Rep. 100-445 (1988), at 140-42.

employees to elect to receive cash or a plan contribution. State and local government employers may maintain SIMPLE IRAs.

Present law

Under present law, all employers other than State and local government employers may establish a 401(k) plan. The Federal Government also maintains the Thrift Savings Plan, which is generally subject to the same rules as 401(k) plans.

Sources of Complexity

The restriction on the ability of State and local governments to maintain 401(k) plans causes complexity by creating confusing distinctions between plans and employers. For example, a State or local government with a grandfathered 401(k) plan may expand an existing 401(k) plan or adopt a new plan. In some cases, the grandfather rule makes the prohibition against maintenance of 401(k) plans by governmental employers meaningless, but adds administrative burdens by requiring the manipulation of existing plans in order to come within the grandfather. State and local government employers may adopt other types of elective deferral plans, including SIMPLE IRAs and section 457 plans which, as described below, operate in a manner similar to 401(k) plans when adopted by government employers.

Recommendation for Simplification

The Joint Committee staff recommends that all State and local governments should be permitted to maintain 401(k) plans.

The recommendation will reduce complexity by eliminating meaningless distinctions between the types of plans that may be offered by different types of employers. The recommendation will also increase the fairness of the tax laws; there is no clear policy reason why some governmental employers, including the Federal Government, may adopt a 401(k) plan, but other governmental employers may not.

9. Redraft section 457 to separate requirements for governmental plans and plans of tax-exempt employers

Present Law

Among the various types of tax-favored retirement plans under present law are eligible deferred compensation plans under section 457. An eligible deferred compensation plan (also known as a "section 457 plan") is a nonqualified plan that is maintained by a State or local government or a tax-exempt organization[327] and that meets certain requirements. Among the requirements that must be satisfied is that the amount deferred cannot exceed the lesser of (1) $8,500 (for 2001) or (2) 33-1/3 percent of compensation. Compensation deferred under an eligible deferred compensation plan is not includible in gross income until paid or made

[327] Section 457 does not apply to a plan maintained by a church or a church-controlled organization. Sec. 457(e)(13).

available to the individual.[328] Eligible deferred compensation plan treatment is not limited to arrangements that permit employees to elect whether to defer compensation or receive it currently, but section 457 plans commonly take an elective deferral approach. Although many of the rules relating to section 457 plans apply equally to plans of governmental and tax-exempt employers, as described below, there are significant differences between the rules in some cases as applied to each type of employer.

Section 457 also contains rules for unfunded deferred compensation plans of State and local governments and tax-exempt employers that do not meet the requirements of section 457. Amounts deferred under such a plan are includible in gross income in the first year in which there is no substantial risk of forfeiture of such amounts.[329] As a result, an eligible deferred compensation plan is generally the only means by which a State or local government or a tax-exempt organization can provide nonqualified deferred compensation on a tax-deferred basis.

Although the original rules of section 457 applied only to unfunded plans, section 457 now requires that governmental plans be funded. Applying a funding requirement to governmental section 457 plans, but not plans of tax-exempt organizations, creates a significant distinction between different types of section 457 plans and alters the nature of such plans. As a result of the funding requirement, governmental section 457 plans are now more similar to qualified retirement plans, and many governmental section 457 plans operate in a manner similar to 401(k) plans.

Certain types of plans are not subject to section 457, even though they may operate in practice to defer compensation. With respect to both governmental and tax-exempt employers, such plans include bona fide vacation, sick leave, compensatory time, severance pay, disability pay, or death benefit plans. In addition, a qualified governmental excess benefit arrangement that provides benefits that cannot be provided under a qualified plan maintained by the government employer because of the limits on benefits under such plans is exempt from the requirements that apply under section 457. Similar excess benefit arrangements of tax-exempt employers are subject to the restrictions of section 457.

Besides the funding requirement, section 457 contains other distinctions between plans maintained by governments and by tax-exempt organizations. A governmental plan that is administered in a manner that is inconsistent with the section 457 requirements is entitled to a special grace period before being treated as not meeting the requirements.[330]

Besides the distinctions between section 457 plans maintained by governments and by tax-exempt organizations under the tax laws, distinctions exist under Title I of ERISA. Plans maintained by government employers, including section 457 plans, are exempt from many of the

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[328] Sec. 457(a).

[329] Sec. 457(f).

[330] The IRS has various programs that allow a sponsor of a qualified plan to correct compliance problems with the plan rather than having the plan disqualified. Rev. Proc. 2001-17, 2001-7 I.R.B. 589.

ERISA requirements. However, no special ERISA exemption exists for section 457 plans maintained by tax-exempt organizations. Because of conflict between some of the requirements under section 457 and requirements under ERISA (such as funding and exclusive purpose), ERISA has the effect of limiting the ability of a tax-exempt organizations to maintain broad-based section 457 plans. Thus, such plans are generally limited to management employees, whereas many governmental section 457 plans cover a broad group of employees.

Sources of Complexity

Despite the differences between section 457 plans maintained by State and local governments and plans maintained by tax-exempt organizations, the same Code provision deals with both types of plans. This causes drafting complexity in that employers and practitioners must review all the rules under section 457 in order to determine those that apply to its plan.

Recommendation for Simplification

The Joint Committee staff recommends that the statutory provisions dealing with eligible deferred compensation plans should be redrafted so that separate provisions apply to plans maintained by State and local governments and to plans maintained by tax-exempt organizations.

Under the Joint Committee staff recommendation, section 457 would be amended so that separate provisions would apply to eligible deferred compensation plans maintained by State and local governments and to plans maintained by tax-exempt organizations. As a result, employers and practitioners could more readily identify the requirements that apply to each type of plan. For example, an employer considering whether to establish an eligible deferred compensation plan would have to review only the requirements that would apply to its plan. This would make it easier for employers to understand and comply with the requirements. In addition, statutory amendments that affect only one type of employer would not cause confusion for the other type of employer. The new statutory structure would also reflect the differences in operation between the two different types of plan.

10. Adopt uniform ownership attribution rules for qualified retirement plan purposes

Present Law

In general

Ownership of a business is relevant for various qualified retirement plan purposes. For example, controlled groups of corporations, unincorporated businesses under common control, and members of affiliated service groups are treated as a single employer for purposes of various qualification requirements, including the nondiscrimination rules and the limits on contributions and benefits.[331] In addition, ownership is relevant in determining whether an employee is a

[331] Secs. 414(b), (c), and (m).

highly compensated employee for nondiscrimination purposes, a key employee for top-heavy purposes, or a disqualified person for purposes of the prohibited transaction rules.[332]

Different attribution rules apply to different provisions for which ownership is relevant. For example, the attribution rules used in determining controlled group status for purposes of preventing corporations from receiving multiple tax benefits ("controlled group attribution rules") apply in determining whether a group of corporations is a single employer for qualified retirement plan purposes.[333] The attribution rules in subchapter C of the Code ("subchapter C attribution rules") apply in determining whether an employee is a highly compensated employee or a key employee.[334] The attribution rules used in the case of transactions between related parties ("related party attribution rules") apply in determining whether someone is a disqualified person.[335] These attribution rules, and the purposes for which they are used, are described in detail below.

Controlled group rules

Definitions

A controlled group of corporations is treated as a single employer for certain qualified retirement plan requirements. The concept of "controlled group of corporations" is generally based on the definition of that term under the rules that prevent corporations from receiving multiple tax benefits. Under that definition, a chain of corporations connected through ownership of 80 percent of the stock is treated as a parent-subsidiary controlled group. In addition, a brother-sister controlled group exists if five or fewer persons own at least 80 percent of the stock in two or more corporations and also own 50 percent of the stock, taking into account only the same percentage of stock owned by each person in all the corporations.

Similar controlled group rules apply in the case of unincorporated entities.[336] Under regulations, a chain of organizations connected through 80 percent ownership is treated as a parent-subsidiary group under common control.[337] In addition, a brother-sister group under common control exists if five or fewer persons own at least 80 percent of two or more organizations and also own 50 percent of the organizations, taking into account only the same percentage owned by each person in all the organizations.

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[332] *See* sec. 414(q)(2) (highly compensated employee), sec. 416(i)(1)(B) (key employee), and sec. 4975(e)(2) (disqualified person).

[333] *See* sec. 414(b), cross referencing sec. 1563(a).

[334] *See* secs. 414(q)(2), 416(i)(1)(B), and 318.

[335] *See* sec. 4975(e), cross referencing sec. 267(c).

[336] Sec. 414(c).

[337] Treas. Reg. sec. 1.414(c)-2.

Attribution rules

The controlled group attribution rules apply in determining whether a controlled group of corporations exists for qualified retirement plan purposes. Under those rules, stock owned by a corporation or a partnership is treated as owned by a shareholder or partner having at least a five-percent interest in the corporation or partnership, in proportion to that interest. In addition, stock owned by an estate or a trust is treated as owned by a beneficiary having at least a five-percent interest in the estate or trust, in proportion to that interest. The holder of an option is treated as owning the stock subject to the option, and stock owned by a grantor trust is treated as owned by the grantor or other owner of the trust.

An individual is treated as owning the stock of his or her spouse (subject to an exception if certain requirements are met) or a minor child (under age 21), and a minor child is treated as owning the stock of his or her parents. An individual who, before application of this rule, owns more than 50 percent of a corporation is treated as owning the stock of his or her parents, grandparents, adult children, and grandchildren.

The controlled group attribution rules deal with ownership of stock in a corporation. Similar rules, dealing with ownership of all types of interests, apply under the regulations relating to groups under common control.[338] For example, a partnership interest owned by a corporation or a partnership is treated as owned by a shareholder or partner having at least a five-percent interest in the corporation or partnership, in proportion to that interest. Similarly, an interest in a trust held by an estate is treated as held by a beneficiary having at least a five-percent interest in the estate, in proportion to that interest.

Affiliated service groups, highly compensated employees, key employees

Definitions

The members of an affiliated service group are treated as a single employer for certain qualified retirement plan purposes.[339] An affiliated service group consists of a service organization ("first organization") and one or more other entities that bear certain relationships to the first organization. An affiliated service group exists if another service organization (an "A organization") is a shareholder or partner of the first organization and either regularly performs services for the first organization or is regularly associated with the first organization in performing services for third parties. Alternatively, an affiliated service group exists between a first organization and another organization (a "B organiation") if a significant portion of the other organization's business is the performance of services for the first organization (or a member of an affiliated service group with the first organization), the services are of a type historically performed by employees, and 10 percent or more of the interests in the B organization is held by highly compensated employees of the first organization (or a member of an affiliated service group with the first organization).

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[338] Treas. Reg. sec. 1.414(c)-4(b).

[339] Sec. 414(m).

The group of highly compensated employees of an employer includes an employee who is a five-percent owner at any time during the year or preceding year. A key employee is an employee who, at any time during the relevant determination period, is (1) a five-percent owner of the employer, (2) a one-percent owner of the employer and receives compensation of more than $150,000, or (3) one of the 10 employees owning the largest interests in the employer and receives compensation of more than $35,000 (for 2001). These definitions are based on ownership of stock if the employer is a corporation or on ownership of a capital or profits interest if the employer is not a corporation.

Attribution rules

The subchapter C attribution rules apply in determining ownership for purposes of affiliated service group, highly compensated employee, or key employee status. Although these rules apply only to stock ownership, similar treatment of other interests applies for qualified retirement plan purposes.[340]

An interest owned by a corporation or a partnership is treated as owned by a shareholder having at least a five-percent interest in the corporation or a partner of the partnership, in proportion to the shareholder's interest in the corporation or the partner's interest in the partnership.[341] In addition, an interest owned by an estate or a trust (other than a qualified retirement plan trust) is treated as owned by a beneficiary of the estate or trust, in proportion to the beneficiary's interest in the estate or trust. The holder of an option is treated as owning the interest subject to the option, and an interest owned by a grantor trust is treated as owned by the grantor or other owner of the trust.

Unlike the controlled group attribution rules, the subchapter C attribution rules also attribute ownership to an entity from its owners. Specifically, an interest owned by a 50-percent shareholder of a corporation, a partner, a five-percent beneficiary of a trust (other than a qualified retirement plan trust), or a beneficiary of an estate is treated as owned respectively by the corporation, partnership, trust, or estate. An interest owned by the grantor or other owner of a grantor trust is treated as owned by the trust.

An individual is treated as owning an interest owned by the individual's spouse, children, grandchildren or parents.

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[340] Prop. Treas. Reg. sec. 1.414(m)-2(d), sec. 416(i)(1)(B).

[341] Under the general subchapter C attribution rules, stock owned by a corporation is treated as owned by a shareholder only if the shareholder's interest in the corporation is at least 50 percent, but five percent is substituted for 50 percent for qualified retirement plan purposes. *See* secs. 318(a)(2)(C) and 416(i)(1)(B)(iii)(I).

Prohibited transactions and disqualified persons

Definitions

A qualified retirement plan is prohibited from engaging in certain transactions, such as a property sale, with disqualified persons.[342] Disqualified person includes (1) a fiduciary of the plan, (2) a person providing services to the plan, (3) an employer with employees covered by the plan, (4) an employee organization with members covered by the plan, and (5) the owner of 50-percent or more of such an employer or employee organization.[343] Disqualified person also includes a corporation, partnership, trust or unincorporated enterprise, in which persons described in the preceding sentence have an interest of 50 percent or more.

Attribution rules

In determining ownership for purposes of disqualified person status, the related party attribution rules apply.[344] Although these rules apply only to stock ownership, similar treatment of partnership, trust and unincorporated interests applies for purposes of determining disqualified person status.[345]

An interest owned by a corporation, partnership, estate or trust is treated as owned proportionately by its shareholders, partners, or beneficiaries. In addition, solely for purposes of determining stock ownership, an individual is treated as owning stock owned by his or her partner. With respect to attribution among family members, an individual is treated as owning an interest owned by a spouse, ancestor, lineal descendent or spouse of a lineal descendent.[346]

Sources of Complexity

The rules for attribution of ownership are generally complex. In addition, the various sets of rules contain minor differences that have relatively insignificant effect when applied for qualified retirement plan purposes. For example, interests held by business owners are attributed to the business under only the subchapter C attribution rules. The subchapter C attribution rules

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[342] Sec. 4975(c).

[343] Sec. 4975(e)(2)(A), (B), (C), (D), (E), (G). Other categories of disqualified person exits, some of which are also based on ownership, but no attribution rules apply.

[344] Exemptions apply in some cases to transactions that would otherwise be prohibited. However, most prohibited transaction exemptions do not apply to shareholder-employees. A shareholder-employee is an employee or officer of an S corporation who owns more than five percent of the outstanding stock of the S corporation; the subchapter C attribution rules for family members apply in determining ownership for this purpose. Sec. 4975(f)(6).

[345] Sec. 4975(e)(5).

[346] Instead of the definition of family under section 267(c)(4) (brothers and sisters, spouse, ancestors and lineal descendents), the definition under section 4975(e)(6) applies.

apply, for example, in determining whether an employee is a five-percent owner of the employer. However, these rules further provide that an interest that is attributed to a business may not be reattributed from the business to its owners. As a result, even if an interest were attributed to a business owned by an employee, it could not be reattributed to the employee to create five-percent owner status.

The qualified retirement plan requirements for which ownership is relevant, such as those that require the treatment of related employers as a single employer for certain purposes, are highly technical and difficult rules, apart from the attribution rules. The use of multiple attribution rules with minor differences that have little effect adds an unnecessary layer of complexity for sponsoring employers and administrators.

Recommendation for Simplification

The Joint Committee staff recommends that the attribution rules used in determining controlled group status under section 1563 should be used in determining ownership for all qualified retirement plan purposes.[347]

Uniform attribution rules would enable the employer to perform a single ownership analysis for all relevant qualified retirement plan purposes. In addition, because the same controlled group rules apply for purposes of preventing multiple tax benefits and for qualified retirement plan purposes, the attribution rules that apply in determining controlled group status should apply for all qualified retirement plan purposes. This will assure that the definition of a controlled group will be consistent for all purposes.

The use of the controlled group attribution rules for all qualified retirement plan purposes should not have a significant effect on the requirements for which they apply. For example, under the controlled group attribution rules, an interest held by a business is attributed only to five-percent or more owners, in proportion to their ownership of the business. Under other rules, attribution applies proportionately to all of the business owners. Ownership of five percent or more is generally the level that is significant for qualified retirement plan purposes, so using a five-percent threshold for attribution is appropriate.

Using the controlled group attribution rules for all purposes could affect the application of the affiliated service group rules. These rules apply if an A organization is a shareholder or partner of the first organization. Under present law, an interest in the first organization owned by an individual who also owns an interest in the A organization could be attributed to the A organization for purposes of the affiliated service group rules. In order to avoid a significant change in result, the Joint Committee staff recommends a coordinating change to the affiliated service group rules. That is, an affiliated service group could exist if (1) an A organization is a

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[347] The Joint Committee staff also recommends the use of a uniform definition of family for purposes of applying ownership attribution rules for all Code purposes, including qualified retirement plan purposes. *See* Section IV.D. of this Part, below.

shareholder or partner of the first organization or (2) an A organization has a common shareholder or partner with the first organization.[348]

[348] That change would make the affiliated service group rules slightly more complicated, but not enough to offset by the benefit of using the same attribution rules for all qualified retirement plan purposes.

D. Basis Recovery Rules for Qualified Retirement Plans and IRAs

Present Law

1. In general

Distributions from qualified retirement plans and IRAs are includible in gross income except to the extent that the distribution is a return of the individual's investment in the contract (i.e., basis). An individual will have basis in a qualified retirement plan if the individual has made after-tax contributions to the plan. An individual will have basis in a traditional IRA if the individual has made nondeductible contributions. All contributions to a Roth IRA are made on an after-tax basis, thus, any individual who has made contributions to a Roth IRA has basis in the Roth IRA.[349]

The rules for determining what portion of a distribution is attributable to basis and therefore not includible in gross income are different for qualified plans, traditional IRAs, and Roth IRAs. In the case of qualified retirement plans, the basis recovery rules also vary based on the form of the distribution.

In all cases, the total amount excludable from income is limited to the individual's basis. If the individual dies before recovering all of his or her basis, then a deduction for the remaining basis is allowed on the individual's final return.

2. Qualified retirement plans

Overview

In general, the amount of a distribution from a qualified retirement plan that is includible depends on: (1) whether the distribution is a periodic payment or a nonperiodic payment; and (2) in the case of a nonperiodic payment, whether it is made before or on or after the annuity starting date. In the case of periodic payments, basis is generally recovered on a pro-rata basis as payments are made. That is, each payment is treated in part as a return of basis and in part as taxable income.

In the case of nonperiodic payments, the pro-rata basis recovery rule generally applies to amounts received before the annuity starting date. In the case of nonperiodic payments received after the annuity starting date, the distribution is generally fully includible in income (i.e., no portion of the payment is treated as a return of basis).

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[349] Certain adjustments to basis may be required in some situations.

Definitions

Periodic payments

A payment is considered a periodic payment only if it meets all of the following three requirements: (1) the payment is received on or after the annuity starting date; (2) the payment is one of a series of payments payable in periodic installments at regular intervals (e.g., annually, semiannually, quarterly, monthly, or weekly) over a period of more than one year; and (3) subject to certain exceptions, the total amount payable is determinable at the annuity starting date either directly under the terms of the contract or plan or indirectly by the use of mortality tables or compound interest calculations in accordance with sound actuarial theory.[350]

Common types of periodic payments include the following:

- Single life annuities, which pay a fixed amount at regular intervals for the lifetime of a single individual.
- Joint and survivor annuities, which pay a fixed amount at regular intervals for the lifetime of a single individual and, following the death of such individual, a fixed amount at regular intervals for the lifetime of another individual. The amount of payments to the survivor may or may not be different than the amount of payments to the first annuitant.
- Term-certain annuities, which pay a fixed amount at regular intervals over a specified period (e.g., 10 years).

Nonperiodic payments

A nonperiodic payment is any payment that is not a periodic payment.[351]

Annuity starting date

The annuity starting date is the first day of the first period for which a periodic payment is received.[352]

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[350] Treas. Reg. sec. 1.72-2(b)(2). The statute and regulations generally refer to periodic payments as "amounts received as an annuity." IRS publications, *e.g.,* Publication 575, *Pension and Annuity Income*, generally use the term employed here, "periodic payments", to refer to such distributions.

[351] The statute and regulations generally refer to nonperiodic payments as "amounts not received as an annuity." IRS publications, *e.g.,* Publication 575, *Pension and Annuity Income*, generally use the term employed here, "nonperiodic payments" to refer to such distributions.

[352] Sec. 72(c)(4).

Taxation of periodic payments

Background and general rule

As mentioned above, in the case of periodic payments, basis is recovered ratably over the period for which payments are made, so that each payment consists in part of a return of basis and in part of taxable income. There are two main methods for determining the amount of each payment that is not taxable: the general rule, and the simplified method, which in the future will apply to most individuals.

As its name implies, the general rule used to be the usual method for determining the amount of each payment that is a return of basis. Under the general rule, the amount of each payment that is excludable from income is determined by multiplying the amount of the payment by the exclusion ratio, which is the ratio of the individual's basis to the total expected payments. Total expected payments are determined under actuarial tables prescribed by the Secretary.[353]

In 1988, the IRS developed an optional simplified method for determining the taxable and tax-free portions of distributions from qualified retirement plans applicable to individuals with annuity starting dates after July 1, 1986.[354] Under this simplified method, the total number of expected payments was determined under a table based on the age of the distributee on the annuity starting date instead of the actual tables used under the general rule. This simplified method could only be used in the case of periodic payments (with or without a guaranteed number of payments) to be paid over the life of the individual or the joint lives of the individual and beneficiary. Thus, this simplified method could not be used in the case of periodic payments payable over a specified period of time. In addition, this simplified method could not be used if the employee was age 75 or older on the annuity starting date and annuity payments are guaranteed for at least five years. Individuals who were not eligible to use the simplified method or those that elected not to, use the general rule.

The 1996 Act[355] adopted statutorily a modified version of the simplified method developed administratively by the IRS. This simplified method is required to be used for all periodic payments in the case of annuity starting dates after November 18, 1996, except that the simplified method is not available if employee was age 75 or older on the annuity starting date and annuity payments are guaranteed for at least five years. Individuals who may not use the simplified method must use the general rule.

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[353] In the case of annuity starting dates before July 2, 1986, employees could use a special three-year basis recovery rule. Under this rule, if the total amount of basis could be recovered within three years of annuity payments, all distributions were treated first as recovery of basis until all basis was recovered, and thereafter all payments were fully includible in income. This three-year rule was repealed by the 1986 Act.

[354] Notice 88-118, 1988-2 C.B. 450.

[355] Sec. 1403 of Pub. L. No. 104-188.

The 1997 Act modified the simplified method by prescribing a different table if the payments are based on the lives of more than one individual.[356] The new table applies to annuity starting dates after December 31, 1997.[357] The 1997 Act did not modify the rules applicable to periodic distributions based on the life of a single individual.

Because the simplified method is now generally required for annuity starting dates after November 18, 1996, the general rule is applied to distributions from qualified retirement plans[358] only in the following situations: (1) the annuity starting date is after November 18, 1996, and the individual is not eligible to use the simplified method, i.e., the individual is age 75 or older on the annuity starting date and annuity payments are guaranteed for at least five years; (2) the annuity starting date is before November 19, 1996, and after July 1, 1986, and the employee either was not eligible to use the simplified method or did not elect to do so.

Simplified method for determining amount includible in income

The simplified method is generally required to be used by individuals with an annuity starting date on or after November 19, 1996. The simplified method cannot be used if the primary annuitant has attained age 75 on the annuity starting date, unless there are fewer than five years of guaranteed payments under the contract or plan. As described above, individuals that cannot use the simplified method must use the general rule.

Under the simplified method, in the case of payments that are payable over the lives of one or more individuals, the amount of each periodic payment that is a return to basis is equal to the employee's total basis as of the annuity starting date, divided by the number of anticipated payments as determined under statutorily specified tables.[359] These tables (Tables 15 and 16, below) in the case of annuity starting dates after November 18, 1996, but before January 1, 1998, show the number of payments is based on the age of the primary annuitant, regardless of the number of annuitants. For annuity starting dates on or after January 1, 1998, one table applies in the case of one annuitant and a separate table applies in the case of more than one annuitant.

If the number of payments is fixed under the terms of the annuity contract or plan, then that number is used instead of the number of anticipated payments listed in the table.

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[356] Sec. 1075 of Pub. Law No. 105-34, codified at sec. 72(d).

[357] The IRS has issued transition rules for annuity starting dates after November 18, 1996, and before January 1, 1997. IRS Notice 98-2, 1998-1 CB 266.

[358] The general rule still applies to commercial annuities, private annuities, and distributions from nonqualified employee plans.

[359] The number of payments are based on monthly payments; appropriate adjustments are to be made to take into account the period on which payments are made if other than monthly.

Table 15.--Annuity Payments Under Simplified Rule for Annuity Starting Dates Before January 1, 1998

Age on Annuity Starting Date	Number of Payments	
	Annuity starting date before November 19, 1996	Annuity starting date after November 18, 1996
55 or under	300	360
56-60	260	310
61-65	240	260
66-70	170	210
71 or older	120	160

Source: IRS Notice 98-2.

Table 16.--Annuity Payments Under Simplified Rule for Annuity Starting Dates After December 31, 1997

Combined Ages Of Annuitants At Annuity Starting Date	Number of Payments
110 or under	410
111-120	360
121-130	310
131-140	260
141 or older	210

Source: IRS Notice 98-2.

If, in connection with commencement of periodic payments, the recipient receives a lump sum payment that is not part of the periodic payments, that payment is taxed as a nonperiodic payment received before the annuity starting date. In such a case, the basis for applying the simplified method to the periodic payments is reduced by the amount of basis attributed to the nonperiodic payment.

Traditional IRAs

Overview

In general, individuals may make deductible or nondeductible contributions to a traditional IRA. The maximum permitted annual deductible IRA contribution generally is the lesser of $2,000 or the individual's compensation includible in gross income for the year. In the case of a married couple, deductible IRA contributions of up to $2,000 can be made for each spouse (including, for example, a homemaker who does not work outside the home), if the combined compensation of both spouses is at least equal to the contributed amount. If the individual for whom the contribution is made is an active participant in an employer-sponsored

retirement plan, the $2,000 deduction limit is phased out for taxpayers with adjusted gross income ("AGI") over certain levels for the taxable year.[360]

To the extent an individual cannot or does not make deductible contributions to an IRA or contributions to a Roth IRA, the individual may make nondeductible contributions to an IRA. Nondeductible contributions must be reported on the individual's tax return for the year (even if the individual is not otherwise required to file a return). If nondeductible contributions are not reported, then those contributions will be includible in income when distributed, unless the individual can show with other satisfactory evidence that nondeductible contributions were made. In no event can the total IRA contributions for an individual for a year exceed the lesser of $2,000 or the individual's compensation (or the total compensation of both spouses).

Taxation of IRA distributions

Distributions from a traditional IRA may be either fully taxable or partially taxable.[361] If an individual has made no nondeductible contributions to any traditional IRAs, then all distributions from the individual's traditional IRAs are taxable.

If an individual has made nondeductible IRA contributions to any traditional IRA, a portion of each distribution is nontaxable, until the total amount of nondeductible contributions has been received. In general, the amount of a distribution that is not taxable is determined by multiplying the amount of the distribution by the ratio of the remaining nondeductible contributions to the total IRA balance. In making this calculation, all traditional IRAs of an individual are treated as a single IRA, all distributions during any taxable year are treated as a single distribution, and the value of the contract, income on the contract, and investment in the contract are computed as of the close of the calendar year.[362]

Roth IRAs

Overview

Individuals with AGI below certain levels may make nondeductible contributions to a Roth IRA. The maximum annual contribution that may be made to a Roth IRA is the lesser of $2,000 or the individual's compensation includible in income for the year. The contribution limit is reduced to the extent an individual makes contributions to any other IRA for the same taxable year. As under the rules relating to IRAs generally, a contribution of up to $2,000 for each spouse may be made to a Roth IRA provided the combined compensation of the spouses is at least equal to the contributed amount. The maximum annual contribution that can be made to a

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[360] A separate, higher income limitation applies if the individual is not an active participant in an employer-sponsored retirement plan, but the individual's spouse is.

[361] Distributions that are rolled over into another traditional IRA or an eligible employer-sponsored retirement plan are not includible income.

[362] Sec. 408(d)(1).

Roth IRA is phased out for single individuals with AGI between $95,000 and $110,000, and for married individuals filing joint returns with AGI between $150,000 and $160,000.

Taxpayers with modified AGI of $100,000 or less generally may convert a traditional IRA into a Roth IRA. Married taxpayers filing separate returns may not convert a traditional IRA into a Roth IRA. The amount converted from a traditional IRA into a Roth IRA is includible in income as if a withdrawal had been made.

Taxation of distributions

Distributions from a Roth IRA may be either partially taxable or fully excludable from income.

Amounts held in a Roth IRA that are withdrawn as a qualified distribution are not includible in income. A qualified distribution is a distribution that is made (1) after the five-taxable-year period beginning with the first taxable year for which the individual made a contribution to a Roth IRA, and (2) after attainment of age 59-1/2, on account of death or disability, or for first-time homebuyer expenses of up to $10,000.

To the extent attributable to earnings, a distribution from a Roth IRA that is not a qualified distribution is includible in income. In determining the portion of a distribution that is attributable to earnings, contributions and earnings are deemed to be distributed in the following order:

(1) Regular Roth IRA contributions;

(2) Taxable conversion contributions;

(3) Nontaxable conversion contributions;

(4) Earnings on contributions.

In determining the amount of taxable distributions, all Roth IRA distributions in the same taxable year are treated as a single distribution; all regular contributions for the year (including those made after the close of the year but before the due date of the return for the year) are treated as a single contribution; and all conversion contributions during the year are treated as a single contribution.

The effect of these rules is that no amount is includible in income due to a withdrawal from a Roth IRA until all nontaxable amounts have been received. After that, the total amount of nonqualified distributions will be attributable to earnings and fully includible in income.

Sources of Complexity

The basis recovery rules for qualified plans and IRAs are complex both because they involve complicated calculations and because the rules for similar types of tax-favored vehicles are different.

The general rule requires extensive calculations and the use of complicated actuarial tables. IRS Publication 939 (Rev. June 1997), *General Rule for Pensions and Annuities,* contains approximately 63 pages of actuarial tables for use in applying the general rule. While most taxpayers are not now required to use the general rule for qualified retirement plan contributions, those that are consist of the most elderly of taxpayers (75 years or older), for which complicated rules are likely to be particularly burdensome. While the simplified method is a marked improvement over the general rule, it still requires significant calculations on the part of taxpayers.

The rules applicable to traditional IRAs require extensive calculations as illustrated by the following example excerpted from IRS materials.

Example of taxation of distributions from traditional IRAs. Rose Green has made the following contributions to her traditional IRAs.

Year	Deductible	Nondeductible
1993	$2,000	-0-
1994	2,000	-0-
1995	2,000	-0-
1996	1,000	-0-
1997	1,000	-0-
1998	1,000	-0-
1999	700	$300
Totals	$9,700	$300

In 2000, Rose, whose IRA deduction for that year may be reduced or eliminated, makes a $2,000 contribution that may be partly nondeductible. She also receives a distribution of $5,000 for conversion to a Roth IRA. She completed the conversion before 12/31/00 and did not recharacterize any contributions. At the end of 2000, the fair market values of her accounts, including earnings, total $20,000. She did not receive any tax-free distributions in earlier years. The amount she includes in income for 2000 is figured as follows:

Worksheet To Figure Taxable Part of Distribution

Use only if you made contributions to a traditional IRA for 2000 and have to figure the taxable part of your 2000 distributions to determine your modified AGI.

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1)	Enter the basis in your traditional IRA(s) as of 12/31/99	$ 300
2)	Enter the total of all contributions made to your traditional IRAs during 2000 and all contributions made during 2001 that were for 2000, **whether or not deductible**. Do not include rollover contributions properly rolled over into IRAs	$ 2,000
3)	Add lines 1 and 2	$ 2,300

4)	Enter the value of ALL of traditional IRA(s) as of 12/31/00 (include any outstanding rollovers from traditional IRAs to other traditional IRAs)	$ 20,000
5)	Enter the total distributions from traditional IRA (including amounts converted to Roth IRAs that will be shown on line 14c of Form 8606) received in 2000. (Do not include outstanding rollovers included on line 4 or any rollovers between traditional IRAs completed by 12/31/00. Also, do not include certain return returned contributions described in the instructions for line 7, Part I, of Form 8606.)	$ 5,000
6)	Add lines 4 and 5	$25,000
7)	Divide line 3 by line 6. Enter the result as a decimal (to at least two places). Do not enter more than 1.00.	.092
8)	**Nontaxable portion** of the distribution. Multiply line 5 by line 7. Enter the result here and on line 10 of Form 8606	$ 460
9)	**Taxable portion of the distribution (before adjustment for conversions).** Subject line 8 from line 5. Enter the result here and if there are no amounts converted to Roth IRAs, STOP HERE and enter the result on line 13 of Form 8606	$ 4,540
10)	Enter the amount included on line 9 that is allocable to amounts converted to Roth IRAs by 12/31/00. (See **Note** at the end of this worksheet.) Enter here and on line 16 of Form 8606.	$ 4,540
11)	Taxable portion of the distribution (after adjustment for conversions). Subtract line 10 from line 9. Enter the result here and on line 13 of Form 8606	$ -0-

Note. If the amount on line 5 of this worksheet includes an amount converted to a Roth IRA by 12/31/00, you must determine the percentage of the distribution allocable to the conversion. To figure the percentage, divide the amount converted (from line 14c of Form 8606) by the total distributions shown on line 5. To figure the amounts to include on line 10 of this worksheet and on line 16, Part II of Form 8606, multiply line 9 of the worksheet by the percentage you figured.

The rules applicable to Roth IRAs are different still from those applicable to qualified retirement plans and traditional IRAs. The rules applicable to Roth IRAs are simpler than the rules applicable to traditional IRAs, because they do not require as extensive calculations. Rather, to apply the rule, the individual merely needs to keep track of basis and previous distributions.

The fact that the rules relating to the three types of vehicles are different also results in complexity. It is common for taxpayers to have both an IRA and benefits under qualified retirement plans. Taxpayers that have funds in more than one type of these vehicles may need to

understand and apply all three different sets of rules. This may be particularly confusing in the case of IRAs; taxpayers may be more likely to mistakenly believe the rules for all IRAs are the same, and thereby report income incorrectly.

Recommendation for Simplification

The Joint Committee staff recommends that a uniform basis recovery rule should apply to distributions from qualified retirement plans, traditional IRAs, and Roth IRAs. Under this uniform rule, distributions would be treated as attributable to basis first, until the entire amount of basis has been recovered.[363]

The proposal would provide simplification both by providing a more simpler basis recovery rule and by providing the same rule for similar types of vehicles.

Under present law, an individual must not only keep track of his or her basis as distributions are made, but also perform a variety of calculations (depending on whichever basis recovery rule applies). The proposal would eliminate the need to make calculations to determine the amount of any distribution attributable to basis; instead the individual would only need to keep track of his or her basis. This would provide significant simplification for recipients of distributions from qualified retirement plans and IRAs. In addition, by providing a uniform rule for qualified retirement plans, IRAs, and Roth IRAs, the proposal would eliminate potential mistakes due to taxpayers misunderstanding which rules apply in any particular case.

Under the proposal, an individual's tax liability with respect to distributions from qualified plans and IRAs would increase over time as basis is recovered (and the net amount of the distribution would increase). Some view this as an undesirable effect, and may require additional financial planning on the part of taxpayers. On the other hand, some view the rule as generally favorable to taxpayers, as they will enjoy a period of tax-free distributions.

While providing simplification, the proposal would depart from a theoretically pure system of taxation. Tax policy analysts generally agree that the theoretically correct approach to basis recovery is reflected in the general rule, that is, each payment under an annuity represents part of a recovery of basis. Thus, each payment should be partially includible in gross income and partially a tax-free return of basis. The Joint Committee staff believes that the simplification to be achieved by the proposal outweighs this concern in the case of distributions from qualified plans and IRAs, particularly given the relatively small portion of such distributions that are attributable to basis.[364]

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[363] As under present law, if the individual dies before his or her basis is recovered, the amount of remaining basis would be allowed as a deduction on the final return. The Joint Committee is also recommending that section 72 be redrafted to improve readability. *See* section VIII.D., below.

[364] In contrast, the Joint Committee staff is not recommending that this basis first rule be applied to immediate or deferred annuity contracts, life insurance contracts, or endowment contracts. Different policy concerns arise with respect to such contracts than with respect to

E. Employee Benefits

1. Modify cafeteria plan election requirements

Present Law

In general

A cafeteria plan is an arrangement established by an employer under which employees may choose whether to receive cash or instead to receive certain nontaxable benefits.[365] Under a cash or deferred arrangement, an employee may choose whether to receive an amount in cash or to have it contributed to a qualified retirement plan.

Under general tax principles, an employee who is given a choice among cash or nontaxable benefits will be considered to have constructively received the cash.[366] The amount of cash made available to the employee is therefore included in the employee's income even if the employee elects to receive nontaxable benefits and the employee's election is made before the cash becomes currently available. Similarly, if an employee may elect between a current cash payment or a contribution to a deferred compensation plan, the amount of cash is included in the employee's income even if the employee elects a contribution to a deferred compensation plan and the deferred compensation plan is a qualified retirement plan.

Present law provides exceptions to the constructive receipt rules in the case of cafeteria plans and qualified cash or deferred arrangements.[367] No amount is included in the gross income of an employee who participates in a cafeteria plan solely because, under the plan, the employee may choose among cash and the other benefits offered under the plan.[368] Similarly, contributions made to a qualified retirement plan under a qualified cash or deferred arrangement are not treated as made available to the employee merely because the arrangement provides employees with a choice between cash and a contribution to the plan.[369]

IRAs and qualified retirement plans. For example, basis typically represents a larger portion of such contracts than does basis under qualified retirement plans and IRAs. In addition, IRAs and qualified retirement plans are subject to a variety of rules and limitations that do not apply to such contracts.

[365] Sec. 125.

[366] *See, e.g.*, Treas. Reg. sec. 1.451-2(a).

[367] "Qualified cash or deferred arrangement" is defined in section 401(k).

[368] Sec. 125(a).

[369] Sec. 402(e)(3). This provision also applies to elective deferrals to a tax-deferred annuity plan under section 403(b). Similar provisions include section 402(k), permitting elective deferrals to a SIMPLE IRA, and section 132(f)(4), permitting an employee to choose between a qualified transportation fringe and includible compensation.

Employee elections

Although the statutory provisions governing cafeteria plans and qualified cash or deferred arrangements are very similar, Treasury regulations place more restrictions on elections under a cafeteria plan than on elections under a qualified cash or deferred arrangement. In the case of a qualified cash or deferred arrangement, an election may be made with respect to amounts that have not become currently available to the employee.[370] For this purpose, an amount is currently available if it has been paid to the employee or if the employee is able currently to receive it at the employee's discretion.[371] For example, the regulations permit an employee to make an election under a qualified cash or deferred arrangement with respect to compensation for a payroll period as long as the election is made before the date that the compensation is to be paid to the employee.[372]

In contrast, an employee must make a cafeteria plan election before the beginning of the year and generally may not revoke or otherwise change the election during the year.[373] Because this requirement may be too restrictive in some cases, such as when the employee has family health coverage for a spouse and the spouse dies, the regulations permit a modification of an election on account of a change in family status or employment status. An elaborate set of rules has been developed to accommodate the variety of events upon which a change of election is appropriate.[374] In addition, upon a change in an employee's family status or employment status, the regulations permit the employee to change his or her election only to the extent needed to reflect the change. For example, a female employee who has elected family health coverage for a spouse and whose spouse dies during the year may change her election to self-only coverage, but generally may not cancel her own coverage. Moreover, because the restrictions on cafeteria plan elections are inconsistent with election rights and protections provided to employees under other laws, such as the Family and Medical Leave Act, the regulations also provide exceptions and special rules to avoid conflicts with those other laws.

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[370] Treas. Reg. sec. 1.401(k)-1(a)(3)(ii). Section 1425 of the 1996 Act mandates the same treatment of elections under a section 403(b) plan, and the same approach is taken in the regulations recently issued under section 132(f)(4). The SIMPLE provisions of sections 408(p) and 401(k)(11) require that an employee be able to make or change a deferral election at the beginning of each year and be able to terminate deferrals at any time during the year. The employer may permit other changes during the year.

[371] Treas. Reg. sec. 1.401(k)-1(a)(3)(iii).

[372] Treas. Reg. sec. 1.401(k)-1(a)(3)(vi), Example (2). Although the regulations place few restrictions on an employee's ability to make or change an election under a qualified cash or deferred arrangement, employers may, and often do, permit employees to make or change elections only at specified times.

[373] Prop. Treas. Reg. sec. 1.125-1, A-8 and A-15.

[374] Prop. Treas. Reg. secs. 1.125-2, A-6, and 1.125-3; Treas. Reg. sec. 1.125-4.

Deferred compensation, reimbursements, level of coverage

A cafeteria plan may not provide for deferred compensation other than through a qualified cash or deferred arrangement.[375] Treasury regulations therefore do not permit an employee to carry unused amounts over from one year to the next or to convert unused amounts into benefits to be provided in a later year because such designs have the effect of a deferred compensation arrangement.[376]

An employee may exclude from income reimbursements received from his or her employer for medical expenses or for dependent care expenses.[377] However, the exclusion for medical expense reimbursements applies only to amounts that are paid specifically to reimburse the employee for medical care expenses and does not apply to amounts that the employee would be entitled to receive without incurring expense for medical care.[378]

Permissible cafeteria plan benefits include reimbursements of medical and dependent care expenses. The cafeteria plan regulations provide special rules for expense reimbursements.[379] If an employee is entitled to reimbursement of medical or dependent care expenses up to a certain amount and is entitled to receive cash up to that amount to the extent the employee does not incur expenses, the amount of cash that the employee may receive is included in income even if provided as reimbursements. In addition, reimbursements are excluded from the employee's income only if made to reimburse the employee for expenses incurred during the period covered by an employee's cafeteria plan election ("period of coverage"). For this purpose, medical or dependent care expenses are considered to be incurred when the medical or dependent care is received. Although reimbursement may be made after the employee's period of coverage, the expenses reimbursed must have been incurred during the period of coverage. Generally the period of coverage must be a year. In the case of medical expense reimbursements, the reimbursements must be provided under an arrangement that exhibits the risk-shifting and risk-distribution characteristics of insurance.

Reimbursements under a cafeteria plan may be provided through a flexible spending arrangement.[380] A flexible spending arrangement is a benefit program that provides employees with coverage under which medical or dependent care expenses may be reimbursed, subject to reimbursement maximums. A flexible spending arrangement must use a period of coverage of twelve months and must not permit election changes that increase or decrease the level of coverage during those twelve months except for an election change made for the remainder of

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[375] Sec. 125(d)(2).

[376] Prop. Treas. Reg. sec. 1.125-1, A-7.

[377] Secs. 105(b) and 129.

[378] Treas. Reg. sec. 1.105-2.

[379] Prop. Treas. Reg. sec. 1.125-1, A-17 and A-18.

[380] Prop. Treas. Reg. sec. 1.125-2, A-7.

the year on account of a change in family or employment status. In the case of medical benefits, the flexible spending arrangement must also provide uniform coverage throughout the period of coverage. Uniform coverage means that the maximum amount of reimbursements for the year must be available from the beginning of the year even though the employee has paid in only a portion of his premiums or contributions for the year.

Sources of Complexity

The restrictive nature of the rules governing cafeteria plan elections and the differences between those rules and the rules governing elections under qualified cash or deferred arrangements create confusion and administrative burdens for employers and employees. Complicated exceptions and special rules have been developed in order to mitigate some of the harsh results that the basic election rules may produce. Because a violation of the cafeteria plan election rules jeopardizes a plan's tax-favored status, an employer must scrutinize each employee request to change a cafeteria plan election to ensure that one of the exceptions or special rules applies.

Recommendation for Simplification

The Joint Committee staff recommends that the frequency with which employees may make, revoke, or change elections under cafeteria plans should be determined under rules similar to those applicable to elections under qualified cash or deferred arrangements.

Implementation of the recommendation would permit an employee to make a cafeteria plan election as long as the amounts to which the election applies are not currently available to the employee. As in the case of a qualified cash or deferred arrangement, an amount would be currently available if it has been paid to the employee or if the employee is able currently to receive it at the employee's discretion. A cafeteria plan could permit an employee to elect at the beginning of the year to receive nontaxable benefits rather than cash and permit the employee to change or revoke an election during the year as long as the change or revocation applies only to compensation that is not currently available to the employee.[381]

The recommendation would not otherwise change the rules relating to cafeteria plans or flexible spending arrangements. Thus, for example, the recommendation would not change the prohibition against providing deferred compensation (other than a qualified cash or deferred arrangement) under a cafeteria plan or the rule that a payment is not a reimbursement of a medical or dependent care expense if the employee is entitled to receive the payment without incurring expenses.[382]

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[381] Similar to elections under qualified cash or deferred arrangements, an employer may choose to permit employees to make or change cafeteria plan elections only at specified times.

[382] Implementation of the recommendation might require changes to the requirements under the regulations that medical expense reimbursements be provided under an arrangement that exhibits certain characteristics of insurance and that a medical expense flexible spending arrangement provide uniform coverage throughout the year.

Some argue that the present-law restrictions on elections under cafeteria plans serve to limit the amount of compensation that employees may exclude from income on an elective basis. If limits on the amounts that may be excluded from income under a cafeteria plan or flexible spending arrangement are considered desirable, the Joint Committee staff believes that this can be accomplished with simpler rules, such as flat dollar limits on the amount of reimbursable benefits.

2. Employees excluded from application of nondiscrimination requirements

Present Law

In general

Certain employer-provided benefits are excluded from the gross income of employees if provided under statutorily prescribed conditions. Similar exclusions generally apply for employment tax purposes.

Among the conditions that generally apply to the exclusion of employer-provided employee benefits is the requirement that employee benefits be provided on a nondiscriminatory basis. With the exception of the exclusion for employer-provided health insurance, no employee benefit exclusion is available unless the benefit is provided on a basis that does not favor certain categories of employees who are officers, owners, or highly compensated.

Separate nondiscrimination rules apply with respect to each benefit, and an individual in whose favor discrimination is prohibited for one benefit may or may not be such an individual for another benefit.[383] In addition, different rules apply with respect to the exclusion of categories of employees from the determination of whether a particular benefit satisfies the applicable nondiscrimination requirement.

Group-term life insurance plans

If a group-term life insurance plan (sec. 79) maintained by an employer discriminates in favor of key employees as to eligibility to participate or as to the type or amounts of benefits available under the plan, the limited exclusion of the cost of group-term life insurance coverage does not apply with respect to key employees. For purposes of the application of these nondiscrimination requirements, there may be excluded from consideration (1) employees who have not completed three years of service, (2) part-time or seasonal employees, (3) employees not included in the plan who are included in a unit of employees covered by an agreement between employee representatives and one or more employers that the Secretary finds to be a collective bargaining agreement, if the benefits provided under the plan were the subject of good faith bargaining between such employee representatives and such employer or employers, and (4) employees who are nonresident aliens and who receive no earned income from the employer that constitutes income from sources within the United States.

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[383] Another recommendation of the Joint Committee staff would provide for the use of uniform definitions of individuals in whose favor discrimination is prohibited. *See* Section III.C.5. of this Part.

Health benefit plans

If an employer provides its employees with health benefits under a self-insured medical reimbursement plan (sec. 105(h)), the exclusion of a medical reimbursement under such plan is available to a highly compensated individual only to the extent that the plan does not discriminate in favor of highly compensated employees with respect to either eligibility to participate or benefits, and does not discriminate in operation. For purposes of the application of the nondiscrimination requirements, there may be excluded from consideration (1) employees who have not completed three years of service, (2) employees who have not attained age 25, (3) part-time or seasonal employees, (4) employees not included in the plan who are included in a unit of employees covered by an agreement between employee representatives and one or more employers that the Secretary finds to be a collective bargaining agreement, if accident and health benefits were the subject of good faith bargaining between such employee representatives and such employer or employers; and (5) employees who are nonresident aliens and who receive no earned income from the employer that constitutes income from sources within the United States.

Educational assistance programs

In order for employer-paid educational expenses provided under an educational assistance program (sec. 127) to be excluded from the gross income and wages of an employee, the educational assistance program must not discriminate in favor of highly compensated employees with respect to eligibility. For purposes of this nondiscrimination requirement, there shall be excluded from consideration employees not included in the program who are included in a unit of employees covered by an agreement that the Secretary of Labor finds to be a collective bargaining agreement between employee representatives and one or more employers, if there is evidence that educational assistance benefits were the subject of good faith bargaining between such employee representatives and such employer or employers.

Dependent care assistance programs

The exclusion for amounts paid or incurred for an employee under a dependent care assistance program (sec. 129) is not available unless the program does not discriminate in favor of highly compensated employees with respect to eligibility or benefits. For purposes of applying these nondiscrimination requirements, there shall be excluded from consideration (1) employees who have not attained age 21 and completed one year of service, and (2) employees not included in a dependent care assistance program who are included in a unit of employees covered by an agreement that the Secretary finds to be a collective bargaining agreement between employee representatives and one or more employers, if there is evidence that dependent care benefits were the subject of good faith bargaining between such employee representatives and such employer or employers. In addition, for purposes of applying the nondiscrimination requirement with respect to benefits, in the case of any benefits provided through a salary reduction agreement, a plan may disregard any employees whose compensation is less than $25,000.

No-additional-cost services, qualified employee discounts, and meals provided at employer-operated eating facilities

A highly compensated employee who receives a no-additional-cost service, a qualified employee discount, or a meal provided at an employer-operated facility for employees is not permitted to exclude such benefit from income unless the benefit is available on substantially the same terms to each member of a group of employees that is defined under a reasonable classification that is set up by the employer and that does not discriminate in favor of highly compensated employees. For purposes of applying these nondiscrimination requirements, there may be excluded from consideration employees who may be excluded from consideration under section 89(h), as enacted by the 1986 Act and amended by the 1988 Act.[384] Although section 89 was repealed retroactively in 1989, the applicable regulation continues to refer to the section 89(h) exclusion categories, which are (1) employees who have not completed at least one year of service, (2) employees who normally work less than 17-1/2 hours per week, (3) employees who normally work not more than six months per year, (4) employees who have not attained age 21, (5) employees who are included in a unit of employees covered by an agreement that the Secretary finds to be a collective bargaining agreement between employee representatives and one or more employers if there is evidence that the type of benefits provided under the plan was the subject of good faith bargaining between the employee representatives and such employer or employers, (6) employees who are nonresident aliens and who receive no earned income from the employer that constitutes income from sources within the United States, and (7) certain students.

VEBAs

A voluntary employees' beneficiary association ("VEBA") (sec. 505) that is part of an employer plan is not exempt from taxation unless (1) the plan of which the VEBA is a part does not provide any class of benefits to a classification of employees that is discriminatory in favor of highly compensated employees, and (2) with respect to each class of benefits, the benefits do not discriminate in favor of highly compensated employees. For purposes of the application of these nondiscrimination requirements, there may be excluded from consideration (1) employees who have not completed one year of service, (2) employees who have not attained age 21, (3) seasonal employees or less than half-time employees, (4) employees not included in the plan who are included in a unit of employees covered by an agreement between employee representatives and one or more employers that the Secretary finds to be a collective bargaining agreement if the class of benefits involved was the subject of good faith bargaining between such employee representatives and such employer or employers, and (5) employees who are nonresident aliens and who receive no earned income from the employer that constitutes income from sources within the United States.

Sources of Complexity

Each of the six lists of individuals that may or shall be excluded from consideration in the application of nondiscrimination requirements to employee benefits is unique. Even some of the

[384] Treas. Reg. sec. 1.132-8(b)(3).

general classifications of excludable employees that are applicable to more than one type of benefit, e.g., employees who are covered by collective bargaining agreements, vary from benefit to benefit. Furthermore, while four of the lists are identified as lists of employees who may be excluded from consideration, two of the lists are identified as lists of employees who shall be excluded from consideration. It appears that the differences in the lists are attributable solely to the establishment of the lists at different times.

Recommendation for Simplification

The Joint Committee staff recommends that a uniform definition of employees who may be excluded for purposes of the application of the nondiscrimination requirements relating to group-term life insurance, self-insured medical reimbursement plans, educational assistance programs, dependent care assistance programs, miscellaneous fringe benefits, and voluntary employees' beneficiary associations should be adopted.

The uniform definition would provide that the following employees are excluded for purposes of the application of each nondiscrimination requirement: (1) employees who have not completed three years of service, (2) employees who have not attained age 25, (3) part-time or seasonal employees, (4) employees not included in the plan who are included in a unit of employees covered by an agreement between employee representatives and one or more employers that the Secretary finds to be a collective bargaining agreement, if the applicable benefit was the subject of good faith bargaining between such employee representatives and such employer or employers; and (5) employees who are nonresident aliens and who receive no earned income from the employer that constitutes income from sources within the United States. The special rule for disregarding employees with compensation less than $25,000 in testing dependent care assistance provided through a salary reduction agreement would be eliminated.

A uniform definition of excludable employees would eliminate the need to determine different groups to be considered in testing different benefits, thus making nondiscrimination testing easier. Making the exclusion of these employees automatic, rather than elective, eliminates the need for an employer to test on both bases to determine which approach is advantageous.

IV. CORPORATE INCOME TAX

A. Structural Issues Relating to the Corporate Income Tax

1. Corporate integration

Present Law

The corporate level tax

Owners of a business often conduct the business in an entity such as a corporation, partnership, or limited liability company that is a separate business entity. The tax consequences of using a separate entity depend on the type of entity in which the business is conducted. Under present law, a partnership, certain closely-held companies that elect to be taxed under subchapter S, and limited liability companies that are treated as partnerships (or in some circumstances disregarded) are subject to treatment as pass-through entities whose owners take into account the income (whether or not distributed) or loss of the entity on their own tax returns. Generally, an entity whose ownership interests are publicly traded may not be taxed as a partnership.

In contrast, the income of a C corporation[385] is taxed directly to the corporation. Distributions of the corporation's after-tax income are taxed to the shareholders as dividends, and the shareholders take into account any gain (including gain attributable to undistributed corporate income) on the disposition of their shares of stock of the corporation. Thus, the income of a C corporation may be subject to tax at both the corporate and shareholder levels.[386]

Corporate and individual rate structures

In general, C corporations pay income tax on earnings that are taxable income, whether or not distributed, at graduated rates ranging from 15 percent to 35 percent.[387] Corporate income over $75,000 is taxed at 34 percent and over $10,000,000 at the highest corporate rate of 35 percent. Capital gains of a corporation are taxed at the same rates as ordinary income.

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[385] A "C" corporation is one that is taxed under the rules of subchapter C of the Code, which provides rules for corporate and shareholder treatment of corporate distributions and adjustments. "C" corporations are also subject to the corporate-level tax rate structure set out in section 11 of the Code.

[386] Specialized investment entities, such as regulated investment companies and real estate investment trusts, and certain interests in debt interests, such as real estate mortgage investment conduits and financial asset securitization investment trusts, are subject to one level of tax notwithstanding that their ownership interests are publicy traded.

[387] The corporate rate structure also includes a phase-out of the lower rates on taxable income over $100,000. Certain "personal service corporations" may not use graduated corporate rates at all, but pay tax only at the highest corporate rate. Sec. 11(b)(2).

Corporate earnings that are distributed to individual shareholders as dividends are taxed at individual ordinary income tax rates, generally on a cash basis (i.e., when received).[388] The top individual statutory rate is 39.6 percent, imposed for single individuals on taxable income over $297,350 (in 2001). A 36 percent rate applies between $136,750 and $297,350 of taxable income; for income less than $136,750 the rates are 31 percent and below.[389]

Corporate earnings that are not distributed to shareholders in the form of dividends, but rather are distributed in exchange for all or a portion of a shareholder's stock, can be taxed to the shareholder as amounts paid for a sale or exchange of stock at capital gains rates which are significantly below the ordinary income rates.[390] Also, retained earnings that enhance the value of stock are taxed at capital gains rates if the stock is sold.

If stock is held until the death of the shareholder, the stock is given a fair market value basis at death, resulting in no shareholder level income tax on appreciation prior to death if the heirs sell the stock to a third party, or receive corporate distributions in the form of a redemption (i.e., a sale of their stock to the corporation).

Tax-exempt investors are not generally subject to tax on corporate distributions or on sales or exchanges of corporate stock.

Appreciated corporate assets are generally subject to corporate level tax if they are distributed to the shareholders, yielding the same corporate tax result as if the assets had been sold by the corporation and the proceeds distributed to the shareholders.

Personal holding company tax and accumulated earnings tax

In addition to the regular corporate income tax, a corporate level penalty tax is imposed at the top individual tax rate on certain corporate earnings that are not distributed to shareholders.

If a corporation is closely held and most of its income consists of certain types of income generally considered either passive or personally attributable to shareholders, the tax imposed is

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[388] Certain preferred stock accretions are taxed on an accrual basis, similar to an original issue discount debt instrument. *See* sec. 305(c) and (e).

[389] The individual rate brackets are indexed under present law.

[390] The maximum tax rate on net long-term capital gains generally is 20 percent. Section 302 provides rules for determining whether a distribution in redemption of a shareholder's stock qualifies for exchange treatment. A reduction will generally qualify if the shareholder's interest is reduced by more than 20 percent and the shareholder owns less than 50 percent of the stock after the reduction. Lesser reductions can qualify but the determination is based on facts and circumstances, and may be subject to dispute. In the case of a small public shareholder, IRS rulings suggest that almost any reduction is generally considered significant. *See* Rev. Rul. 76-385, 1976-2 C.B. 92 (reduction from .0001118 to .0001081 percent was not essentially equivalent to a dividend); *compare* Rev. Rul. 81-289, 1981-2 C.B. 82 (no net reduction resulted in a dividend).

the "personal holding company tax".[391] This tax was originally enacted to prevent so-called "incorporated pocketbooks" that could be formed by individuals or family groups to hold assets that could have been held directly by the individuals, such as passive investment assets, and retain the income at corporate tax rates that were significantly lower than individual tax rates. The personal holding company tax is 39.6 percent of undistributed personal holding company income.

For corporations that are not personal holding companies, an "accumulated earnings tax"[392] applies to any corporation "formed or availed of for the purpose of avoiding the income tax" with respect to shareholders. If a corporation accumulates earnings "beyond the reasonable needs of the business," that accumulation is determinative of such a purpose unless the corporation proves the contrary by a preponderance of the evidence. The fact that a corporation is a "mere holding or investment company" is prima facie evidence of such a purpose. The regulations do not provide a bright-line test to determine when a corporation will be considered a "mere holding or investment company" or provide exactly how that determination would be made in complex corporate structures involving the use of subsidiaries.[393] The tax does not apply to a corporation that is a personal holding company.[394]

The accumulated earnings tax rate is 39.6 percent, imposed on "accumulated taxable income." However, a minimum of $250,000 of accumulated earnings ($150,000 in the case of certain service corporations) is exempt from the tax.

Treatment of interest and dividends

Classification of an instrument issued by a corporation as "debt' or as "equity" can have important corporate tax consequences. Interest on debt is deductible by the issuer of the debt, whereas dividends are not deductible by the issuer of the stock on which they are paid.

However, dividends paid to a corporation are eligible for a corporate dividends-received deduction. The recipient corporation can generally claim a 100 percent dividends-received deduction if the recipient corporation owns 80 percent or more of the distributing corporation. If the recipient corporation owns less than 80 percent but at least 20 percent of the distributing corporation, the dividends-received deduction is 80 percent. If the recipient corporation owns

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[391] Secs. 541-547.

[392] Secs. 531-537.

[393] The regulations state that "A corporation having practically no activities except holding property and collecting the income therefrom or investing therein shall be considered a holding company. . . .If the activities further include, or consist substantially of, buying and selling stock, securities, real estate, or other investment property...the corporation shall be considered an investment company. . . ." Treas. Reg. sec. 1.533-1(c).

[394] There are also a number of other exceptions to the application of the accumulated earnings tax.

less than 20 percent of the distributing corporation, the dividends-received deduction is 70 percent. There is no corporate exclusion with respect to interest received.

Thus, a C corporation with taxable income might issue debt to obtain an interest deduction. A C corporation with tax loss carryforwards might prefer to issue equity, to provide a corporate investor with a dividends-received deduction.

Another difference in treatment of debt and equity is that interest on debt is often deductible by the payor and includible by the recipient on an accrual basis,[395] while dividends are generally includible on a cash basis.[396]

Characterization of an instrument as "debt" or "equity" depends on factors developed under case law. Generally, debt requires a promise to pay a fixed sum by a date certain, with a reasonable expectation that payment will be made.

Debt instruments can be constructed to have features of both debt and equity, including (1) contingent payments up to a high yield or (2) a significant economic risk that all payments may not be made. Similarly, equity instruments can be constructed to have features of debt, including dividend incentives or put-call arrangements under which the issuer is expected to pay specified dividends and return the initial investment by a date certain.

The Code limits the corporate interest deduction in specified situations. The Code provisions are based in part on case-law factors that distinguish debt from equity, but each provision turns on different facts and is narrowly applied to specific situations. The provisions include the following sections of the Code:

Section 163(i) denies interest deductions on certain high-yield [397]deferred payment discount obligations. The disallowed portion is treated as a dividend.

Section 163(j) denies interest deductions for certain payments to tax-exempt related parties that exceed 50 percent of income if there is a greater than 1.5 to 1 debt equity ratio. A carryover is allowed.

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[395] If current stated interest is not "adequate", then interest is imputed, often on an accrual basis. Other provisions can cause current accrual of stated interest. *See* secs. 1271-1275. Generally, unless a taxpayer elects otherwise, "market discount" (the element of a lower purchase price on the market that reflects a stated interest rate below market when a bond is purchased) is not accrued, but is taxed as ordinary income on disposition of a bond. Secs. 1276-1278.

[396] Certain preferred stock accretions are accrued similar to original issue discount on a bond. *See* secs. 305(c) and (e).

[397] For this purpose, a "high-yield" obligation is a debt instrument with a yield to maturity in excess of the applicable Federal rate in effect when the instrument was issued, plus five percentage points.

Section 163(l) denies interest deductions on certain debt if a substantial amount of the principal or interest of the debt is payable in, or determined by reference to, equity of the issuer at the option of the issuer or a related party. The rules also apply if the choice to receive equity or amounts determined by reference to equity is at the option of the holder of the debt or a related party, if there is "substantial certainty" that the option will be exercised.

Section 172(h) denies net operating loss carrybacks attributable to interest after certain corporate equity reduction transactions (generally, if there has been an acquisition of 50 percent of corporate stock, or an "excess" distribution). Carryforwards are allowed.

Section 279 denies interest deductions for certain narrowly defined "corporate acquisition indebtedness."

Section 385 authorizes the Treasury Department to issue rules distinguishing debt from equity. Several sets of regulations have been proposed, but none has been finalized and retained.

Analysis

The present law structure for separate taxation of corporations and their shareholders contributes to complexity in a number of areas, described below.

However, approaches to eliminate separate taxation and integrate the corporate and individual taxes (often referred to as corporate "integration") also could involve complexity as well as significant policy decisions. Under present law, although the Code provides rules for imposing separate tax at the corporate and at the shareholder level, this does not always result in actual payment of two levels of tax. In some cases, the amounts that are distributed to shareholders may have borne less than a full tax at the corporate level, due to the operation of various deductions, deferrals, or other provisions that have reduced or eliminated corporate level tax. Also, in some cases, shareholders are tax-exempt, or the rate of tax the shareholder may pay is reduced due to capital gains treatment, the dividends-received deduction, step-up in basis of stock at death, or other provisions. Thus, under present law, the combined individual and corporate tax rates on corporate earnings that are distributed to shareholders may not be as great as two full levels of tax, and may be less than a single full level of tax. If a decision were made to increase corporate integration, policy decisions would need to be made regarding those situations in which at least one level of tax should be collected, and complexity would be involved in implementing that result, due to necessary co-ordination of the tax results at the entity and individual levels.

Corporate vs. noncorporate investment

Under present law, there are numerous forms of carrying on business or investment activity that do not invoke a separate entity-level tax. (See discussion of pass-through entities, below.) Because of the different treatment of C corporations and other forms of enterprise, business owners must make a determination as to the form of operation that will best suit their business needs and produce the lowest possible taxes.

Present law generally permits the establishment of S corporations (subject to shareholder and type of stock limitations) and limited liability companies that are taxed as pass-through

entities (or disregarded altogether if they have only one owner). However, the Code contains various complex restrictions on the regimes under which publicly traded entities can qualify for pass-through treatment. Only certain entities engaged in generally passive or specific other types of business can qualify for pass-through treatment if they are publicly traded.

In some circumstances, it is possible that non-publicly traded entities also might choose to operate as C corporations, for example in order to obtain a separate corporate rate bracket or the benefit of special corporate treatment (e.g., the dividends received deduction) for earnings that are to be retained in the corporation.[398]

Retention vs. distribution of corporate income

Present law may affect decisions to retain or to distribute corporate earnings. The two-tier tax on dividend distributions can make it more desirable for a corporation to use retained earnings rather than new equity for its investments. Shareholders can find such earnings retention attractive (subject to the accumulated earnings tax and personal holding company rules) if the shareholder expects to defer tax on capital gains for a substantial period, or intends to hold stock until death (so that appreciation can be passed to his heirs free of individual income tax).

There also may be an incentive under present law to retain earnings if the corporation's effective tax rate on reinvestment is lower than the shareholder tax rate on distributed earnings.[399] By contrast, if the shareholder's tax rate is significantly lower than the corporation's effective tax rate--for example, if the shareholder is a tax-exempt entity or is entitled to a dividends-received deduction--there may be a tax incentive to distribute earnings.

The personal holding company and accumulated earnings tax rules are each intended to address concerns regarding inappropriate corporate accumulations, and each is complex in a different way. The personal holding company tax rules are complex because they are very elaborate in their definition of the types of ownership and types of income that will lead to personal holding company status. The rules can be avoided in some situations by appropriate planning to avoid the levels of control or income that would trigger personal holding company status. At the same time, they may affect types of activities that are difficult to distinguish from active business operations and may serve as a trap for the unwary if there is a change in the corporate activities or ownership.

The accumulated earnings tax rules, by contrast, depend on a subjective determination of whether an accumulation exceeds the reasonable needs of the business. Different determinations by different IRS agents and different courts may lead to perceptions that the accumulated earnings tax is applied in an inconsistent or unpredictable manner.

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[398] Appreciation in corporate assets is generally subject to corporate level tax when the assets are distributed to shareholders. There is no lower rate for corporate capital gains. These factors would be a general deterrent to placing assets into a C corporation. However, there may be situations where lower effective corporate rates could nevertheless provide benefits.

[399] A. Atkinson and J. Stiglitz, *Lectures on Public Economics*, Chapter 5 (1980).

Debt vs. equity finance

Present law tends to encourage financing corporate investment with debt, rather than new equity, because deductible interest payments on corporate debt reduce corporate taxes and nondeductible dividends do not. Accordingly, there may be a tax incentive for corporations to finance investment in excess of retained earnings with new debt rather than equity.

Some investors, however, may prefer equity to debt. The corporate dividends-received deduction provides an incentive for a corporation to invest in stock rather than debt of another corporation. In addition, an issuing corporation with tax losses, or an inability to utilize fully interest deductions for other reasons, may issue preferred stock with characteristics very similar to debt--effectively passing through some of the benefit of its losses to corporate shareholders.

Foreign shareholders may prefer dividend or interest income depending on the tax treatment in their country of residence and the applicable U.S. tax withholding rates.

Under common law, the distinction between debt and equity depends on a number of factors. Instruments with similar economic features might be classified either way.[400] As discussed above, a number of complex Code provisions have developed to attempt to distinguish debt from equity in the case of particular types of instruments. Many of these provisions may be avoidable or manipulated. However, each was a response to a particular type of instrument that was considered troublesome at the time of enactment of the provision.

Debt-equity analysis typically requires an "all-or-nothing" classification, with only limited authority for bifurcation between debt elements and equity elements of a hybrid instrument.[401] Section 385(a) was amended in 1989 to provided Treasury authority to treat an instrument as "in part stock and in part indebtedness." No regulations have been issued under this provision.

Form of corporate distributions

Another source of complexity results when shareholders receive different treatment depending on whether a corporate distribution is characterized as a dividend or as a payment in exchange for stock that is entitled to capital gain treatment and basis recovery. A number of Code provisions have attempted to provide guidance in this area. For example, section 302 provides rules to determine whether a shareholder whose stock is in part redeemed has experienced a sufficient contraction in his interest to be treated as having sold the stock rather than as having received a dividend. Section 304 provides additional complex rules intended to

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[400] An extensive discussion of case law and factors that have been used in determining whether an instrument is classified as debt or equity appears in Plumb, *Tax Significance of Corporate Debt: a Critical Analysis and a Proposal,* 26 Tax L. Rev. 369 (1971).

[401] But on occasion an instrument has been determined to have separate debt and equity features. *See Farley Realty Corp. v. Commissioner*, 279 F. 2d 701 (2d Cir. 1960). *Compare Helvering v. Richmond, F. & P. R.R. Co.*, 90 F2d 971 (4th Cir. 1937). Section 163(e) provides bifurcated treatment of certain high yield deferred payment obligations.

deal with sales of stock to commonly controlled corporations. The application of the basic concepts in other situations, such as mergers and acquisitions, has also been the subject of uncertainty and litigation.[402]

Mergers, acquisitions, and leveraged buyouts are perhaps the most visible transactions facilitating the flow of equity out of corporate entities, through the distributions of cash from corporations to shareholders that may occur in these situations. However, corporate equity contraction also may be accomplished by redemption, debt-for-equity swaps, and extraordinary distributions. In each case, the choice of the most tax-preferred form of distribution may involve complexity.

Discussion of possible proposals

Integration

As a matter of tax policy, it has been suggested that the tax system would be improved by taxing corporate income once, that is, integrating the corporate and shareholder taxes on corporate income. A number of methods could be used to achieve full or partial integration, each of which has associated policy and administrative considerations.[403]

One form, known as "full" integration, involves passing through all items of corporate income and deduction to shareholders, including the pass-through of items of a publicly-traded corporation. This approach would tax investors currently on their share of corporate income even if such income is not distributed to them. Full integration is considered to involve administrative difficulties in determining a shareholder's appropriate share of income, especially when stock changes hands during a corporate taxable year.

Other forms of integration include reduction of the corporate or individual tax on distributed or undistributed corporate earnings. Complexity can arise, however, if it is desired to design a system that will assure the collection of one level of tax, because of the necessity for mechanisms that assure that the amounts exempted at either the shareholder or corporate level are in fact taxed at the other level.

The principal approaches to integration usually discussed involve forms of dividend relief and thereby apply only to distributed earnings. One approach gives relief by allowing the corporation or shareholders to deduct or exclude a portion of dividends. Another approach provides a credit to shareholders for taxes paid by the corporation. In 1992, the Treasury Department published a proposal involving a form of dividend relief through exclusion of

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[402] *See Clark v. Commissioner*, 489 U.S. 726 (1989) and cases cited therein.

[403] For a fuller discussion of the background and issues relating to integration, see Michael J. Graetz and Alvin C. Warren, Jr., *Integration of the U.S. Corporate and Individual Income Taxes* (Tax Analysts, 1998); Joint Committee on Taxation, *Federal Income Tax Aspects of Corporate Financial Structures,* JCS-1-89 (January 18, 1989).

previously taxed dividends from shareholder income.[404] In 1993, the American Law Institute published a proposal involving a credit system based on the model used by a number of other countries.[405]

A determination whether to adopt a form of integration involves significant policy determinations. Among the policy decisions are whether to pass through any corporate business level tax benefits to individual investors; how to treat income attributable to tax-exempt investors; how to treat international transactions; and how to treat existing corporate equity investments. Some decisions may be more easily implemented if the basic form of relief is structured as a simple dividend exclusion at either the corporate or shareholder level. Other issues may be more readily addressed by giving shareholders a credit for their share of the corporate tax when they receive dividends.

While at first it may seem attractive as simplification to eliminate one of the two tiers of tax on corporate income, integration ultimately cannot be regarded as principally a simplification measure. Implementing it would involve not only significant tax policy changes, but also substantial complex changes to taxpayers and tax administrators. A system imposing only one level of tax would not necessarily be simpler than present law. For example, the rules for taxing income of partnerships (which is subject to tax only at the partner level) are quite complex. Similarly, approaches that provide dividend relief and that seek to collect at least one level of tax can involve complexity, due to the need to provide rules to track whether income has borne one level of tax. For these reasons, the Joint Committee staff makes no simplification recommendation with respect to corporate integration.

Eliminating accumulated earnings tax or personal holding company tax

Apart from approaches that would provide broad scale corporate integration, it is also possible to consider whether simplification might be achieved by eliminating the accumulated earnings tax or the personal holding company tax or both. Determinations in this area involve policy decisions regarding whether the tax system should encourage the distribution of earnings in certain circumstances, so that both corporate and individual taxes are paid on earnings; or whether the system instead should attempt to collect only one level of tax on corporate income, at a rate that prevents individuals in high tax brackets from using a corporation with lower tax rates to accumulate earnings. A related issue is how to treat income that is always taxed more lightly to a corporate recipient than to an individual recipient (such as dividends that are fully taxed if received by an individual but that are eligible for the dividends-received deduction if received by a corporation). Because of the necessary policy decisions that would have to be made to address these concerns if the accumulated earnings tax or the personal holding company

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[404] U.S. Department of the Treasury, *Integration of the Individual and Corporate Tax Systems, Taxing Business Income Once* (1992). This study and an introduction also can be found reprinted in Graetz and Warren, *op.cit., supra.*

[405] Alvin C. Warren, Jr., *Integration of Individual and Corporate Income Taxes* (American Law Institute, 1993). This study and an introduction can also be found reprinted in Graetz and Warren, *op.cit., supra.*

tax were eliminated and the additional complexity of rules that would be substituted, the Joint Committee staff makes no recommendation in this area.

2. Mergers, acquisitions, and related tax-free transactions

Present Law

Taxable corporate transactions

In general, if a corporate shareholder exchanges a stock investment in one corporation for a stock investment in another corporation, the exchange is a taxable event, treated as a sale of the transferred stock for the fair market value received and a purchase of the new stock with an equivalent cost basis. Corporations also are generally subject to tax on the disposition of appreciated assets (including the disposition of appreciated stock of a subsidiary). Taxable dispositions generally include distributions of assets or of subsidiary stock to shareholders, as well as the disposition of such assets or subsidiary stock to an unrelated acquiror.

Under present law, corporations and shareholders are taxed separately. There are also different tax results depending on whether stock of a corporation is sold and the shareholders receive the proceeds, or whether assets of a corporation are sold and the shareholders receive the proceeds as a distribution from the corporation.

If the stock of a corporation is sold, the selling shareholders pay tax on any gain from their sale of stock. The acquiror of the corporation holds the acquired stock at its purchase price basis, but the basis of assets inside the acquired corporation does not change to reflect the stock purchase price unless an election is made to pay "inside" corporate level tax on any gain associated with this "inside" asset basis change. Such an election may be made only if 80 percent of stock[406] was acquired by a purchasing corporation, within any 12-month period, in a taxable purchase.[407]

If the assets of a corporation are sold, the seller pays corporate level tax and the buyer obtains a purchase price basis for the assets. If the proceeds of the sale are then distributed to the

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[406] The 80-percent stock test refers to 80 percent of the vote and value of the stock of the acquired corporation, excluding certain nonvoting preferred stock (the same test that applies for purposes of eligibility to file a consolidated return). Sec. 338.

[407] Section 338 provides rules for making the election. If the election is made, the acquired corporation pays tax on a deemed sale of its assets, in addition to any tax the shareholders paid on their sale of stock. Under a special rule, if the seller corporation was filing a consolidated return with the purchased subsidiary (and in certain other circumstances), the seller and purchaser can jointly elect to treat the acquisition of subsidiary stock as if it had been an acquisition of the subsidiary's assets. This results in a single level of tax on the seller, measured by the "inside" asset basis of the acquired corporation's assets (rather than by the seller's stock basis for the acquired corporation's stock). The corporate buyer then holds the acquired subsidiary with a basis for the assets inside the acquired subsidiary determined by reference to the purchase price for the stock. Sec. 338(h)(10).

shareholders of the selling corporation, the shareholders are generally subject to shareholder level tax on such distribution.[408]

Tax-free corporate transactions in general

A number of special provisions enable corporations to combine or separate their businesses, and permit the corporate shareholders to shift their investment interests to the combined or separated enterprises, without the tax impact that would otherwise generally occur on an exchange of appreciated corporate assets for other assets, or of shareholder investment interests for other interests.

Some rules are directed at "acquisitive" transactions, in which one corporation acquires the stock or assets of another. Other rules are directed at "divisive" transactions, in which one corporation divides its business or subsidiaries into entities separately owned by the corporate shareholders. In practice, an acquiror may wish to acquire less than all the assets of a "target" corporation, so that there may be preliminary divisions of assets, or separations of subsidiaries, to accommodate the needs of a particular transaction. The ease with which such changes can occur as part of a transaction and still retain tax-free treatment varies among the different provisions.

Corporate reorganizations

One set of rules establishes several specific types of "corporate reorganizations."[409] Such reorganizations include statutory mergers as well as certain transactions in which either 80-percent stock control,[410] or "substantially all" the assets, of one corporation is acquired for voting stock of another corporation.[411] The "reorganization" rules also address certain combinations and divisions of corporations that were under common control,[412] transactions that are recapitalizations or reincorporations, and bankruptcy restructurings.

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[408] Appreciated corporate assets are generally subject to corporate level tax if they are distributed to the shareholders, yielding the same corporate tax result as if the assets had been sold by the corporation and the proceeds distributed to the shareholders. Shareholders generally are taxed with reference to the fair market value of the assets received in the distribution, and obtain a fair market value basis in such assets.

[409] Secs. 354-368.

[410] "Control" for this purpose is defined as 80 percent of the value of all voting stock and 80 percent of the value of each other class of stock.

[411] The rules also allow certain transactions in which stock of the acquiring corporation's parent corporation is given to former shareholders of the target company in the acquisition, instead of stock of the acquiring company itself.

[412] For purposes of this "common control" provision, control is defined as ownership of at least 50 percent of the vote or value of stock.

The "corporate reorganization" rules allow tax free treatment in a number of different types of situations, provided the proper amount and type of stock consideration is given to the shareholders, and provided that a sufficient amount of stock or assets of the target corporation are acquired. The types of reorganizations are often referred to by reference to the particular subsection of Code section 368 (defining such transactions) in which they are described.

If a transaction qualifies as a "reorganization", the shareholders generally are not taxed on an exchange of stock in one corporation that is a party to the reorganization for stock of another corporation that is a party to the reorganization. However, the shareholders are taxed to the extent they receive cash, securities in excess of securities surrendered, or other "boot" property that may not disqualify the reorganization[413] but that is not permitted to be received by shareholders without tax to them. Certain "nonqualified preferred stock" is treated as "boot" for this purpose.[414] Shareholders generally take a substituted basis for stock or securities permitted to be received without tax consequences; however basis adjustments are made for receipt of nonqualified consideration and to the extent gain or loss was recognized.

If a transaction qualifies as a "reorganization", a corporation that is a party to the reorganization also generally is not taxed on its transfers of assets or stock to another party to the reorganization. In most cases, assumptions of liabilities of the transferor corporation are not treated as taxable consideration to the transferor. Generally, a corporation that is a party to the reorganization takes a substituted basis in property received in the reorganization.

Most types of reorganizations are subject to a number of "substance over form" rules that originated in litigated court cases. A version of these rules has been adopted by the Internal Revenue Service ("IRS") in administrative guidance regarding the circumstances in which the IRS will permit a transaction to be characterized as a reorganization without challenge. These include a "continuity of shareholder interest"[415] rule; a "continuity of business enterprise"[416] rule,

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[413] The extent to which property other than stock or securities can be received without also disqualifying a transaction from "reorganization' treatment varies for the different types of reorganizations.

[414] This is certain stock that is redeemable within 20 years or that has dividend rights that vary with interest rates or other specified indices. Secs. 351(g), 354(a)(2)(C). The Treasury Department has authority to issue regulations that could prescribe the treatment of such stock for other purposes.

[415] The Treasury regulations stating the "continuity of shareholder interest" rule generally require that a substantial part of the value of the proprietary interests in the target corporation be preserved. Treas. Reg. sec. 1.368-1(e). Historically, IRS ruling guidelines have provided a "safe-harbor" if stock representing at least 50 percent of the value of an acquired corporation is exchanged for stock of the acquiror. Rev. Proc. 77-37, 1977-2 C.B. 568.

[416] The Treasury regulations stating the "continuity of business enterprise " rule generally require a continuation of the target corporation's historic business, or use of a significant portion of the target corporation's historic business assets in a business. Treas. Reg. sec. 1.368-1(d).

and a "business purpose" concept. In spite of the fact that these rules originated as "substance over form" concepts, form is extremely important in determining whether a transaction qualifies as a reorganization.

Statutory merger or consolidation (type "A" reorganization)

One basic type of acquisitive reorganization is a statutory merger, or "A" reorganization. (sec. 368(a)(1)(A)). Treasury Regulations require that such a merger occur under a statute of a U.S. state.[417] This type of reorganization offers relatively flexible rules for structuring a transaction. Although such a reorganization is subject to the non-statutory "substance over form" concepts described above, there is no specific statutory requirement that a particular percentage or type of stock consideration must be given to old "target " company shareholders, or that a particular percentage of the target corporation's historic business assets must be transferred in the reorganization.

However, in a recent situation in which a new state law defined a divisive transaction as a "merger", the IRS announced that it would not treat such a divisive transaction as a statutory merger for purposes of the reorganization rules. [418]

Acquisition of corporate stock "control" solely for voting stock (type "B" reorganization)

Another type of basic acquisitive reorganization is the acquisition by one corporation of stock of another corporation, solely for voting stock either of the acquiror or of its direct parent corporation (but not both). Immediately after the acquisition, the acquiror must own 80 percent of the stock of the acquired corporation. The presence of any consideration that is not voting stock can prevent a transaction from qualifying under this provision.

Acquisition of "substantially all" the corporate properties "solely for voting stock" (type "C" reorganization)

A third type of basic acquisitive reorganization is the acquisition by one corporation of substantially all the properties of another corporation, solely for voting stock of the acquiror or the direct parent corporation of the acquiror. IRS ruling guidelines define "substantially all the properties" as 90 percent of the net value of assets and 70 percent of the gross value of assets.[419]

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[417] The merger may also occur under a statute of the United States or of a territory of the United States or of the District of Columbia. Treas. Reg. sec. 1. 368-2(b)(1).

[418] Rev. Rul. 2000-5, 2000-5 I.R.B. 436.

[419] Rev. Proc. 77-37, 1977-2 C.B. 568.

Transfer of substantially all of the assets of a corporation to a related corporation (acquisitive type "D" reorganization)[420]

Another acquisitive type of reorganization is one in which all or a part of a corporation's assets are transferred to another corporation, if immediately after the transfer the transferor or one or more of its shareholders own 50 percent of the vote or value of the transferee, and if the transferor corporation distributes stock or securities of the corporation to which the assets were transferred in a transaction that qualifies under certain other Code provisions (secs. 354, 355, or 356). In order for the distribution to qualify under section 354, the transferor corporation must liquidate and the corporation to which the assets are transferred must acquire substantially all the assets of the transferor.[421] The consideration need not be all voting stock but can include cash or other boot.

The ownership requirement for this type of reorganization differs from that for other acquisitive reorganizations. One purpose of this particular provision is to cause reorganization treatment, with accompanying dividend treatment to individual shareholders, if the shareholders attempt to liquidate a corporation, take out cash at capital gains rates, and then reincorporate the remaining assets.[422]

There is also a type of "D" reorganization that is divisive, which must also satisfy the "spin-off" rules of section 355 to qualify as tax-free.

Other "reorganizations"

Other transactions that qualify as reorganizations are a recapitalization (type "E"); and a "mere change in identity, form, or place of organization of one corporation (type "F"), bankruptcy reorganizations also qualify (type "G").

Transfers to a controlled corporation

Another set of rules governs the general contribution of assets (including stock) to a corporation.[423] These rules permit the tax-free transfer of assets or stock to a corporation whose

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[420] Section 368(a)(1)(D) requires a distribution of the properties received in a transaction that qualifies under 354, 355, or 356. Section 355 provides rules for divisive transactions, in which substantially all the assets do not need to be transferred. Section 354 provides the rules governing an "acquisitive" D reorganization, namely, that substantially all the assets of the transferor must be transferred, and the transferor must liquidate. Section 356 provides rules for treatment of consideration that is taxable to shareholders, if any is received in addition to stock of the transferee.

[421] Sec. 354(b)(1).

[422] *See* Joint Committee on Taxation, *General Explanation of the Revenue Provisions of the Deficit Reduction Act of 1984* (JCS-41-84), December 31, 1984, at 192-194.

[423] Sec. 351.

stock is, in the aggregate, owned at least 80-percent by the transferors who engaged in the transfer. Persons making a transfer can generally receive stock in the transferor tax-free, but cash or other "boot" is generally taxed. Certain non-qualified preferred stock is treated as "boot " for this purpose.[424]

Any person who is part of the transferring group can receive qualified stock tax-free, without regard to whether the other transferors receive stock, so long as immediately after the transfer all the transferors in the aggregate own 80 percent of the transferee.

Liquidation of corporate subsidiary into parent corporation

Another rule permits the combination of related corporations in the form of a tax-free liquidation of an 80-percent owned subsidiary corporation into its parent corporation.[425] For purposes of the liquidation rule, the definition of 80-percent control is the same as that for whether corporations can file a consolidated return.[426]

Divisive "spin-off" and similar transactions

Special rules govern transactions in which one corporation separates its subsidiaries or businesses in a divisive "spin-off" or "split up" transaction, in which shareholders of the original parent corporation receive stock of one or more corporations that were 80-percent controlled by the distributing corporation.[427]

The requirements for tax-free treatment under these rules include restrictions that have evolved over the years in response to a number of different concerns.

Anti-"bail out" rules

One set of restrictions for tax-free treatment was intended to prevent a corporation from distributing excess liquid assets to shareholders in a form that enabled the shareholders to avoid dividend tax. For example, if a corporation distributed excess cash to its shareholders as a dividend, they would pay ordinary income tax on the cash they received. However, if the corporation could put that cash into a separate corporation and distribute, or "spin off" the stock of that corporation to shareholders, then the shareholders could sell the new stock separately, or

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[424] This is certain stock that is redeemable within 20 years or that has dividend rights that vary with interest rates or other specified indices. Secs. 351(g), 354(a)(2)(C).

[425] Sec. 332.

[426] "Control" for this purpose is the ownership of 80 percent of the vote and value of stock, excluding, however, all nonvoting stock that is limited and preferred as to dividends and that does not participate in corporate growth to any significant extent. This definition differs from the definition of "control" under the corporate reorganization provisions (sec. 368(c)).

[427] Sec. 355.

could liquidate the new corporation, in each case obtaining capital gains treatment on the value of the cash received. [428]

In an attempt to limit such transactions, section 355 requires that both the distributing and distributed corporations be engaged in an active business that was not acquired in a taxable transaction within 5 years, and that the transaction not be a "device" to distribute earnings and profits. Generally, a pre-existing arrangement by a shareholder to sell the stock for capital gain would indicate such a device. In addition, common law and IRS rules require that there be a corporate business purpose for the distribution.

Anti- "sale" provisions

The Tax Reform Act of 1986 generally repealed what remained of the so-called *General Utilities* rule that had permitted the sale or disposition of an entire corporate business without corporate level tax.[429]

After the 1986 Act, section 355 remained as a potential method for disposing of a subsidiary without corporate level tax. Some such transactions could be structured that would provide the acquiror with a fair market value basis in the stock of the subsidiary. Other transactions did not necessarily produce a fair market value basis but might otherwise be considered "sale-like" in that they involved a plan to dispose of stock to new owners in connection with the distribution.

Several special rules were enacted in an attempt to address such transactions.

One restriction imposes a corporate level tax if an acquiror obtains control of a distributing corporation or its separately distributed subsidiary (but not both) in a divisive transaction where the acquiror recently purchased the stock that it controls (Sec. 355(d)).

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[428] *See, e.g., Gregory v. Helvering*, 293 U.S. 465 (1935), in which the major shareholder, Mrs. Gregory, attempted to spin off investment assets through this method. Even before the enactment of section 355, the Supreme Court denied tax-free treatment, stating that the transaction did not have an adequate business purpose and was done solely to avoid dividend tax.

A corporation can distribute excess cash in the form of a redemption of its shareholder's stock and provide capital gains treatment to the shareholders if the transaction results in a meaningful reduction of the shareholders' interests. *See* sec. 302.

[429] *See General Utilities & Operating Co. v. Helvering*, 296 U.S. 200 (1935). The actual case involved a dividend distribution of stock of a subsidiary to shareholders, followed by a sale of the stock to an acquiror. The court upheld the taxpayer's position that this was not in effect a taxable sale by the corporation but was entitled to tax-free treatment on the distribution, under the then existing statute. By the time of the 1986 Act, statutory changes had significantly narrowed the cases in which a corporation could distribute appreciated stock or assets without corporate level tax. The 1986 Act eliminated the statutory provisions that had permitted such a result in an acquisition or liquidation of the entire distributing corporation. However, the 1986 Act retained the tax-free spin-off rules of section 355.

Another, later-enacted restriction imposes corporate level tax if 50 percent or more of a corporation or its distributed subsidiary is acquired by new shareholders as part of a plan related to a spin-off (sec. 355(e)).

Partnership rules

Partnership rules permit corporations to combine their assets without tax through joint venture or other partnership operations, and to separate assets out of partnership structures, often also without tax.[430] These rules differ from the corresponding rules for transferring assets in and out of corporate structures. In general, the partnership rules permit a greater range of tax-free transfers than do the corporate rules. However, in some situations the corporate rules might more readily permit certain types of transfers.

Analysis

The different rules permitting particular corporate transactions to receive tax-free treatment are varied and frequently inconsistent. In some cases, more than one rule could apply to the form of a particular corporate transaction. The statute and the administrative pronouncements of the IRS over the years have attempted to resolve overlap situations and to provide guidance regarding other interpretive issues.

The structure of present law is in part a result of the historical development and aggregation of provisions. The structure also reflects reactions to judicial decisions interpreting particular provisions, and reflects legislative developments establishing new rules and accompanying concern that existing provisions, if not limited, might conflict with or undermine the new rules.

The different, and often overlapping, variations within the merger and acquisition rules can be viewed as a significant source of complexity. On the other hand, these rules, as they have been interpreted and clarified over the years through administrative pronouncements, provide a large amount of taxpayer selectivity and certainty. Taxpayers are relatively assured of obtaining a specific tax result so long as the transaction satisfies the formalistic requirements of the chosen merger and acquisition provision. Moreover, comprehensive reform of these rules and the imposition of consistency could not generally be accomplished without recommending fundamental changes in the tax policy reflected by one or another of the provisions.

Discussion of possible proposals

The Joint Committee staff considered a number of possible proposals relating to corporate mergers and reorganizations. Because the adoption of any of these proposals would involve policy implications the Joint Committee staff concluded that no specific legislative simplification recommendation would be made with respect to these issues. The proposals that were considered, and the associated policy issues, are described briefly below.

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[430] Secs. 721-737.

Elective carryover basis for "qualified acquisitions"

An approach that has been suggested by a number of commentators in the past would generally permit a corporation to dispose of a business for any type of consideration, including cash, and elect to pay no corporate level tax, provided the consideration received is distributed to shareholders and that they pay tax (if they are taxable shareholders) on any cash or other consideration that is not a qualified continuing stock interest.

The acquiring corporation would not obtain a stepped-up fair market value basis in the acquired corporate assets if the election were made not to pay corporate level tax.

Only certain transactions that involved the acquisition of a significant amount of the stock of another corporation or the assets of a corporate business would qualify for this election.

Such a proposal was included in a 1985 Staff report submitted to the Senate Committee on Finance.[431] That proposal also included other conforming changes in its attempt to substitute a single approach for the present law varied rules affecting tax-free acquisitions. For example, the proposal would have conformed the various definitions of "control" under present law to the definition for filing a consolidated return.

Another version of such a proposal was presented at, and appears in the report of, an invitational conference addressing subchapter C issues, sponsored by the American Bar Association and New York State Bar Association Tax Sections in 1987.[432] An earlier proposal of this type was made by the American Law Institute.[433]

This type of proposal involves a specific policy choice to abandon the existing statutory requirements for continuity of shareholder interest. The proposal would exempt a corporation from tax on a sale of its assets, even if the corporation receives cash consideration for the transfer of a business, so long as the cash is distributed to shareholders and the assets transferred retain a carryover basis.

Several policy arguments can be made in favor of this change. First, as long as assets do not obtain a stepped up basis, there will be corporate level tax in the future as the recipient corporation earns income and retains the low basis assets. Second, as long as shareholders pay

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[431] *The Subchapter C Revision Act of 1985, A Final Report Prepared by the Staff,* Committee on Finance, United States Senate, S. Prt. 99-47 (May, 1985).

[432] Ginsburg, Levin, Canellos, and Eustice, "Reexamining Subchapter C: An Overview and some Modest Proposals to Stimulate Debate", (copyright 1987 by Martin D. Ginsburg); *reprinted in Corporate Tax Reform, A Report of the Invitational Conference on Subchapter C*; American Bar Association Section of Taxation, New York State Bar Association Tax Section (1988) pp. 39-80; *see ,e.g.,* Proposals VII-VIIC and IX-XI.

[433] "Proposals on Corporate Acquisitions and Dispositions" adopted by the American law Institute June 13, 1980, published in American Law Institute, *Federal Income Tax Project Subchapter C* (1982).

tax on any cash that is received, this single tax is sufficient as a current tax. Third, the corporate reorganization provisions are complex and can be manipulated; and an explicit election would simplify corporate tax planning.

Several policy arguments can also be made against the change. When assets are transferred from one corporation to another for cash, the transferring corporation is generally taxed on gain at the time of the transaction or when the cash is received. Payment of tax in the future, if the recipient corporation pays more because of a carryover basis, is not the economic equivalent of payment of tax at the time of the transaction, but is significantly less due to the time value of money. Questions may arise where to draw the line that would allow certain transfers of corporate assets, such as a transfer of a " business," to be exempt from corporate level tax while other transfers, such as sales in the ordinary course of business, would not be so exempt. Interpretations of the line so drawn would be required. In addition, proposals for such restructuring have often involved new sets of rules such as rules regarding the definition of control or other issues. New rules could also involve further interpretation and could lead to new uncertainty and complexity.

Provide one set of consideration and continuity rules for acquisitive reorganizations

There have been a number of proposals to conform the consideration rules for acquisitive reorganizations to require a specified percentage of stock consideration (*e.g.*, 50 percent) and to conform the rules as to whether the stock must be voting stock.[434]

One policy issue related to such recommendations is the determination what type of stock will be counted in determining continuity and for purposes of determining whether shareholders are taxed. For example, one version of such a proposal suggested that all stock would count (thus eliminating a voting stock requirement) but made an exception for certain preferred stock that is redeemable within 5 years. [435]

The recommendations are typically made only for the reorganization rules contained in section 368. Frequently, no change is recommended to the non-reorganization rules relating to transfers to controlled corporations under section 351.[436]

Under this type of proposal, if the rules for non-reorganization transfers to controlled corporations under section 351 are not modified, then many of the same planning choices that exist under present law would continue to be available. Unless the rules of section 351 are

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[434] *See, e.g., American Bar Association recommendation 1981-5*, 107 ABA Repts. 559, 34 Tax. L. 1386 (1981).

[435] *American Bar Association recommendation 1981-5, supra.*

[436] The American Law Institute Proposals that included a provision for elective carryover basis, described above, did include a provision overriding section 351 for certain qualified acquisitions. However, since the basic proposal for qualified acquisitions abandoned a shareholder continuity of interest requirement for qualified acquisitions, the impact of overriding section 351 in those cases was confined to a much narrower range of issues.

tightened to conform to the new 368 rules in cases that resemble acquisitive reorganizations, it is arguable that little general consistency would be accomplished.[437]

In addition, a modification that limited the application of section 351 could be viewed as a policy decision to tighten the rules relating to acquisitive transactions.

Extend statutory merger rules to include mergers under foreign law

Consideration was given to statutorily extending the statutory merger rules to cover mergers under foreign law.

Some commentators have suggested that such a change might not require a statutory change, but could be done administratively by regulation, since regulations are the source of the present-law restriction to domestic statutes.[438]

If such a change were to be required by statute, effective implementation would likely require extensive administrative examination of particular foreign laws to determine whether they conform to U.S. concepts of tax-free mergers.[439] It is not clear that such a statutory requirement would achieve simplification as compared to present law.

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[437] Partnership rules also could continue to offer different planning approaches to combining businesses and assets in some circumstances.

[438] *See, e.g.*, Thomas L. Evans, *Respecting Foreign Mergers Under U.S. Tax Law*, 88 Tax Notes 93 (July 3, 2000).

[439] Issues were recently raised by a U.S. state law that described a divisive transaction under its merger law. *See* Rev. Rul. 2000-5, 2000-5 I.R.B. 436. Similar issues, possibly more difficult to discern, could arise in the application of foreign law.

B. Eliminate Collapsible Corporation Provisions

Present Law

Under present law, gain from the sale or exchange of stock of a collapsible corporation is treated as ordinary income.[440] A "collapsible corporation" is a corporation formed or availed of principally for the production of property (or certain other activities) with a view to (1) a sale, liquidation, or distribution before the corporation has realized two-thirds of the taxable income to be derived from the property and (2) a realization by the shareholders of the gain attributable to the property. The ordinary income rule does not apply if (1) the shareholder does not own more than five percent in value of the outstanding stock, (2) not more than 70 percent of the gain is attributable to the collapsible property, (3) the shareholder realizes gain more than three years after the corporation completes production or purchase of the collapsible property, (4) the shareholder meets certain requirements as to the net unrealized appreciation on certain assets,[441] or (5) the corporation consents to recognize gain on the disposition of certain of its assets.[442]

These provisions were enacted in the 1950's to prevent the use of corporations to avoid the individual ordinary income tax rates by having a corporation produce property, such as movies or homes in residential subdivisions, and then liquidate before the corporation sold the property. The shareholder would then claim capital gain and no corporate tax would be imposed.

The Tax Reform Act of 1986 required corporations to recognize gain upon distributions of appreciated assets. This change eliminated the ability to use a collapsible corporation to convert ordinary income to long-term capital gain because a tax will be imposed at the corporate level. Thus, the collapsible corporation provisions are largely deadwood today. According to one commentator, "section 341 continues as little more than a bloated, but insignificant, relic from a bygone era, and seems destined to function now merely as a trap for the uninformed."[443] Another commentator says "it is time to repeal section 341"[444], and finally another states "Repeal section 341. If it did not exist, we would not invent it."[445]

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[440] Sect. 341.

[441] These requirements are set forth in section 341(e), which may be the most complex provision in the Internal Revenue Code.

[442] Since 1986, a corporation is required in any event to recognize gain on liquidating and other distributions to its shareholders, as well as on liquidating sales, meaning that the corporation can give its consent to recognize gain without significant adverse tax consequences.

[443] Bittker and Eustice, *Federal Income Taxation of Corporations and Shareholders* (7th Ed., 2000), Par 10.60.

[444] Ginsburg and Levin, *Mergers, Acquisitions, and Buyouts* (2000), par. 305.3.

[445] Feld, *Collapse Section 341*, Tax Notes, March 2, 1998, p. 1187.

Sources of Complexity

The provisions are among the most complex in the Internal Revenue Code. In 1982, the American Law Institute described these provisions as "characterized by a pathological degree of complexity, vagueness and uncertainty."[446]

Under present law, these provisions are largely deadwood, but their presence may cause an unwary taxpayer to lose the benefit of long-term capital gain on the sale of stock.

Recommendation for Simplification

The Joint Committee staff recommends that the collapsible corporation provisions should be repealed.

The repeal of the collapsible corporation provisions will eliminate one of the most complex provisions of the Internal Revenue Code. The provisions were enacted to deal with an abusive transaction that no longer exists, namely the ability to convert ordinary income to long-term capital gain through the use of a corporation that could liquidate without the imposition of a corporate tax. The repeal will prevent unwary taxpayers from running afoul of these provisions.

[446] American Law Institute, *Federal Income Tax Project: Subchapter C,* at 111 (1982).

C. Section 355 "Active Business Test" Applied to Chains of Affiliated Corporations

Present Law

A corporation generally is required to recognize gain on the distribution of property (including stock of a subsidiary) to its shareholders as if such property had been sold for its fair market value. An exception to this rule applies if the distribution of the stock of a controlled corporation satisfies the requirements of section 355 of the Code. To qualify for tax-free treatment under section 355, both the distributing corporation and the controlled corporation must be engaged immediately after the distribution in the active conduct of a trade or business that has been conducted for at least five years and was not acquired in a taxable transaction during that period.[447] For this purpose, a corporation is engaged in the active conduct of a trade or business only if (1) the corporation is directly engaged in the active conduct of a trade or business, or (2) the corporation is not directly engaged in an active business, but substantially all of its assets consist of stock and securities of a corporation it controls that is engaged in the active conduct of a trade or business.[448]

In determining whether a corporation satisfies the active trade or business requirement, the IRS position for advance ruling purposes is that the value of the gross assets of the trade or business being relied on must constitute at least 5 percent of the total fair market value of the gross assets of the corporation directly conducting the trade or business.[449] However, if the corporation is not directly engaged in an active trade or business, then the IRS takes the position that the "substantially all" test requires that at least 90 percent of the fair market value of the corporation's gross assets consist of stock and securities of a controlled corporation that is engaged in the active conduct of a trade or business.[450]

Sources of Complexity

Prior to a spin-off, corporate groups that have conducted activities in separate corporate entities must often undergo elaborate restructuring to place 5-year active businesses in the proper entities to satisfy the 5-year active business requirement. If the top-tier corporation of a chain that is being spun off or retained is a holding company, then the requirements regarding the

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[447] Sec. 355(b). If the distributing corporation had no assets other than stock or securities in the controlled corporations immediately before the distribution, then each of the controlled corporations must be engaged immediately after the distribution in the active conduct of a trade or business.

[448] Sec. 355(b)(2)(A).

[449] Rev. Proc. 99-3, sec. 4.01(33), 1999-1 I.R.B. 111.

[450] Rev. Proc. 86-41, sec. 4.03(4), 1986-2 C.B. 716; Rev. Proc. 77-37, sec. 3.04, 1977-2 C.B. 568.

activities of its subsidiaries are more stringent than if the top-tier corporation itself engaged in some active business.

Recommendation for Simplification

The Joint Committee staff recommends that the active business requirement of section 355 should be applied on an affiliated group basis and that the "substantially all" test should be eliminated. [451]

The proposal would simplify the business planning for corporate groups that use a holding company structure to engage in distributions that qualify for tax-free treatment under section 355. It is common for affiliated groups with a holding company, in contemplation of a tax-free spin-off, to undergo a series of preliminary restructurings simply to satisfy the active business requirement. This proposal would eliminate the need for such restructurings.

Under the Joint Committee staff recommendation, the active business test would be determined by reference to the relevant affiliated group. For the distributing corporation, the relevant affiliated group would consist of the distributing corporation as the common parent and all corporations affiliated with the distributing corporation through stock ownership described in section 1504(a)(1)(B) (regardless of whether the corporations are includible corporations under section 1504(b)). The relevant affiliated group for a controlled corporation would be determined in a similar manner (with the controlled corporation as the common parent). Applying the active trade or business requirement on a limited affiliated basis is consistent with the treatment accorded to affiliated groups for other purposes of section 355(b)(2).[452]

The proposal also is consistent with the purpose of the active business test, since it does not dilute the existing restrictions against the tax-free separation of ownership of an active business from a more passive corporate entity that might be used to permit shareholders to obtain investment assets in separately saleable form.

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[451] This proposal was included in the conference report to H.R. 2488 (sec. 1316 of H. Rep. 106-289), which was passed by the House of Representatives and the Senate on August 5, 1999.

[452] The flush language to section 355(b)(2) provides that, for purposes of determining acquisition of control of a corporation under section 355(b)(2)(D), all distributee corporations that are members of the same affiliated group are treated as one distributee corporation. However, section 355(b)(2)(D) is an anti-abuse provision, so the inconsistent treatment may be appropriate.

D. Uniform Definition of a Family for Purposes of Applying Attribution Rules

Present Law

The tax treatment of a transaction involving the disposition of corporate stock often depends on whether the taxpayer who is transferring the stock retains an ownership interest in the corporation subsequent to the transaction. The continued ownership interest may be the result of the taxpayer actually owning stock in the corporation, or because the taxpayer has a sufficiently close nexus with another person who, directly or indirectly, owns stock in the corporation. In the latter case, present law provides rules that identify situations in which, for Federal tax purposes, the taxpayer is treated as the owner of stock that is actually owned by another person. These rules generally are referred to as "attribution rules."

There are several different sets of attribution rules; each contains its own definitions, operating rules, and special rules. The most-often used attribution rules are found in sections 267 (relating to loss transactions between related parties) and 318 (relating to constructive ownership of stock).

Sources of Complexity

The various attribution rules have their own definitions, operating rules, and special rules. While the different attribution rules do not necessarily overlap in their application, the different definitions and rules can be confusing and a source of complexity. For example, the section 267 definition of a family include a taxpayer's siblings, whereas the section 318 definition does not. Similarly, section 267 defines "family" to include an individual's parents, children, grandparents, and grandchildren (i.e., two generations removed from the individual), whereas the section 318 definition is limited to parents, children and grandchildren.

Recommendation for Simplification

The Joint Committee staff recommends that a uniform definition of a "family" should be adopted with respect to stock attribution rules. For this purpose, a "family" would be defined as including brothers and sisters (other than step-brothers and step-sisters), a spouse (other than a spouse who is legally separated from the individual under a decree of divorce whether interlocutory or final, or a decree of separate maintenance), and ancestors and lineal descendants. An exception would be provided with respect to limiting multiple tax benefits in the case of controlled corporations (section 1561), in which case the present-law rules of section 1563(e) would be retained.

There are at least 13 different, stand-alone definitions of a "family" for purposes of attributing stock ownership.[453] There are many more instances in which a Code section modifies

[453] *See* sections 263A(e)(2)(C), 267(c)(4), 318(a)(1)(A), 447(e)(1), 544(a)(2), 554(a)(2), 1563(e), 2701(e)(1), 2704(c)(2), 4946(d), 4975(e)(6), 6039C(c)(3)(B), and 6046(c).

one of the independent definitions of a family (or fails to define what constitutes a family).[454] Table 17, which follows this recommendation, provides examples of different family attribution rules under present law.

A uniform definition of a "family" for purposes of the attribution rules would achieve some simplification. Taxpayers, practitioners, and the IRS would benefit from the simplicity of having a single definition to apply. A single definition also could eliminate many of the inconsistencies that have developed over the years. For example, the lack of sibling attribution under section 318 (as compared to section 267) appears to be more the result of historical happenstance than a specific policy decision.[455]

A uniform rule also would serve as a catalyst to modernize the definition of a family for attribution purposes to reflect a changing society. The section 267 rules do not include a reference to situations involving divorce or separate maintenance. Similarly, under the section 318 attribution rules, an interlocutory decree of divorce may not be sufficient to break attribution between spouses.[456] In contrast, the section 1563 attribution rules, which were enacted subsequent to sections 267 and 318, permit interlocutory decrees to break spousal attribution.[457] A uniform rule would be beneficial in this regard.

It should be noted, however, that applying a single definition of a family would make it more difficult to target a provision to affect a particular class of individuals. In many cases under present law, the different definitions of "family" reflect a policy objective to expand, or to limit, the relation of individuals that are treated as members of a family. For example, the present-law rule regarding controlled corporations reflects a clear Congressional desire of allowing spouses that own separate businesses to each benefit from the graduated corporate tax rates provided that there is no cross-ownership of stock. No doubt that there are other instances

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[454] *See e.g.,* section 613A(c)(8)(D)(ii) (modifying the section 267 definition of a family to include only the spouse and minor children) and section 1235(d)(2) (modifying section 267(c)(4) to include only a spouse, ancestors, and lineal descendants). For examples of provisions in which the term "family" is not defined, *see* section 151(c)(6)(A)(i) and section 162(n)(3).

[455] Some argue that sibling attribution is not appropriate because disputes over family businesses commonly develop between siblings. Stock ownership should not be attributed between persons whose interests are hostile.

[456] An interlocutory decree is a decree that is interim; it has not been finalized. Legislation was introduced over 40 years ago to amend section 318 regarding interlocutory decrees, but it was never enacted. *See*, Avi-Yonah, 554-2nd T.M., *The Attribution Rules*, Tax Management Portfolio (BNA) at n. 25 (the "Revised Report on Corporate Distributions and Adjustments of the Subchapter C Advisory Group," 85th Cong., 2nd Sess., later introduced as H.R. 4459 (Feb. 12, 1959), recommended that section 318 be amended so that interlocutory divorce decrees break attribution).

[457] Section 1563(f)(5), which became effective in 1964, states that a legal separation "under a decree of divorce whether interlocutory or otherwise" is sufficient to break attribution.

where Congress may determine that a special definition of a "family" is warranted (and a uniform definition should not apply).

Moreover, while a uniform definition may be desirable, adopting such a proposal may lead to unexpected and significant changes for existing entities. For example, the recommended definition of a "family" may have the effect of causing some foreign corporations to be treated as controlled foreign corporations;[458] similarly, it may have the effect of causing some family farm corporations to cease qualifying as a family corporation.[459] Consideration could be given to applying the recommended definition on a prospective basis, though this approach would minimize the simplification that the recommendation is intended to achieve.

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[458] Section 958(b) provides that, in determining whether a foreign corporation is a controlled foreign corporation, the attribution rules of section 318(a) (with certain modifications) apply. Because the proposed definition is broader than the present-law definition in section 318, more foreign corporations may be treated as controlled foreign corporations.

[459] Because the staff recommendation's definition of a family is narrower than the present-law definition used in section 447(e), fewer family corporations may satisfy this definition.

Table 17. -- Examples of Different Family Attribution Rules in the Code

	Sec. 267(c)(4) Related party losses	Sec. 318(a) Constructive stock ownership	Sec. 447(e)(1) Family farm accounting rules	Sec. 544(a)(2) Personal holding companies	Sec. 1563(e) Controlled corporations	Sec. 2032A(e)(2) Special farm valuation rules
Spouse	Included.	Included unless legally separated under divorce decree or separate maintenance.	Included.	Included.	Included unless legally separated under decree of divorce, whether interlocutory or final, or a decree of separate maintenance.	Included.
-divorce/separate maintenance	No statutory reference regarding divorce decree or separate maintenance (case law provides that divorce decree breaks attribution).		No statutory reference regarding divorce decree or separate maintenance.	No statutory reference regarding divorce decree or separate maintenance.		
-provisional divorce decree	No reference regarding provisional divorce decrees.	No reference regarding provisional divorce decrees.	No reference regarding provisional divorce decrees.	No reference regarding provisional divorce decrees.	Refers to interlocutory divorce decrees.	
-other rules					Also excludes spouse in situations where each spouse operates separate businesses with no actual cross-ownership.	
Brothers and Sisters	Included, whether whole blood or half-blood.	Not included.	Included (as well as their spouse), whether whole blood or half-blood.	Included, whether whole blood or half-blood.	Not included.	Included (as well as their spouse), whether by whole blood or half-blood.
-step brothers and step sisters	Does not include step-brothers or step-sisters.		Does not include step-brothers or step-sisters.	Does not include step-brothers or step-sisters.		Does not include step-brothers or step-sisters.
Parents and Grandparents	Includes ancestors.	Includes parents but not grandparents.	Includes parents and grandparents, as well as brothers and sisters of the parents and grandparents (i.e., great uncles and great	Includes ancestors.	A minor child (under 21) includes stock owned by its parent. Otherwise, an individual includes the stock of parents and	Includes any ancestor of the individual.

Table 17. -- Examples of Different Family Attribution Rules in the Code

	Sec. 267(c)(4) Related party losses	Sec. 318(a) Constructive stock ownership	Sec. 447(e)(1) Family farm accounting rules	Sec. 544(a)(2) Personal holding companies	Sec. 1563(e) Controlled corporations	Sec. 2032A(e)(2) Special farm valuation rules
(parents and grandparents cont'd)			aunts), and ancestors and spouses of the above.		grandparents only if the individual would otherwise own more than 50% of the vote or value of the corporation.	
-remote ancestors	Regulations provide that "ancestors" means parents and grandparents.		No regulatory limitation on remoteness of ancestors.	No regulatory limitation on remoteness of ancestors.		No regulatory limitation on remoteness of ancestors.
-step parents	Does not include step-parents.	Does not include step-parents.	Would include step-parents.	Does not include step-parents.	Does not include step-parents.	Does not include step-parents.
Children and Grandchildren	Includes lineal descendants.	Includes only children and grandchildren.	Includes lineal descendants of the individual's brothers and sisters, parents, and grandparents (and their brothers and sisters), and their spouse.	Includes lineal descendants.	A parent includes stock owned by a minor child (under 21). Otherwise, an individual includes the stock of adult children and grandchildren only if the individual would otherwise own more than 50% of the vote or value of the corporation.	Includes lineal descendants of the individual, of the individual's spouse, or of a parent of the individual (and any spouse).
-remote descendants	Regs provide that "lineal descendants" means children and grandchildren.		No limit on remoteness of descendants.	No limit on remoteness of descendants.		No limit on remoteness of descendants.

Table 17. -- Examples of Different Family Attribution Rules in the Code

	Sec. 267(c)(4) Related party losses	Sec. 318(a) Constructive stock ownership	Sec. 447(e)(1) Family farm accounting rules	Sec. 544(a)(2) Personal holding companies	Sec. 1563(e) Controlled corporations	Sec. 2032A(e)(2) Special farm valuation rules
(children and grandchildren cont'd)						
-effect of adoption	Regulations provide that full effect is given to legal adoption.	Statute provides that a legally adopted child is treated as a child of the individual.	Statute provides that legal adoption is treated as if related by whole blood.	No statutory reference regarding legally adopted children.	Statute provides that a legally adopted child is treated as a child of the individual	Statute provides that a legally adopted child is treated as a child of the individual.
-step children	Does not include step-children.	Does not include step-children.	Does not include step-children.	Does not include step-children.	Does not include step-children.	Would include step-children.
Other rules						
-reattribution	No re-attribution among family members.	No re-attribution among family members.		No re-attribution among family members.	No re-attribution among family members.	
-other rules	No option attribution rule.	Option attribution rule trumps family re-attribution limit.		Option attribution rule trumps family re-attribution limit.	Option attribution rule trumps family re-attribution limit.	

Source: Joint Committee on Taxation

E. Limit Application of Section 304

Present Law

Section 304 is designed to prevent a taxpayer from using related corporations to convert ordinary income (*i.e.*, dividends) into long-term capital gain or tax-free return of capital. In order to prevent this conversion of ordinary income, section 304 recasts the sale of stock from one related corporation to another related corporation into a series of fictional transactions that may give rise to dividend treatment. The predecessor of section 304 was enacted in 1950 to reverse the result of the decision in *Commissioner v. Wanamaker*, 178 F.2d 10 (3rd Cir. 1949), in which a taxpayer successfully used a subsidiary corporation to acquire stock of its parent in order avoid a dividend on the property received. In 1954, the provisions were extended to "brother-sister" corporations. Beginning in 1982, numerous amendments have been adopted to prevent "abuses" under section 304.

Section 304 generally recasts sales by controlling shareholders of stock in one corporation to another corporation ("brother-sister" corporations),[460] and sales by shareholders of stock in a parent corporation to a controlled subsidiary ("parent-subsidiary" corporations).[461] In each case the transactions are recast as distributions in redemption of stock. Unless the requirements for sale or exchange treatment under section 302(a) or section 303 are met, the receipt of property is treated as a distribution to which section 301 applies, thus giving rise to a dividend to the extent of corporate earnings and profits. Special rules apply to include the earnings and profits of both related corporations in determining the amount of the dividend. A dividend resulting from the application of section 304 may give rise to a dividends received deduction or a foreign tax credit.

Sources of Complexity

Although section 304 is intended to prevent the bailout of earnings and profits by individuals at capital gain rates, the section produces unusual and unknown results be recasting transactions, often in ways that could not be done directly. Section 304 may have unintended consequences because its emphasis was to prevent individual shareholders from converting ordinary income into long-term capital gains. In other cases, the proper treatment of the recast transactions are uncertain. Some taxpayers rely on section 304 to produce tax benefits that could not otherwise be obtained, notwithstanding that it is intended as an anti-abuse provision.

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[460] Sec. 304(a)(1).

[461] Sec. 304(a)(2).

Recommendation for Simplification

The Joint Committee staff recommends that section 304 should apply only if its application would result in a dividend (other than a dividend giving rise to a dividends received deduction).

The recommendation will eliminate from the recast of section 304 transactions that do not give rise to a conversion of ordinary income taxation of dividends to long-term capital gain. If, after the application of the redemption provisions of section 302 or 303, sale or exchange treatment would be applicable, there is no need to recast the transaction. Also, in the case in which the transaction would give rise to a dividends received deduction, recasting the transaction as a redemption is not necessary to carry out the purposes of the section.[462]

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[462] Several commentators have recommended that section 304 not apply to corporate transferors. *See*, for example, Bittker and Eustice, *Federal Income Taxation of Corporations and Shareholders* (7th Ed. 2000) par 9.09 [6](g), and Brockway, *Section 304 is Very Strange*, Tax Forum No. 517 (June 2, 1997), 72.

F. Post-Reorganization Transfers of Assets

Present Law

In general, gain or loss is recognized for Federal income tax purposes on the sale or exchange of property. One exception is in the case of an exchange of stock or corporate assets in a transaction that qualifies as a tax-free reorganization. To qualify as a tax-free reorganization, a transaction must satisfy one of several sets of statutory requirements provided in section 368(a). In addition, under the "continuity of interest" requirement, a substantial part of the value of the proprietary interests in the reorganized corporation must be preserved in the reorganization.[463] Furthermore, under the "continuity of business enterprise" requirement, the issuer of the stock that preserves those proprietary interests must continue a significant line of the reorganized corporation's historic business or use a significant portion of its historic business assets in a business.[464]

Historically, there was a question as to whether a corporation acquiring stock or assets in a reorganization could transfer the acquired stock or assets to a subsidiary without disqualifying the acquisition under the statutory reorganization requirements or the continuity of interest requirement.[465] Section 368(a)(2)(C), enacted in 1954 (and subsequently modified), provides that certain reorganizations (i.e., statutory mergers or consolidations, certain stock acquisitions, certain asset acquisitions, and acquisitions in a title 11 or similar case) do not lose their tax-free status merely because part or all of the assets or stock acquired in the transaction are transferred to a controlled subsidiary of the acquiring corporation. Treasury regulations under section 368(a)(2)(C) permit successive transfers of stock or assets to one or more corporations controlled in each transfer by the transferor corporation.[466] Moreover, recent revisions to Treasury regulations have largely eliminated questions about continuity of interest and continuity of business enterprise on the transfer of acquired stock or assets to controlled subsidiaries even with respect to reorganizations to which section 368(a)(2)(C) does not apply.[467] By virtue of the possible application of the "step-transaction" doctrine, some uncertainties remain, however, regarding the satisfaction of the statutory requirements in such cases.

Types of reorganizations that are not described by section 368(a)(2)(C) include: (i) certain transfers by a corporation of all or a part of its assets to a corporation controlled immediately after the transfer by the transferor or its shareholders (but only if, in pursuance of the plan of reorganization, the stock or securities of the controlled corporation are distributed in a

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[463] Treas. Reg. sec. 1.368-1(b) and (e).

[464] Treas. Reg. sec. 1.368-1(d).

[465] *See e.g.*, *Helvering v. Bashford*, 302 U.S. 454 (1938); *Groman v. Commissioner*, 302 U.S. 82 (1937).

[466] Treas. Reg. sec. 1.368-2(k).

[467] T.D. 8760, 1998-1 C.B. 803, 806.

transaction which qualifies under section 354, 355 or 356) (a "D reorganization"), and (ii) a change in identity, form, or place of organization of one corporation (an "F reorganization").

Sources of Complexity

The uncertainty regarding limitations on remote continuity in connection with D and F reorganizations results in complexity for taxpayers and the IRS.

Recommendation for Simplification

The Joint Committee staff recommends that assets acquired in a D reorganization or F reorganization should be allowed to be transferred to a controlled subsidiary without affecting the tax-free status of the reorganization.

Limitations on transfers of acquired assets to controlled subsidiaries have been significantly liberalized as a result of statutory and regulatory changes to section 368, though some limitations arguably may continue to apply. The continued policy justification for any such limitations in connection with D or F reorganizations is unclear. However, the uncertain nature of any such limitation results in unwarranted complexity. Taxpayers planning to engage in post-reorganization restructuring must be careful so that the restructuring does not jeopardize the tax-free status of the reorganization. The uncertainties surrounding this area also raise administrative concerns for the IRS.

The staff recommendation would extend the scope of section 368(a)(2)(C) dropdown rule to cover D and F reorganizations. Thus, a uniform rule would apply to post-reorganization transfers to controlled subsidiaries after reorganizations involving the acquisition of stock or assets.

G. Redemptions Incident to Divorce

Present Law

In general

When a corporation redeems the stock of a shareholder and distributes cash or property to that shareholder for the stock, the tax treatment of the distribution to the shareholder generally depends upon whether the shareholder has significantly reduced or has terminated his or her interest in the corporation. If either of these has occurred, the redemption distribution is treated as sale or exchange, eligible for capital gain treatment. However, if the shareholder's interest is not significantly reduced after the redemption, the transaction can be treated as essentially equivalent to a dividend, with ordinary income treatment to the shareholder. Attribution rules, including spousal attribution, apply in making the determination whether the shareholder has significantly reduced his or her interest.[468] (Code Sec. 302).

If a corporation makes a payment to a third person in satisfaction of a liability of a shareholder to that person, the payment is generally treated as a dividend to the shareholder, followed by a transfer of the funds from the shareholder to the third person. This same concept would generally characterize a corporate redemption of one shareholder as a dividend to the unredeemed shareholder, if the unredeemed shareholder had a "primary and unconditional obligation" to buy the redeemed person's stock.[469]

Special rules

Section 1041 of the Code

Section 1041 of the Code provides special rules for the transfer of property between spouses while married, or incident to their divorce. Such transfers are not taxable. The recipient of the property does not report income, nor does the transferor realize gain or loss on the transfer. The recipient takes the property from the transferor with a carryover basis.

Regulations under section 1041 of the Code

Temporary regulations in questions and answer format address the general question whether transfers of property to third parties "on behalf of " a spouse (or former spouse) qualify under section 1041. The regulations state that there are three situations in which such a transfer qualifies. First, where the transfer to the third party is "required by a divorce or separation instrument." Second, where the transfer to the third party is "pursuant to the written request of the other spouse (or former spouse)". Third, where the transferor receives from the other spouse (or former spouse) a written consent or ratification of the transfer to the third party. In each of

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[468] In limited circumstances a redeemed married spouse can avoid attribution from the continuing spouse if there is a complete termination of the redeemed person's interest and the person has no interest in the business other than as a creditor for at least 10 years. Sec. 302(c)(2).

[469] Rev. Rul. 69-608, 1969-2 C.B. 42.

these cases, the transfer is treated as made directly to the nontransferring spouse (or former spouse) and that person is treated as immediately transferring the property to the third party. The deemed transfer from the nontransferring spouse (or former spouse) to the third party is not a transaction that qualifies for nonrecognition under section 1041.

Fact situations in divorce redemption context

When the spouses in a divorcing couple each own stock in a closely held corporation, or when they have joint ownership of the stock, one spouse may be bought out of the corporation incident to the divorce. This buyout is often accomplished by causing the corporation to redeem the stock of the spouse whose interest is terminated. In some cases, before the redemption, the spouses shared control of the corporation 50-50. In others, one spouse, (typically the remaining one), controlled the corporation. In others, the corporation is a jointly owned franchisee and the franchise agreement forbids ownership of the corporation by anyone outside the family of the person operating the franchise. Thus, the franchise business would cease to be available to the remaining spouse unless the redeemed divorced spouse who is not operating the corporation is bought out of the corporation.

In some cases, the redemption format is mandated by the divorce agreement or decree. In others, the divorce agreement gives the remaining spouse the option of buying the stock directly from the terminating spouse, or of alternatively causing the corporation to redeem the stock.

The question arises in each case whether the transaction should be treated as a simple redemption of the redeemed spouse, with capital gain treatment to that spouse on the proceeds received, or whether instead the transfer by the corporation should be viewed as made to satisfy an obligation of the remaining spouse. In the latter case, the redemption would be treated as a dividend to the remaining spouse, and a tax-free transfer of the funds to the redeemed spouse by the remaining spouse, in exchange for the transfer of the redeemed spouse's stock.

In the divorce context, if the redemption is provided for at all in the separation or divorce document, the redeemed spouse contends under the regulations that the redemption is a transfer of property (the stock) to a third party (the corporation) pursuant to the divorce decree and therefore not a taxable event. Instead, the redeemed person treats the transaction as a transfer of the redeemed stock first to the nonredeemed spouse, followed by a surrender of the stock by that spouse to the corporation for a dividend to that spouse.

Case law in the divorce context

The courts have adopted different legal approaches in addressing these cases. The differences lie in the differing language used to interpret the 1041 regulations in these settings. Some courts have stated that the "on behalf of " standard in the regulations under section 1041 is to be interpreted as importing the common law non-divorce requirement of a "primary and unconditional" obligation of the non-transferring spouse, before the non-transferring spouse can have a dividend on the transaction. Other courts have concluded that the "on behalf of" standard is a separate standard, that can be satisfied when the transfer is pursuant to a divorce decree. Under the particular facts of different divorce agreements, spouses have taken opposing positions regarding who should be taxed on a particular transfer.

In one case, the Ninth Circuit Court applied the "on behalf of" standard to exempt the wife from tax, while the Tax Court concluded that the "primary and unconditional " standard was implicit in the regulations, and exempted the husband from tax.[470]

In another case, husband and wife each claimed exemption from tax under their respective interpretations of the "primary and unconditional" standard. The Tax Court in that case did not analyze their interpretations, but revised its earlier view and concluded that the "primary and unconditional" standard was not the correct standard to apply. The Court imposed tax on the husband rather than the wife under the "on behalf of" standard in the regulations, because the redemption was pursuant to the divorce decree, a situation specified in the regulations. In that case, the divorce decree required that the husband, or, at his election, the corporation, would redeem the wife's stock. [471]

Sources of Complexity

Present law is complex because it contains two differently stated standards for determining when the redemption of a spouse should be taxed as a dividend to the other spouse. There is confusion among the courts and taxpayers whether the "for the benefit of" standard stated under the section 1041 regulations is intended to differ from the "primary and unconditional obligation" standard that applies outside the divorce context.

Another potential source of complexity, even under the "primary and unconditional obligation" standard, is the possibility that the spouses might take different positions regarding the proper application of that standard.

Recommendation for Simplification

The Joint Committee staff recommends that a stock redemption incident to a divorce should be treated as a taxable redemption of the stock of the transferor spouse, unless both parties agree in writing that the stock is to be treated as transferred to the other spouse prior to the redemption.

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[470] The spouses were joint owners of all the stock of a corporation that owned a MacDonald's franchise. The franchisor required 100 percent ownership by the operator and forbad joint ownership after a divorce. The parties agreed that the husband would continue as the operator of the business. The divorce decree directed the corporation to redeem the wife's stock. In the wife's case, the Ninth Circuit Court of Appeals held that the redemption was 'on behalf of" the husband because he had benefitted from it in settling his property obligations. The Tax Court, however, in the later husband's case, held that the husband did not have a "primary and unconditional obligation" to purchase the stock, only the corporation did. In this set of cases, neither party paid tax. *Compare, Joann Arnes v. United States*, 981 F.2d 456 (9th Cir. 1992); *John A. Arnes v. Commissioner*, 102 T.C. 522 (1994).

[471] *Carol M. Read, et. al., v. Commissioner*, 114 T.C. 14 (2000).

Analysis

The recommendation would reduce complexity by adopting a clear standard for divorce cases that does not require interpretation of concepts such as "on behalf of" and "primary and unconditional obligation"[472] or any similar terms. This recommendation will reduce the situations where the parties take inconsistent positions (thus requiring the IRS to litigate with each of the spouses). The recommendation also should eliminate any uncertainty as to the transferor spouse's tax treatment, since this spouse (who receives the money from the corporation) will be the one who treats the exchange as a taxable redemption unless there is an explicit agreement to the contrary. The fact that the standard differs from the general non-divorce standard regarding redemptions should not be troublesome since divorce is not likely to be undertaken to achieve particular stock redemption consequences.

Taxpayers would still be able to fashion the results by providing the appropriate agreement, so that the stock will be treated as transferred between the spouses in a non-taxable section 1041 transaction and then surrendered by the other spouse in a taxable transaction. Taxpayers could also modify the form of the transaction so that one spouse actually purchases the stock of the other spouse, in which case the form would be respected.

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[472] Rev. Rul. 69-608, 1969-2 C.B. 42 sets out the IRS litigating position on the interpreation of the phrase "primary and unconditional obligation". However, the ruling reaches differing tax results in similar economic examples, leaving open the possibility that taxpayers might take differing positions. *See, e.g.,* the positions of the spouses in *Carol M. Read, et. al., v. Commissioner*, 114 T.C. 14 (2000).

H. Conform Treatment of Boot Received in a Reorganization with the Stock Redemption Rules

Present Law

Stock redemptions

If a corporation redeems its stock and one of four tests is satisfied, the redeemed shareholder treats the redemption as a sale or exchange. This allows the shareholder to reduce the amount included in income by his basis in the redeemed stock and also entitles the shareholder to capital gains treatment. If none of the tests is met, the redemption is treated as a dividend to the extent that the distribution is either out of accumulated earnings and profits or out of earnings and profits for the current year.

The four tests are: (1) the redemption is not essentially equivalent to a dividend; (2) the distribution is substantially disproportionate with respect to the shareholder (i.e., the shareholder's ownership of voting stock and common stock declines by more than 20 percent as a result of the redemption and the shareholder owns less than 50 percent of the voting stock after the redemption); (3) the shareholder's interest is completely terminated; and (4) a shareholder (other than a corporation) is redeemed in partial liquidation of the distributing corporation.

The transfer of stock in one corporation to another corporation controlled by the same person or persons is treated as a stock redemption. The tests described above determine whether or not the transfer is an exchange or as a distribution of property. If the transaction is treated as a distribution of property, the amount treated as a dividend is determined by reference to the earnings and profits of both the acquiring and issuing corporations.

Boot in reorganizations

In general, gain or loss is not recognized with respect to exchanges of stock and securities in corporate reorganizations (or section 355 distributions). If such exchanges also involve the receipt of nonqualifying consideration ("boot"), gain is recognized up to the amount of the boot. Further, part or all of that gain may be taxable as a dividend if the exchange has the effect of a distribution of a dividend. Unlike the rules that apply to ordinary dividends, under the boot dividend rules a shareholder's dividend income is limited to his ratable share of accumulated earnings and profits; current earnings and profits are not taken into account. If the amount of gain exceeds the allocable portion of accumulated earnings and profits, the excess generally is treated as capital gain.

The courts and the IRS have held that the principles developed in interpreting the rules relating to stock redemptions are applicable in determining whether boot received in a reorganization exchange or a section 355 exchange is treated as a dividend. The Supreme Court has explicitly applied the substantially disproportionate test of the stock redemption rules in the reorganization context[473]. Nevertheless, there is no explicit statutory coordination between the

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[473] *Clark v. Commissioner*, 489 U.S. 726 (1989).

stock redemption rules and the rules relating to the treatment of boot received in a reorganization exchange or a section 355 exchange.

Some reorganizations (under sections 368(a)(1)(D), (E), and (F)) involve corporations under common control, or restructurings of a single corporation.

Sources of Complexity

The present law rules governing dividend treatment are slightly different for redemptions than for reorganizations and different results may be obtained depending on the form of the transaction. Eliminating these differences would achieve simplification.

Recommendation for Simplification

The Joint Committee staff recommends that the rules relating to the treatment of "boot" received by a shareholder in a corporate reorganization involving corporations under common control or a restructuring of a single corporation[474] (or in a section 355 transaction) should be conformed to the rules relating to the redemption of stock.[475]

Analysis

The same rules would apply for determining whether a distribution is a dividend under the rules relating to redemptions and to reorganizations that involve corporations under common control or restructurings of a single corporation. Under the recommendation, boot received by a shareholder in such a reorganization, or in a section 355 transaction (involving the division of a corporation) would be treated as gain from a sale or exchange and not as a dividend only if one of the tests enumerated in the stock redemption rules is met. In addition, if boot received in such a reorganization or section 355 transaction is treated as a dividend, the amount treated as a dividend would be determined under general tax principles, i.e., the boot would be treated as a dividend to the extent the distribution is made out of current or accumulated earnings and profits and the amount of the dividend would not be limited to the amount of gain in the stock.

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[474] *I.e.*, reorganizations under sections 368(a)(1)(D), (E), or (F).

[475] Consideration could also be given to extending the proposal to other reorganizations, such as acquisitive reorganizations under sections 368(a)(1)(A) and (C).

V. PASS-THROUGH ENTITIES

A. Structural Issues Relating to Pass-Through Entities

Present Law

In general

Present law provides for a number of types of entities in which income of the entity is subject to one level of tax ("pass-through entities"). The Federal income tax treatment of pass-through entities differs from the two-tier tax that applies to income of corporations. A corporation's income is taxed both at the entity level when earned, and at the shareholder level when distributed. By contrast, the income of pass-through entities is subject to only one level of tax, at the owner level. The mechanisms for eliminating tax at the entity level differ among the types of entities. Several types of pass-through entities are subject to special rules as to permitted income, assets or activities.

Partnerships

A partnership generally is treated as a pass-through entity.[476] Income earned by a partnership, whether distributed or not, is taxed to the partners. Distributions from the partnership generally are tax-free. The items of income, gain, loss, deduction or credit of a partnership generally are taken into account by a partner as allocated under the terms of the partnership agreement. If the agreement does not provide for an allocation, or the agreed allocation does not have substantial economic effect, then the items are to be allocated in accordance with the partners' interests in the partnership. To prevent double taxation of these items, a partner's basis in its interest is increased by its share of partnership income (including tax-exempt income), and is decreased by its share of any losses (including nondeductible losses).

Under regulations promulgated in 1996, any domestic non-publicly traded unincorporated entity with two or more members generally may elect to be treated as either a partnership or a corporation. The regulations also provide that a single-member unincorporated entity may be disregarded for Federal income tax purposes, that is, treated as not separate from its owner. These regulations, known as the "check-the-box" regulations, replaced the four-factor test for classifying an entity as a partnership or a corporation under prior law. The regulations were a response, in part, to the growth of limited liability companies, which generally are neither partnerships nor corporations under applicable State law, and which generally provide limited liability to owners. The regulations permit a limited liability company simply to elect to be treated as a partnership rather than meeting the prior-law four-factor test.

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[476] An exception to pass-through treatment is provided in the case of publicly traded partnerships. A publicly traded partnership is treated as a corporation for Federal tax purposes. Thus, its income is subject to tax at the entity level, and in addition, owners generally include in their income amounts that the entity distributes to them. A publicly traded partnership is a partnership whose interests are (1) traded on an established securities market, or (2) readily tradable on a secondary market (or the substantial equivalent thereof).

S corporations

In general, an S corporation is not subject to corporate-level income tax on its items of income and loss. Instead, an S corporation passes through its items of income and loss to its shareholders. Each shareholder takes into account separately his or her pro rata share of these items on his or her individual income tax return. To prevent double taxation of these items, each shareholder's basis in the stock of the S corporation is increased by the amount included in income (including tax-exempt income) and is decreased by the amount of any losses (including nondeductible losses) taken into account.

A small business corporation may elect to be treated as an S corporation. A "small business corporation" generally is defined as a domestic corporation which does not have (1) more than 75 shareholders; (2) as a shareholder, a person (other than certain trusts or estates) who is not an individual; (3) a nonresident alien as a shareholder; and (4) more than one class of stock. The S corporation provisions were added to the tax law in 1958, and substantially revised in 1982 and 1996.

Trusts and estates

A trust or estate generally is treated as a separate taxable entity and is subject to tax as if it were an individual, with some modifications. In determining the trust's or estate's taxable income, a deduction is allowed for amounts that are required to be distributed (for example, as required by the trust instrument). The amount of the deduction for distributed amounts may not exceed the distributable net income of the trust or estate for the taxable year. The beneficiary of the trust or estate includes in income the amount distributed for the taxable year, but the amount includable cannot exceed the trust's or estate's distributable net income for the year. Thus, the distributed income of the trust or estate (up to the amount of distributable net income for the year) is not taxed at the trust or estate level. Rather, the beneficiary includes it in income.

A grantor trust is a trust whose grantor has retained the right to exercise certain powers over the trust. A grantor trust is not treated as a separate taxable entity. Instead, the grantor is treated as the owner of the trust's property and is subject to tax on trust income.

Regulations governing the classification of entities as trusts or corporations provide that trusts generally do not have associates (for example, shareholders) or an objective to carry on business for profit.

Other types of entities

Regulated investment companies

A regulated investment company is an entity that receives most of its income from passive investments in stock and securities, currencies and similar instruments; in common parlance, a mutual fund. A regulated investment company must be an electing domestic corporation that, at all times during the taxable year, is registered under the Investment Company Act of 1940 as a management company or as a unit investment trust, or that has elected to be treated as a business development company under that Act. A regulated investment company also is subject to specific requirements with respect to the source of its income and the nature of

its assets. A regulated investment company is treated as a pass-through because it deducts dividends paid to shareholders in computing its taxable income. The dividends generally are included in the regulated investment company shareholders' income. Thus, distributed income of a regulated investment company is taxed only at the shareholder level, not at the regulated investment company level. A regulated investment company generally is required to distribute at least 90 percent of its income during the taxable year as dividends to shareholders.

Real estate investment trusts

A real estate investment trust is an entity that derives most of its income from passive real-estate-related investments. A real estate investment trust must satisfy a number of tests on an annual basis that relate to the entity's organizational structure, the source of its income, and the nature of its assets. If an electing entity meets the requirements for real estate investment trust status, the portion of its income that is distributed to its investors each year generally is treated as a dividend deductible by the real estate investment trust, and includible in income by its investors. In this manner, the distributed income of the real estate investment trust is not taxed at the entity level. The distributed income is taxed only at the investor level. A real estate investment trust generally is required to distribute 90 percent of its income to its investors before the end of its taxable year.

Real estate mortgage investment conduits

A real estate mortgage investment conduit is an entity used for securitizing mortgages on real estate. A real estate mortgage investment conduit is not subject to tax at the entity level (except for a 100-percent excise tax on prohibited transactions); income or loss of the real estate mortgage investment conduit is taken into account by the holders of interests in the real estate mortgage investment conduit. Real estate mortgage investment conduits are subject to restrictions on organizational structure, income, assets, and permitted transactions.

Financial asset securitization investment trusts

A financial asset securitization investment trust is an entity used for securitizing debt obligations such as credit card receivables, home equity loans, and auto loans. A financial asset securitization investment trust is not subject to tax at the entity level. Its income or loss is taken into account by the holders of interests in the financial asset securitization investment trust. These entities are subject to restrictions on organizational structure, income, assets, and permitted transactions. A 100-percent excise tax applies with respect to prohibited transactions.

Cooperatives

There are several types of cooperatives, including tax-exempt farmers' cooperatives and other corporations operating on a cooperative basis. In determining its taxable income, a cooperative does not take into account the amount of patronage dividends to patrons of the cooperative. The cooperative deducts other distributions, including dividends paid on capital stock, and amounts distributed on a patronage basis to patrons during the taxable year. Patrons of the cooperative include in their income the amount of patronage dividends and other distributions made on a patronage basis. Thus, these amounts are subject to tax in the hands of

the patrons, but not in the hands of the cooperative. To this extent, a cooperative is treated as a pass-through entity.

Analysis

In general

As a matter of simplification, one might inquire whether any of the multiple types of pass-through entities is redundant. If any of them is redundant, then the tax law could be simplified by eliminating the redundant pass-through regimes. Having fewer types of pass-through entities would provide transactional simplification for taxpayers, because their choices of business entities would be more limited. Taxpayers' analyses of the choice of entity would be narrower and less time-consuming.

Targeted pass-through entities

A number of the types of pass-through entities provided under present law do not overlap. Many of them are special-purpose vehicles designed for particular lines of business or types of transactions. These regimes provide not only pass-through treatment, but also special rules targeted to particular economic activity. Indeed, it could be argued that the existence of these targeted pass-through entities actually is simplifying for taxpayers, because their specific rules give certainty as to the tax results of particular business transactions in which the entities are designed to engage. While one might question why certain lines or forms of business receive pass-through treatment, that question could be viewed as a tax policy question rather than purely a simplification issue.

These targeted types of pass-through entities include regulated investment companies, real estate investment trusts, real estate mortgage investment conduits, and financial asset securitization investment trusts. The rules governing these types of entities are limited to a particular line of business. These rules provide pass-through treatment specifically to mutual funds, real estate investment vehicles, mortgage securitization vehicles, and vehicles for securitization of certain other debt, respectively. The additional detailed rules of each set of provisions are aimed at providing clear tax treatment for that type of business. In addition, the rules governing cooperatives, although not exclusively limited to a particular line of business, provide certainty for a particular method of doing business, that is, in cooperative form, with distributions or allocations to patrons of the cooperative. The provisions governing cooperatives are a further example of a targeted type of pass-through entity.

Trusts

One type of pass-through entity provided under present law differs from all the rest, in that a trust generally is not for the purpose of conducting business activities. Trusts have historically been vehicles for transferring wealth, but not specifically for conducting business. In fact, the entity classification regulations refer to the purpose of the arrangement as "to vest in trustees responsibility for the protection and conservation of property for beneficiaries who cannot share in the discharge of this responsibility and, therefore, are not associates in a joint

enterprise for the conduct of business for profit."[477] If the entity has associates and an objective to carry on business for profit, these regulations continue, the entity may more properly be characterized as a corporation or partnership. Although some uses of trusts might be characterized by some as evidencing an objective to carry on business for profit (for example, the use of trusts with multiple classes of ownership interests to facilitate investment in a portfolio of mortgages), it could nevertheless be argued that these uses of trusts do not suggest that all trusts are redundant with other pass-through business entities, or that the all the functions served by trusts under present law could be served by another existing type of pass-through entity. Thus, it cannot reasonably be argued that eliminating trusts as pass-through entities reduces redundancy or achieves greater simplification for taxpayers or tax administrators.

Unified pass-through entity regime

It has been suggested by some that there is overlap between partnerships and S corporations. Particularly since the 1996 "check-the-box" regulations, permitting limited liability companies to be treated as partnerships at taxpayers' election, these two types of entities have increasingly similar uses. These regulations call into question whether the tax law should continue to provide parallel, but somewhat different, pass-through treatment for business entities that are partnerships and those that are S corporations. Selecting one of these regimes and making it available for pass-through tax treatment to any domestic business entity would arguably provide significant simplification.

Under a hypothetical unified pass-through regime, any domestic business entity, whether a corporation, partnership or limited liability company, could elect to be treated as a pass-through entity. The two-tier system for taxing income of a corporation under subchapter C of the Code would be retained for non-electing entities.[478] Either the present-law partnership rules, or the present-law S corporation rules, could be selected as the pass-through paradigm.

Selecting the S corporation rules would have the advantage for taxpayers that C corporations could elect pass-through treatment tax-free,[479] and could generally engage in mergers and other corporate reorganization transactions with other corporations on a tax-free basis, but would have the disadvantage for taxpayers of eliminating the flexibility currently available through partnerships. Selecting the partnership rules would have the advantage of permitting taxpayers greater flexibility than is available under the S corporation rules. However, allowing existing corporations to elect partnership status would raise administrative, revenue and equity concerns that might outweigh the simplification benefit for taxpayers. For example,

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[477] Treas. Reg. sec. 301.7701-4(a).

[478] Proposals to integrate the corporate tax are discussed in section IV. A., Structural Issues Relating to the Corporate Income Tax, above.

[479] The provisions of section 1374, imposing tax on built-in gains of C corporations that elect S status, would continue to provide some protection against avoidance of corporate-level tax on gains that would have been subject to tax, absent the corporation's election of pass-through treatment.

because it may not be feasible to allocate entity income among existing stock interests, this approach might require a corporation to formally liquidate and reorganize as an unincorporated business. Under present law, many corporations have not undergone such transactions because of the applicable corporate and shareholder taxes. To address revenue concerns, a toll charge could be imposed on a corporate-to-partnership conversion based upon a portion of the gain that would be recognized on a fully taxable liquidation. Different toll charges could apply to electing C corporations and S corporations. Consideration would have to be given to whether to limit the election to non-publicly traded domestic corporations, or to corporations below a certain size, or whether to allow existing corporations to elect only for a limited time. Each of these issues would arguably entail substantial tax policy determinations.

In light of the significant policy issues that could not be avoided in implementing a unified pass-through tax regime for domestic business entities, the Joint Committee staff is not offering a recommendation of this type.

Repeal of S corporation rules

In the absence of a unified regime for pass-through entity treatment, it could still be argued that there is no need for both the S corporation rules and the partnership rules for pass-through treatment. Simplification could be achieved, it is argued, by eliminating the S corporation regime from the tax law. Under this approach, a business desiring pass-through tax treatment would choose to be a partnership or limited liability company, and the S corporation regime would be eliminated.

There are two fundamental similarities between partnerships and S corporations. One is that both regimes tax income of the entity only at the owner level, thus providing pass-through treatment. The other is that, since limited liability companies can be treated as partnerships, all owners of either type of entity generally can have limited liability, that is, be insulated from personal liability with respect to the debts and obligations of the entity. This similarity is attributable to the fact that applicable State law generally provides this treatment both to shareholders of a corporation (as an S corporation must be), and to members of a limited liability company.

Although for tax purposes S corporations (and their shareholders) generally are treated similarly to partnerships (and their partners), some differences exist as well. For example, the items of income, gain, loss, deduction or credit of a partnership generally are allocated to, and taken into account by, a partner pursuant to the partnership agreement, so long as the allocation has substantial economic effect. Items of income, gain, loss deduction or credit of an S corporation cannot be separately allocated to a particular shareholder, but are taken into account on a per-share, per-day basis, due to the one-class-of-stock rule. Another instance in which partnerships are considered more flexible than S corporations is the effect of entity-level debt on the owner's basis in his interest. A partner includes partnership-level debt in the basis of his interest, whereas an S corporation shareholder does not. The increase in the owner's basis in his interest for entity-level debt is important, because this basis serves as a limit on losses and

deductions passed through to the owner from the partnership or S corporation. Other differences may also affect taxpayers' choice of entity.[480]

Nevertheless, using the flexible partnership tax rules, taxpayers either can establish a very simple venture along the lines of an S corporation, with per-interest, per-day allocations to owners, or can set up a complex business arrangement with different classes of interests and special allocations of particular items to match the tax results to the business arrangement. In either case, so long as the partnership tax rules are observed, the entity through which the venture is conducted can be treated as a pass-through for tax purposes.

Notwithstanding the basic similarity between partnerships and S corporations, it can be said that concerns unrelated to redundancy among pass-through systems weigh in favor of retaining the S corporation regime. Some argue that, as a practical matter, the continued existence of the S corporation rules is worthwhile. A corporate charter is a prerequisite imposed by regulators for some trades or businesses (for example, to hold certain licenses). Limited liability companies may not (at least at present) meet such regulatory requirements, so repealing the S corporation rules would take away pass-through tax treatment for those types of businesses.

In addition, some point out that the corporate form is a familiar, time-tested format for doing business, while the limited liability company form is relatively new and unfamiliar. This issue may be more acute with respect to the comity accorded by one State to entities established under another State's law, in the event of a business undertaking interstate commerce. Further, until limited liability company interests are as easily issued in capital markets as traditional corporate stock, the S corporation may continue to be an attractive vehicle in which to start a business, if it is anticipated that it will later go public. As limited liability companies become an increasingly accepted form of business entity, these concerns should lessen, but it is argued that the time has not yet arrived. If the S corporation rules are not yet obsolete, it is argued, any simplification benefit from repealing them would be outweighed by transactional complexity as taxpayers attempt to reproduce the prior-law results.

Further, significant transitional issues would result from repealing the S corporation rules. Currently approximately three million S corporations are in existence, many of them the vehicle for small business ventures. Forcing these businesses to adopt a new business form, even after a waiting period of several years, would not constitute simplification for those taxpayers. Alternatively, maintaining the S corporation rules indefinitely for these existing corporations, but not allowing the formation of new S corporations, would not achieve the simplification goal of reducing the number of pass-through regimes in the tax law. Preventing the formation of new S corporations while permitting the continuation of existing ones might be perceived as unfair or arbitrary, as well as maintaining the complexity of current law.

It is also argued that both the S corporation and the partnership tax rules are too complex for small businesses, and that a new, much simpler pass-through regime just for small businesses should be added to the tax law. Partnership and S corporation tax treatment would be reserved

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[480] Other differences include the determination of the character of gain on sale of interests in the entity, and treatment of distributions of appreciated property.

for larger or more sophisticated business ventures. Under this view, repeal of the S corporation rules would not achieve simplification for unsophisticated taxpayers.[481] In addition, more taxpayers would be exposed to the partnership rules, which some argue can be complex in certain circumstances.

On balance, because of these competing concerns, and because of the issue that repeal of the S corporation rules may represent a significant shift in tax policy extending beyond mere simplification of the tax law, no recommendation for repeal of the S corporation rules is included in this study.

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[481] *See* George K. Yin and David J. Shakow, *Reforming and Simplifying the Income Taxation of Private Business Enterprises*, in Volume III of this study.

B. Partnership Simplification Recommendations

1. Modernize references to "limited partner" and "general partner"

Present Law

State law defines types of entities for conducting business, such as corporations and partnerships, and describes basic characteristics of such entities and the rights, duties and obligations of their owners. The laws of all 50 States and the District of Columbia provide for the establishment of partnerships, including limited partnerships, and have so provided for many decades.

In general, under State law, a partnership is a mutual agency arrangement, and each partner is an agent of the firm. State law provides rules for general partnerships, in which all partners ordinarily can bind the partnership, can participate in control of the partnership's business, and have personal liability for debts and obligations of the partnership. State law also provides rules for limited partnerships, which can have as owners both general partners and limited partners. Under State law, a limited partner normally is not personally liable for the debts and obligations of the partnership, and generally cannot participate in the control of the partnership's business activities. Thus, State law historically has distinguished between general partners, who do have personal liability and can participate in control of the business (whether in a general partnership or limited partnership), and limited partners, who do not have personal liability and cannot participate in control of the partnership's business.

Within the past two decades, a new form of unincorporated business entity has arisen under State law: the limited liability company. The laws of all 50 States and the District of Columbia now provide for limited liability companies. State laws differ as to the rights of limited liability company owners to participate in control of the limited liability company 's business; State law often provides for several classes of ownership interests with different rights as to distributions, voting, and participation in management, for example.[482] However, the common characteristic of limited liability company owners is that they ordinarily are not personally liable for the debts and obligations of the limited liability company. Utilization of limited liability companies (rather than corporations or partnerships under State law) as the choice of entity for new business activities has increased significantly.

For Federal income tax purposes, limited liability companies generally are classified as partnerships rather than as corporations.[483] The owners of a limited liability company that is

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[482] In some States, members of limited liability companies are classified as managing and non-managing members.

[483] Under Federal income tax law, generally income of entities classified as partnerships is subject to one level of tax (i.e., only to owner-level but not to entity-level income tax on earnings), whereas income of entities classified as corporations is subject to two levels of tax (i.e., both to owner-level and entity-level income tax on earnings). Treasury regulations issued in 1996 provide that Federal tax classification of an entity that is not a corporation under State law, such as a limited liability company, as either a corporation or a partnership is elective. A

classified as a partnership for tax purposes are treated as partners for Federal income tax purposes. However, under State law, limited liability company owners are not defined as either general partners or limited partners.

Nevertheless, a number of provisions of the tax law refer to either "general partners" or "limited partners." These references generally predate the widespread use of limited liability companies, and are based on the distinction made under State law with respect to general and limited partners of partnerships. The distinction is difficult to interpret when applied to owners of a limited liability company, who, though treated as partners for Federal income tax purposes, are not subject to the State-law rules relating to partners and partnerships, and are neither general partners nor limited partners under State law.

Present-law references to "general partners" in the Internal Revenue Code are found in:

(1) section 465(c)(7)(D)(ii)(I), in a rule identifying an active business of a corporation eligible for an exception to the at-risk rules;

(2) section 736(b)(3)(B), in a rule identifying service partners eligible for exchange treatment of payments for good will upon retirement or death;

(3) section 988(c)(1)(E)(v)(I), in a rule identifying owners of funds eligible for special treatment of foreign currency gains and losses;

(4) section 2701(b)(2)(B)(II), in a rule to determine "control" under special valuation rules of the generation skipping tax; and

(5) section 6231(a)(7), in a rule identifying the "tax matters partner" under the 1982 Act partnership audit rules.

Present-law references to "limited partners" in the Internal Revenue Code are found in:

(1) section 464(c)(1)(B) and (e)(2)(A), in rules identifying holdings attributable to active management and defining farming syndicates under a limitation on farming deductions;

(2) section 469(h)(2) and (i)(6)(C), in rules identifying investors that do not materially participate in a business activity or actively participate in a rental real estate activity;

(3) section 772(f), in a rule specifying the operation of simplified flow-through rules for electing large partnerships;

(4) section 1256(e)(3) and (e)(4)(A), in rules identifying "active management" transactions eligible for a hedging exception to mark-to-market rules;

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limited liability company that does not elect to be treated as a corporation for Federal tax purposes generally is treated as a partnership (unless it is a single-member limited liability company that is treated as a disregarded entity), under these regulations.

(5) section 1258(d)(5)(C), in a rule identifying passive investments that are not eligible for an exception for options dealers and commodities traders to ordinary income treatment;

(6) section 1402(a)(13), in a rule excluding from tax on self-employment income partnership income that is not a guaranteed payment for the partner's personal services; and

(7) section 9701(c)(2), in a rule identifying employers that are subject to Coal Industry Health Benefits rules.

Sources of Complexity

References in the Code to "general partners" and "limited partners" have become out-of-date, due to the increase in utilization of limited liability companies. Limited liability companies are generally treated as partnerships -- and their owners as partners -- for Federal income tax purposes. Nevertheless, limited liability company owners are neither general nor limited partners under applicable State law. Applying provisions of the tax law that refer specifically to general or limited partners to limited liability company owners creates difficult questions of interpretation.

The development of limited liability companies under State law and the resulting change in business practices have made it advisable to modernize references in the Code to general and limited partners to accommodate the existence of persons who are partners within the meaning of the Federal tax law, but are not either general partners or limited partners.

Recommendation for Simplification

The Joint Committee staff recommends that references in the Internal Revenue Code to "general partners" and "limited partners" should be modernized consistently with the purpose of the reference. In most cases, the reference to limited partners may be updated by substituting a reference to a person whose participation in the management or business activity of the entity is limited under applicable State law (or, in the case of general partners, not limited). In a few cases, the reference to limited partners can be retained because the provisions also refer to a person (other than a limited partner) who does not actively participate in the management of the enterprise, which can encompass limited liability company owners with interests similar to limited partnership interests. In one case, the reference to a general partner can be updated by referring to a person with income from the partnership from his own personal services.

In general

Two principal differences between general and limited partners under State law are important for Federal tax purposes: (1) whether the partner's liability for partnership obligations is limited; and (2) whether the partner may participate in management or business activity of the partnership.

If the relevant aspect of references to general or limited partners were limited liability, then the appropriate update of references to limited partners would be to substitute a reference to partners whose liability for partnership obligations is limited (or, in the case of general partners, not limited). State law generally does provide limited liability for limited liability company owners with respect to obligations of the limited liability company. Under this approach, then, all limited liability company owners would be treated as limited partners under the present-law rules, even if the limited liability company owners were active in the management or business of the limited liability company. This approach[484] would tend in some cases to change the scope of the present-law rules that include such references, rather than just modernize the reference so that the rule retains its present scope. Further, it would not take into account the purpose of the reference to serve as a shorthand measure of the partner's personal involvement in the management or activity of the partnership, a purpose that appears to be common to many of the provisions that include such references, as illustrated by the provision-by-provision analysis below.

Therefore, it is argued, the relevant aspect of the references to general or limited partners is probably not limited liability in most cases, but rather, is whether the partner's participation in the management or business activity of the partnership is limited under State law. State limited liability company laws do not invariably provide, as does most State law with respect to limited partners, that a limited liability company owner is prohibited from, or limited in, participation in the management or business of the partnership. State laws vary, but most provide that at least some classes of limited liability company owners are permitted to participate without restriction. Under this approach, the appropriate update for references to limited partners would be to substitute a reference to a person whose participation in the management or activity of the partnership is limited under State law (or, in the case of general partners, not limited).[485]

Provision-by-provision analysis

Below is a provision-by-provision analysis of the direct references in the Code to limited partners and general partners. Other, indirect references to these terms generally are assumed to be for purposes similar to the direct references, and therefore, are not specifically discussed. For example, the definition of a syndicate (which includes a reference to limited partners in section 1256) is incorporated indirectly by reference in rules governing whether the taxpayer may use the cash method of accounting for Federal tax purposes (sec. 448). This indirect reference is not separately discussed. Similarly, references to general partners or limited partners in Treasury regulations are not discussed. While the purpose of the reference in each provision that is

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[484] *See Gregg v. U.S.*, D. Or., No 99-845-AA, Nov. 29, 2000, a recent case in which the court refused to take this approach.

[485] One provision of present law, further discussed below, provides a definition of a limited entrepreneur, which means a person with an interest in an enterprise other than as a limited partner, who does not actively participate in the management of the enterprise. Although this is a somewhat different notion than relying on the interest-holder's right to participate in management or activities of the business as defined under State law, it could be a starting point for drafting.

discussed may not be precise or explicit in the legislative history, it may generally be inferred from the context of the provision.

References to general partners

At-risk rules (sec. 465(c)(7)(D)(ii)(I)).--The at-risk rules serve to limit individuals' and closely held corporations' losses and deductions from a business activity to the amount that the taxpayer could actually lose in the activity, i.e., the taxpayer's amount at risk. A special rule provides an exception for certain active businesses conducted by closely held corporations. To qualify for this active business exception, a corporation must have a certain minimum number of full-time employees performing services in the business. If the business is conducted by a partnership in which the closely held corporation is a partner, then to qualify for the active business exception, the corporation must be a general partner. In addition, the corporation must satisfy tests based on minimum percentage ownership and dollar value investment in the partnership. Although the legislative history of these requirements for corporate partners in active businesses is not explicit about the purpose of the general partner requirement,[486] it would not be inconsistent with the sense and scope of the provision to substitute for the general partner requirement a requirement that the closely held corporate partner not be prohibited or limited under applicable State law from participation in the management or business of the partnership. This approach would provide simplification by eliminating the reference to general partners, without changing the meaning or effect of the reference. The partner would still be required to satisfy the other parts of the test, relating to its minimum percentage ownership and dollar value investment. In addition, a minimum full-time employee requirement applies. Thus, for example, under this approach, a closely held corporation conducting an active business as an owner of an limited liability company could qualify for the active business exception under the at-risk rules, provided that applicable State law governing the corporation's interest in the limited liability company did not limit the corporation's participation in management or business of the limited liability company. This result would follow even though the corporation's liability for obligations of the limited liability company is limited under State law. This approach would continue the same result as under present law with respect to general partners, as the new language generally would correlate to rights of general partners under State law.

Payments to retiring partner (sec. 736(b)(3)(B)).--Special rules provide for the character as either ordinary income, or capital gain, of payments made in liquidation of the partnership interest of a retiring or deceased partner. Under this rule, a payment that is treated as a distributive share (which can be ordinary income to the partner) is effectively deductible by the partnership, while a payment that is treated as a distribution in exchange for the partner's partnership interest (which is generally capital gain to the partner) is not deductible by the partnership. A payment to a retiring partner may be treated as in exchange for the partnership interest (with capital gain treatment), unless it is a payment for unrealized receivables, or for good will. An additional special rule provides that a payment for unrealized receivables or good will may nevertheless qualify for favorable exchange treatment, if two requirements are met. The first requirement is that capital is not a material income-producing factor for the partnership,

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[486] *See* Joint Committee on Taxation, *General Explanation of the Revenue Provisions of the Deficit Reduction Act of 1984* (JCS-41-84), Dec. 31, 1984, at 730 (reasons for change), 735.

and the second requirement is that the partner was a general partner. Both of these requirements are intended to ensure that the retiring or deceased partner performed personal services for a service partnership.[487] It would be consistent with this intent to substitute for the general partner requirement a requirement that the retiring or deceased partner was subject to tax on self-employment income from the partnership. This approach would serve the same purpose as the present-law reference to a general partner, that is, to provide that the retiring or deceased partner was not merely an investor but actually performed personal services in the partnership's service business. It would serve this purpose better than merely providing a reference to whether the partner was limited by State law in the participation in management or business of the partnership, because the self-employment income would be evidence of his performance of services.

Foreign currency transactions (sec. 988(c)(1)(E)(v)(I)).--Section 988 provides generally that foreign currency gains and losses are treated as ordinary. Transactions that are defined as section 988 transactions subject to this rule generally include (among other things) entering into or acquiring any forward contract, futures contract, option or similar financial instrument, that is denominated in, or by reference to, a foreign currency. In the case of taxpayers that elect to be treated as "qualified funds," however, these types of transactions are not treated as section 988 transactions if they would otherwise be marked to market under section 1256, which provides for 40-percent/60-percent short-term/long-term capital gain or loss treatment.[488] A "qualified fund" means an electing partnership meeting certain statutory requirements, including a requirement that at all times while its election is in effect, it has at least 20 partners, and no single partner owns more than 20 percent of the interest in the capital or profits of the partnership. This rule has the effect of diversifying the ownership of the partnership. An exception is provided to the 20-percent limit in the case of an interest of a general partner, "if neither that partner, nor any person whose taxable income is combined with such general partner's taxable income in a consolidated return, has ordinary income that is foreign currency gain or loss. . ."[489] The legislative history further explains, "[t]hus, a general partner's share of profits or capital may be any percentage if none of that partner's ordinary income or loss is exchange gain or loss from a section 988 transaction."[490] The reference appears to be to a partner that is active in a business (outside the qualified fund) other than one involving section 988 transactions.

The reference in the qualified fund election to a general partner could be modernized by substituting a reference to a person not limited as to participation in the management or activity

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[487] *See* H. Rep. 103-111 (May 25, 1993), at 782-783.

[488] The qualified fund election has the effect of benefiting "commodity pool" partnerships that might not otherwise have uniform capital treatment for all of their foreign currency contracts under the general section 988(a)(1)(B) election, which provides for capital treatment of gains and losses on foreign currency contracts unless they are part of a straddle under section 1092.

[489] H. Rep. 100- 1104 (October 21, 1988), at 191.

[490] *Id.*

of the qualified fund. The effect of the present-law reference is to require partners with a greater-than-20 percent interest in the fund to be general partners, that is, to give up the limited liability for fund obligations that they would have as limited partners. Unlimited liability in a qualified fund has the potential for significant consequences because of the inherent volatility of foreign currency derivatives, particularly if the unlimited liability cannot be hedged with offsetting foreign currency transactions outside of the qualified fund. Changing the reference to accommodate limited liability company owners that can participate in management or activity of the fund would have the effect of allowing fund owners to have greater-than-20-percent interests without giving up limited liability.[491] Arguably, this could be a substantive change in the scope of the qualified fund exception to section 988 treatment; it could make the section 1256 treatment available even though no owner of the qualified fund has to give up limited liability for it. If this result is inconsistent with the original purpose of the provision, then expanding the general partner exception to the 20-percent limit to encompass limited liability company owners may be inappropriate.

Special valuation rules for generation-skipping tax (sec. 2701(b)(2)(B)(II)).--The generation-skipping transfer tax is imposed on transfers, either directly or through a trust or similar arrangement, to a beneficiary in a generation more than one generation below that of the transferor. Special valuation rules apply for valuing interests in corporations and partnerships. These rules provide that the value of control of the corporation or partnership that is retained by the transferor is treated as zero, for purposes of determining whether the property transferred to the younger generation is a gift. In determining control of a partnership, the rules provide that control means holding an interest as a general partner, in the case of a limited partnership. Because the provision relates to control, the ability of the transferor to participate in the management or activity of the partnership is relevant. To update the references, the provision could be rewritten to provide that in the case of a partnership, any members of which are limited as to participation in management or activity of the partnership, control means holding an interest that is not limited as to participation in management or activity of the partnership. This would broaden the definition of control to cover a situation that is not addressed in present law, giving greater certainty, a transactional simplification benefit.

1982 Act partnership audit rules (sec. 6231(a)(7)).--Rules for audits of partnerships, in which determinations can be made at the partnership level so that items are treated consistently for all partners, were added by the Tax Equity and Fiscal Responsibility Act of 1982. Under these rules, a "tax matters partner" is selected who may represent other partners and transmit information to them about the audit process. The tax matters partner is defined as the general partner designated in accordance with procedures set forth in regulations, or if none is designated, the general partner with the largest profits interest. These references are designed to

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[491] The limited liability company owner would still be precluded from engaging in section 988 transactions outside of the qualified fund, and so would not be able to hedge the (albeit limited) liability associated with its ownership interest through offsetting foreign currency contracts.

point to a partner who is familiar with the operations of the partnership.[492] It would be consistent with the purpose of the provision to substitute for the reference to a general partner a reference to a partner who is not limited as to participation in management or activity of the partnership.

References to limited partners

Concept of "limited partner or limited entrepreneur" (secs. 464(c)(1)(B) and (e)(2)(A), 1256(e)(3)(B) and (C) and (e)(4)(A), and 1258(d)(5)(C)).--Several provisions of the tax law utilize the concept of "limited partner or limited entrepreneur," generally to disallow or limit tax benefits with respect to those persons. Rules deferring certain farming deductions in the case of a farming syndicate include in the definition of farming syndicate a partnership, if more than 35 percent of the losses during any period are allocable to limited partners or limited entrepreneurs. This same concept is applied to exclude from the hedging exception to the mark-to-market rules for section 1256 contracts any transaction entered into by or for a syndicate. For this purpose, a syndicate includes any partnership, if more than 35 percent of the losses for the taxable year are allocable to limited partners or limited entrepreneurs. In a rule recharacterizing gain from certain financial transactions as ordinary income, an exception from the recharacterization rule for options dealers and commodities traders does not apply in the case of any gain recognized by a limited partner or limited entrepreneur. Each of these rules refers to the section 464 definition, which provides that a limited entrepreneur is a person other than a limited partner who does not actively participate in the management of the enterprise. In each case, the reference to a limited partner is coupled with a reference to a limited entrepreneur. A limited entrepreneur, under the present-law definition, encompasses a limited liability company owner that is not permitted to participate in the management or activity of the limited liability company; if State law prevents the limited liability company owner's participation, then the limited liability company owner would clearly not be actively participating. It can be argued, therefore, that there is no harm in retaining the limited partner references in these provisions, because the accompanying notion of limited entrepreneur picks up the parallel case of the limited liability company owner. Alternatively, if the concern about limited partners is their lack of participation, then the definition of limited entrepreneur under present law covers the case involving limited partners that gives rise to concern. Therefore, the limited partner reference could be dropped and only the limited entrepreneur notion retained, without changing the meaning or effect of the provisions.

Material participation and active participation under the passive loss rules (sec. 469 (h)(2) and (i)(6)(C)).--The passive loss rules serve to defer losses and deductions from activities in which the taxpayer does not materially participate, until the taxpayer disposes of the entire interest in the activity in a taxable transaction. These rules were developed to stem the growth of tax shelters among individual taxpayers in the md-1980's. The definition of material participation includes a provision that an interest in a limited partnership as a limited partner is not an interest with respect to which the taxpayer materially participates. Similarly, in a special rule for individuals who actively participate in a rental real estate activity, the definition of active participation includes a provision that an interest in a limited partnership as a limited partner is

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[492] *See* Joint Committee on Taxation, *General Explanation of the Revenue Provisions of the Tax Equity and Fiscal Responsibility Act of 1982* (JCS-38-82), December 31, 1982, at 268-274 (describing the role of the tax matters partner).

not an interest with respect to which the taxpayer actively participates. These references are found in provisions whose basic purpose relates to the taxpayer's level of personal involvement in the activity of the entity. It would be consistent with this purpose to substitute for the references to interests as a limited partner in a limited partnership a reference to a person whose participation in the management or business activity of the entity is limited under applicable State law. This would provide certainty that limited liability company owners who, like limited partners, may not participate in partnership management or activities, are not treated as materially or actively participating. It would also have the effect of clarifying that a limited liability company owner who is not so restricted is treated like a general partner under the material or active participation tests, with the result that his or her participation is assessed under regulations applicable to everyone who is not a limited partner.[493]

Reporting rules for large partnerships (sec. 772(f)).--Partnerships with more than 100 partners may elect simplified reporting and audit rules. Under the reporting rules, the number of separately stated items that are reported to partners (and to the IRS) is reduced. Certain provisions are not modified or consolidated for purposes of these simplified reporting rules, such as the passive loss rules. The reference to limited partners in the simplified reporting rules conforms the reporting of passive losses under these rules to the reporting of passive losses from partnerships that do not elect simplified reporting. The same substituted reference as is recommended above under the passive loss rules would be appropriate. However, in a separate section of this study, it is recommended that these reporting and audit rules be repealed, so the reference would be eliminated.

Self-employment tax rules (sec. 1402(a)(13)).--The tax on net earnings from self-employment applies to gross income derived by an individual from any trade or business carried on by the individual, less the allowable deductions attributable to the trade or business. In the case of a partner, net earnings from self employment include the partner's distributive share (whether or not distributed) of income or loss from any trade or business carried on by the partnership. A special rule provides that net earnings from self employment does not include the distributive share of any partnership item of income or loss of a limited partner (other than guaranteed payments for services actually rendered). The issues involved in modernizing this limited partner reference are discussed in a separate section of this study.

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[493] This approach would be consistent with the result in *Gregg v. U.S.*, above. In that case, the issue was whether a limited liability company owner would be treated as a limited partner or a general partner in determining his material participation under the passive loss rules. The court concluded that the limited liability company owner should not be treated as a limited partner solely because of his limited liability, but rather, should be treated as a general partner. The court noted, "the legislative history clearly shows that Congress enacted the limited partnership test for the purpose of the passive activity loss rules to thwart the deduction by investors, such as limited partners in a limited partnership, of 'passive' losses from 'tax shelter' investments against other non-passive income, since 'a limited partner generally is precluded from participating in the partnership's business if he is to retain his limited liability status.'" *See* S. Rep. 99-313 (May 29, 1986), at 731.

Coal industry health benefit provisions (sec. 9701(c)(2)).--These provisions provide special health benefit rules with respect to a particular industry. They serve nontax purposes, and modifying the limited partner reference in these provisions is outside the scope of this simplification study.

Other possible approaches

Some have argued that an approach based on actual performance of services would be an appropriate replacement for references to limited or general partners. Ordinarily the reference was a shorthand method of identifying the partner's level of involvement in the partnership's business activity. If the purpose of the reference in the present-law rules is to identify a partner who not only is permitted under State law to participate in the entity's business, but actually is providing personal services, then a rule defining minimum personal services by hours per year could be substituted for the current limited or general partner reference.

It could be argued that an hours-per-year test would be better than a reference to whether the person is limited under State law from participating in management or activity of the entity. It is argued that an hours-per-year test more precisely focuses on the difference between limited and general partners. In a limited partnership, a limited partner normally has to give up his limited liability and become a general partner, in order to participate in management or activity of the partnership. Thus, if someone is a general partner in a limited partnership, that person probably is involved in partnership activities. Similarly, if the choice of entity is a general partnership rather than a limited partnership, the liability risk taken on by the partners is the trade-off for the ability to participate in the partnership's activity. Thus, a general partner is relatively likely to be performing services, having given up limited liability. This calculus does not apply in the limited liability company context, however, because the limited liability company owner does not have to give up limited liability in order to have an ownership interest that permits participation in the partnership's activities. Thus, it is argued, the analogy to a limited or general partner is not complete if one merely substitutes a reference to whether the person is (or is not) permitted under State law to participate in the management or activities of the entity. Some reference to the limited liability company owner's level of personal service for the limited liability company is also needed, it is argued. Thus, it could be argued, a minimum number of hours per year of personal service for the partnership would be an appropriate test, providing an easy-to-administer, simple, bright-line test.[494]

On the other hand, an hours-per-year test could be criticized on several grounds. The particular minimum number of hours could be criticized as either too many or too few, depending on the factual circumstances. The same number of hours might not be appropriate for each provision. Another difficulty of a minimum hours test is that it would impose a record-keeping burden on taxpayers. They would need to keep a log or other record of their hours, which generally would not be viewed as a simplification. In some instances, there could be a perverse incentive to work up to or past the minimum. For example, while escaping limited partner treatment would be beneficial to taxpayers under many of the above provisions, working

[494] An hours-per-year test would be administratively simpler, and easier for taxpayers to apply, than a subjective test that did not provide for quantifiable services.

significant hours might have the result of subjecting the taxpayer's income from the activity to self-employment tax (depending on what the test might be under that provision; no recommendation is made in this study). A further concern would be the need for aggregation, or disaggregation, as the case might be, of an individual's services in multiple activities. An aggregation rule would be a complex but probably necessary addition to a minimum hours test. In addition, it is argued that actually imposing a minimum level of service measured in hours is substantively different from examining the status of a person as a general or a limited partner under State law. No such requirement applies to general partners either as a matter of State law or under Federal income tax law, so any attempt to quantify the services that a general partner is likely to perform in any particular instance would alter the substantive results of the affected provisions. Thus, it is argued, trying to assess taxpayers' level of involvement in partnership activities based on an hours-per-year test could be more complex than present law.

2. Eliminate large partnership rules

Present Law

In general

A partnership generally is treated as a conduit for Federal income tax purposes. Each partner takes into account separately his distributive share of the partnership's items of income, gain, loss, deduction, or credit. The character of an item is the same as if it had been directly realized or incurred by the partner. Limitations affecting the computation of taxable income generally apply at the partner level.

The taxable income of a partnership is computed in the same manner as that of an individual, except that no deduction is permitted for personal exemptions, foreign taxes, charitable contributions, net operating losses, certain itemized deductions, or depletion. Elections affecting the computation of taxable income derived from a partnership are made by the partnership, except for certain elections such as those relating to discharge of indebtedness income and the foreign tax credit.

Reporting of partnership items

In general

A partnership is required to provide in its return a statement setting forth separately those items that impact the computation of a partner's income tax liability.[495] A partnership must separately report: (1) gains and losses from sales or exchanges of capital assets held for not more than one year; (2) gains and losses from sales or exchanges of capital assets held for more than one year; (3) gains and losses from sales or exchanges of property described in section 1231 (relating to certain property used in a trade or business and involuntary conversions); (4) charitable contributions (as defined in section 170(c)); (5) dividends with respect to which there is a deduction under part VIII of subchapter B; taxes, described in section 901, paid or accrued to foreign countries and to possessions of the United States; (6) certain taxes paid to foreign

[495] Sec. 6031(a).

jurisdictions; (7) other items of income, gain, loss, deduction, or credit, to the extent provided by regulations prescribed by the Secretary; and (8) taxable income or loss, exclusive of items requiring separate computation.[496] In addition to these separately reported items, partnerships with certain types of partners (e.g., tax-exempt entities) or partnerships involved in specific activities (e.g., search for and extraction of crude oil or natural gas) must separately state information that is relevant for the partners to compute their taxable income. For example, if any partner is a tax-exempt entity, information regarding unrelated business taxable income must be separately stated to the partners.

A partnership is required to furnish an information return to each of its partners on or before the day on which the income tax return for the year is required to be filed, including extensions.[497]

Special rules for electing large partnerships

A large partnership (generally, any partnership that elects under the provision, if the number of partners in the preceding taxable year is 100 or more) may elect special rules regarding the reporting of partnership items to the partners.[498] The special rules provide that, in lieu of the general rules described above for reporting of partnership items to a partner, each partner takes into account separately the partner's distributive share of the following items, which are determined at the partnership level: (1) taxable income or loss from passive loss limitation activities; (2) taxable income or loss from other activities (e.g., portfolio income or loss); (3) net capital gain or loss to the extent allocable to passive loss limitation activities and other activities; (4) tax-exempt interest; (5) net alternative minimum tax adjustment separately computed for passive loss limitation activities and other activities; (6) general credits; (7) low-income housing credit; (8) rehabilitation credit; (9) credit for producing fuel from a nonconventional source; (10) creditable foreign taxes and foreign source items; and (11) any other items to the extent that the Secretary determines that separate treatment of such items is appropriate.[499]

Under the special rules for electing large partnerships, the taxable income of an electing large partnership is computed in the same manner as that of an individual, except that the items described above are separately stated and certain modifications are made. These modifications include disallowing the deduction for personal exemptions, the net operating loss deduction and

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[496] Sec. 702.

[497] Sec. 6031(b).

[498] Secs. 771-777.

[499] Separate treatment may be appropriate, for example, should changes in the law necessitate such treatment for any items. In addition, in determining the amounts required to be separately taken into account by a partner, those provisions of the large partnership rules governing computations of taxable income are applied separately with respect to that partner by taking into account that partner's distributive share of the partnership's items of income, gain, loss, deduction or credit. This rule permits partnerships to make otherwise valid special allocations of partnership items to partners.

certain itemized deductions.[500] All limitations and other provisions affecting the computation of taxable income or any credit (except for the at-risk, passive loss and itemized deduction limitations, and any other provision specified in regulations) are applied at the partnership (and not the partner) level. All elections affecting the computation of taxable income or any credit generally are made by the partnership.

An electing large partnership is required to furnish an information return to each of its partners on or before March 15 following the close of the partnership's taxable year.[501]

Audit proceedings for partnerships

In general

The Tax Equity and Fiscal Responsibility Act of 1982 established unified audit rules applicable to all but certain small (10 or fewer partners) partnerships. These rules (the "1982 Act rules") require the tax treatment of all "partnership items" (as provided in regulations) to be determined at the partnership, rather than at the partner level.

Under the 1982 Act rules, a partner must report all partnership items consistently with the partnership return or must notify the IRS of any inconsistency. In addition, the IRS may challenge the reporting position of a partnership by conducting a single administrative proceeding to resolve the issue with respect to all partners, but must assess any resulting deficiency against each of the taxpayers who were partners in the year in which the understatement arose. A settlement agreement with respect to partnership items binds all parties to the settlement.

These rules establish a "Tax Matters Partner" as the primary representative of the partnership in dealing with the IRS. The Tax Matters Partner is generally a general partner designated by the partnership or, in the absence of a designation, the general partner with the largest profits interest. The IRS is generally required to give notice of the beginning of partnership-level administrative proceedings and any resulting administrative adjustments to all partners whose names and address are furnished to the IRS.

Special rules for electing large partnerships

Electing large partnerships and their partners are subject to unified audit rules.[502] Thus, the tax treatment of "partnership items" is determined at the partnership, rather than the partner level. However, partnership adjustments generally flow through to the partners for the year in which the adjustment takes effect. Thus, the current-year partners' share of current-year

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[500] An electing large partnership is allowed a deduction under section 212 for expenses incurred for the production of income, subject to 70 percent disallowance. No income from an electing large partnership is treated as fishing or farming income.

[501] Sec. 6031(b).

[502] These rules were added in 1997 (Pub. Law No. 105-34).

partnership items of income, gains, losses, deductions, or credits are adjusted to reflect partnership adjustments that take effect in that year (regardless of the year to which the adjustments originally relate). In lieu of flowing an adjustment through to its partners, the partnership may elect to pay an imputed underpayment. In addition, the partnership, rather than the partners individually, generally is liable for any interest and penalties that result from a partnership adjustment.

Under the electing large partnership audit rules, a partner is not permitted to report any partnership items inconsistently with the partnership return, even if the partner notifies the IRS of the inconsistency. The IRS may challenge the reporting position of a partnership by conducting a single administrative proceeding to resolve the issue with respect to all partners. Unlike general audit rules, however, partners will have no right individually to participate in settlement conferences, or to request a refund. In addition, only the partnership (and not the partners individually) may petition for a readjustment of a partnership item through a court proceeding.

Each electing large partnership must designate a partner or other person to act on its behalf. If an electing large partnership fails to designate such a person, the IRS is permitted to designate any one of the partners as the person authorized to act on the partnership's behalf. Unlike the general audit rules, the IRS is not required to give notice to individual partners of the commencement of an administrative proceeding or of a final adjustment. Instead, the IRS is authorized to send notice of a partnership adjustment to the partnership itself by certified or registered mail.

Sources of Complexity

The Code contains multiple regimes for reporting by and audit of large partnerships. Having multiple regimes, of which one is used by relatively few taxpayers, for taxation of similar entities results in complexity for tax practitioners in understanding and evaluating the regimes and for the IRS by requiring the expenditure of resources on an alternative set of rules rarely used by taxpayers.

Recommendation for Simplification

The Joint Committee staff recommends that the special reporting and audit rules for electing large partnerships should be eliminated and that large partnerships should be subject to the general rules applicable to partnerships.

The special rules for electing large partnerships were enacted with the intent to ease the reporting burden of both an electing large partnership and its partners, to facilitate matching by the IRS, and to provide efficiency in administrative proceedings of large partnerships. The special rules have not been widely elected by large partnerships. This may indicate that the benefits of such rules are perceived as insignificant or outweighed by their disadvantages. Multiple regimes for the taxation and audit of large partnerships result in unnecessary complexity for both tax practitioners and the IRS.

There are alternative ways in which simplification of the rules applicable to large partnership could be achieved. For example, simplification could be achieved by making the special rules for large partnerships mandatory. By requiring large partnerships to use the special rules, the complexities associated with having multiple regimes for taxation of similar entities (although multiple regimes for partnerships would still exist) would be lessened, and the efficiencies contained in the special rules with respect to reporting requirements and administrative proceedings could be retained. Alternatively, the special rules could be made mandatory for all partnerships. This, in connection with the elimination of the applicable general rule for partnerships, would result in a single rule for all partnerships irrespective of size.

Another alternative would be to eliminate certain of the large partnership provisions while making others mandatory. For example, making the audit procedures for electing large partnerships mandatory for large partnerships (or for all partnerships currently subject to the 1982 Act rules) while eliminating the general 1982 Act provisions for those partnerships may accomplish simplification. Simplification could result through this approach because the audit procedures for large partnerships that have not elected the special rules for large partnerships are inefficient and more complex than those for large partnerships that have elected the special rules. Under the 1982 Act audit rules, the IRS must assess any deficiency arising from a partnership audit against a large number of partners, many of whom cannot easily be located and some of whom may no longer be partners. In addition, the 1982 Act audit procedures are cumbersome and can be complicated further by the intervention of partners acting individually. Under the special rules for electing large partnerships, partnership adjustments generally flow through to the partners for the year in which the adjustment takes effect rather than the year of the adjustment, eliminating the need to locate individual partners. In addition, under both the 1982 Act rules and the electing large partnership rules, the IRS may challenge the reporting position of a partnership by conducting a single administrative proceeding to resolve the issue with respect to all partners. Unlike the 1982 Act audit rules, however, under the electing large partnership rules, partners have no right individually to participate in settlement conferences or to request a refund, eliminating the complications of intervention by individual partners.

The Joint Committee staff has not made the recommendation to make mandatory the use of certain or all of the special rules by large partnerships (or all partnerships), because such a recommendation involves policy considerations that were recently considered by Congress. The legislative history of the enactment of the special rules for large partnerships reflects that Congress considered various proposals that would have made similar provisions mandatory for large partnerships.[503] Congress ultimately rejected these proposals in favor of the elective rules enacted.

3. Conform timing rules for guaranteed payments and other non-partner payments

Present Law

A partnership is a pass-through entity for Federal income tax purposes. Each partner includes in income its share of the partnership's income, gain, loss, deduction and credit. A

[503] *See* H. Rep. 102-1034 (October 5, 1992), 231-252, and H.R. 3419 (1994).

partner's portion of these partnership items is referred to as its "distributive share," and is taken into account in determining the partner's taxable income whether or not any actual distribution is made with respect to the item.

A partner may also engage in transactions with the partnership in a capacity other than as a partner. For example, the partner may transfer property to the partnership in a transaction properly characterized as a sale, not a contribution to capital. As another example, a partner may perform services for the partnership in a capacity other than as a partner. Amounts the partner receives from the partnership in these types of transactions are not part of the partner's "distributive share" of partnership income. Special rules govern these types of transactions.

Special rules are provided governing guaranteed payments to partners.[504] Guaranteed payments are defined as payments determined without regard to the income of the partnership. Guaranteed payments include preferred returns to partners that are made regardless of the partnership's income. Two types of guaranteed payments are contemplated under present law: for services, or for the use of capital.

In general, a partner includes an amount in income whether it is a guaranteed payment or distributive share. The partnership deducts guaranteed payments in determining partnership income. Although distributive shares of partners are not deductible in determining partnership income, any amount allocated to one partner as its distributive share has the practical effect of reducing the other partners' distributive shares, so the effect is similar to a deduction.

Present law provides a specific rule that matches the timing of inclusion of guaranteed payments by partners and the deduction of such payments by the partnership. The timing rule is that the partner includes the guaranteed payment in income in the taxable year of the partner that ends within, or ends at the same time as, the taxable year of the partnership in which the partnership deducts the payment (Treas. Reg. sec. 1.707-1(c)). Under this timing rule, the matching of income and deduction is based on the partnership's method of accounting for the deduction.

A separate set of special rules applies to transactions between a partnership and a partner if the partner is not acting in its capacity as a partner.[505] These rules were modified (to add rules relating to disguised sales) in 1984, 30 years after the partnership rules were codified in 1954. These rules apply generally if a partner performs services for a partnership or transfers property to a partnership, and there is a related allocation or distribution to the partner. These rules also apply if the partner transfers money or other property to the partnership, and the partnership transfers property or money to any partner, in a transaction that is a properly characterized as a sale or exchange.

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[504] Sec. 707(c).

[505] Sec. 707(a).

The timing rules for these provisions differ from the timing rules applicable to guaranteed payments. Under these timing rules, a payment by the partnership is not deductible by the partnership until the payment is includible in the partner's income.[506]

Sources of Complexity

Needless complexity arises from the existence of different timing rules for guaranteed payments (sec. 707(c)), and the rules governing transactions between partnerships and partners that are not acting in their capacity as such (sec. 707(a)).

Both guaranteed payments for capital, and guaranteed payments for services, have counterparts in the more recent section 707(a) rules. As described above, the rules for the timing of the partner's inclusion and the partnership's deduction differ, depending on whether a payment is treated as a guaranteed payment (sec. 707(c)) or a non-partner payment (sec. 707(a)). These types of distinctions not only create complexity in the administration of the tax law, but also create opportunities for abuse and manipulation of the rules, rather than being neutral as between economically similar transactions. This lack of neutrality wastes government administrative resources as well as taxpayer resources.

Recommendation for Simplification

The Joint Committee staff recommends that the timing rules for guaranteed payments and for transactions between partnerships and partners not acting in their capacity as such should be conformed. The timing rule for all such payments should be based on the time the partnership takes the payment into account.

In general

The recommendation would conform the differing income and deduction timing rules for similar types of payments by partnerships to partners. One of these rules requires matching of the timing of the partner's inclusion to the time of the deduction; the other requires matching of the timing of the deduction to the partner's time of inclusion. In selecting one of these rules and eliminating the other, it can be argued that the former -- i.e., matching based on the partnership's time of deduction -- is preferable. A principal reason is that this timing rule does not change any accounting method, taxable year, or other timing rules applicable to the partnership. Rather, if any party's timing is changed by this rule from what it would have been under its accounting method, it is that of the partner engaged in the transaction, not the whole partnership. A further argument in favor of selecting the partnership-based timing rule is that it is more likely to accelerate the timing of the deduction and income inclusion, and this acceleration removes the necessity for record-keeping associated with reporting the item in a future taxable year. This likelihood may arise for service payments to partners, for example, because the partnership is more likely to be on the accrual method of accounting than is the recipient partner (who is likely to be an individual if the payment is for services).

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[506] Sec. 267(a)(2).

On the other hand, selecting the partnership-based timing rule could be criticized in that in some instances, it may cause a cash-method partner in an accrual-method partnership to include an item of income before receiving the cash. However, this is a relatively common circumstance with respect to partners generally, because the pass-through nature of partnerships requires the partners to include in income their distributive shares of any partnership income, whether it is distributed or not. Another argument against selecting the partnership-based timing rule could be that it is not the rule used outside the partnership context, and it would be simpler for practitioners to use the more broadly applicable rule (i.e., the partner-based rule in section 267). However, it can be argued that selecting the partner-based rule would be the more disruptive choice for the partnership (particularly disrupting the treatment of guaranteed payments), and thus would not maximize the simplification benefit of conforming the timing rules.

Other approaches

It has been suggested that a broader approach, that of repeal of the rules for guaranteed payments to partners, would eliminate the duplication that causes problems under present law.[507] Under this approach, payments by a partnership to a partner that are not payments of the partner's distributive share would be governed by one set of rules, the present-law rules relating to transactions between a partnership and a partner when the partner is not acting in its capacity as a partner (sec. 707(a)).

Additional clarification could be provided with respect to payments formerly treated as guaranteed payments. Guaranteed payments for capital would be treated as interest on debt. The nature of a payment that does not depend on the income of the partnership, that is made by a partnership on an amount contributed to the partnership by the partner, conceptually resembles interest on debt. Imputed interest rules would perhaps become necessary. Clarification could be provided that transactions not properly characterized as debt could be treated as some other arrangement between the partnership and the partner, as is already provided under the present-law section 707(a) rules.

This broader approach, however, could be criticized as adding complexity and also as not necessary to cure the real problem arising from the two sets of rules, that is, inconsistent timing rules. This problem can be addressed, as above, by conforming the timing rules. It is further argued that, particularly in service partnerships such as law and accounting firms, the current guaranteed payment rules provide certainty as to common types of payments, and that repealing the guaranteed payment rules would actually create complexity, not simplicity, for taxpayers by eliminating this certainty.

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[507] *See* Joint Committee on Taxation, *Review of Selected Entity Classification and Partnership Tax Issues* (JCS-6-97), April 8, 1997 at 45 - 47, especially footnotes 96 - 101.

C. S Corporation Simplification Recommendations

1. Excess passive income of S corporations

Present Law

A corporate-level tax is imposed on an S corporation with accumulated earnings and profits in any year in which more than 25 percent of the S corporation's gross income is considered passive investment income.[508] If an S corporation with accumulated earnings and profits for three consecutive years has excess passive investment income in such years, the S corporation election is terminated.[509]

Sources of Complexity

Determining whether an S corporation item of income is passive investment income is inherently fact-intensive, requiring both taxpayers and the IRS to spend time and resources in an area in which the policy is unclear in light of developments since 1982.

Recommendation for Simplification

The Joint Committee staff recommends that the special termination rule for certain S corporations with excess passive investment income should be eliminated.

The Joint Committee staff also recommends that the corporate-level tax on excess passive investment income should be modified so that the tax would be imposed only on an S corporation with accumulated earnings and profits in any year in which more than 60 percent (as opposed to 25 percent) of its gross income is considered passive investment income.

Prior to the Subchapter S Revision Act of 1982 ("the 1982 Act"), any corporation with excess passive income for a taxable year was ineligible to be an S corporation for that year. The 1982 Act repealed the passive income rule for S corporations with no subchapter C accumulated earnings and profits. The 1982 Act also modified the application of the rule by applying a tax on the excess passive income rather than disqualification unless the corporation had excess passive income for three consecutive taxable years.

The passive income rules were retained by the 1982 Act for corporations with earnings and profits accumulated while a C corporation. The rules were retained to prevent C corporations that had accumulated income at the corporate tax rates from electing S corporation status and holding passive investments, the income of which would be subject to only one level

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[508] Sec. 1375. The amount of "excess net passive investment income" is taxed at the highest rate of tax specified in section 11(b).

[509] Sec. 1362(d)(3).

of tax.[510] As a practical matter, a C corporation that was an investment company could either (1) be treated as a personal holding company whose income was distributed or otherwise be subject to tax at both the corporate and individual levels, or (2) liquidate and the shareholders would pay an individual capital gain tax. Electing S corporation status would have given an investment company whose earnings had avoided the high individual rates during its status as a C corporation a significant tax benefit by allowing the earnings to be taxed only at one level without the imposition of a capital gain tax at the shareholder level that a liquidation would entail.

Prior to the early 1980's, the corporate tax rates historically had been substantially lower than the maximum individual tax rate, so that earnings that had been accumulated by a C corporation had not been subject to tax at the higher individual tax rates. Since 1981, however, the corporate tax rates and the maximum individual tax rate have become much closer, and the capital gains tax rate on individuals has been reduced, thereby lessening the significance of these rules. Nevertheless, the administrative burdens caused by the passive income rules for taxpayers and the IRS has not diminished. Because the tax consequences of failing these rules are significant, taxpayers often seek guidance from the IRS regarding specific factual situations, generally involving income attributable to real property. For these reasons, the special termination rule for S corporations with excess passive investment income should be eliminated.

By increasing the level of passive income that must exist for the imposition of the corporate-level tax to 60 percent (from 25 percent), the recommendation should eliminate the uncertainty and complexity for many S corporations regarding the character of their income, while at the same time conform the tax with the personal holding company rules applicable to C corporations[511] (that serve a similar purpose).

2. Trusts as permitted shareholders of S corporations

Present Law

Under present law, certain types of trusts are permitted shareholders of S corporations. These trusts include (1) grantor trusts, (2) voting trusts, (3) certain testamentary trusts, (4) "qualified subchapter S trusts," and (5) "electing small business trusts."[512]

Qualified subchapter S trust

A "qualified subchapter S trust"[513] is a trust that, under its terms, (1) is required to have only one current income beneficiary (for life), (2) any corpus distributed during the life of the beneficiary must be distributed to the beneficiary, (3) the beneficiary's income interest must

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[510] *See* S. Rep. 97-640 (1982), at 6.

[511] Secs. 541-47.

[512] Sec. 1361(c)(2).

[513] The rules for a qualified subchapter S trust are found in section 1361(d).

terminate at the earlier of the beneficiary's death or the termination of the trust, and (4) if the trust terminates during the beneficiary's life, the trust assets must be distributed to the beneficiary. All the income (as defined for local law purposes) must be currently distributed to that beneficiary. The beneficiary is treated as the owner of the portion of the trust consisting of the stock of the S corporation.

Electing small business trust

An "electing small business trust"[514] is a trust in which all beneficiaries of the trust are individuals, estates, and certain charitable organizations. No interest in the trust may be acquired by purchase. The portion of the trust that consists of stock in an S corporation is treated as a separate trust for purposes of computing the income tax attributable to the S corporation stock held by the trust.[515] The trust is taxed at the highest individual rate on this portion of the trust's income.[516] This income is not included in the distributable net income of the trust (and thus is not included in the beneficiaries' income). Capital losses are allowed only to the extent of capital gains. The tax liability may be reduced by the tax credits that are attributable to the S corporation stock. With respect to the remaining portion of the trust, the items taken into account by the subchapter S portion of the trust are disregarded. Although distributions from the trust are deductible in computing the taxable income on this portion of the trust (under the normal rules of subchapter J), the trust's distributable net income does not include any income attributable to the S corporation stock.[517]

Sources of Complexity

An electing small business trust provides the most flexibility in terms of income accumulation and distribution with respect to its beneficiaries. The operating rules regarding electing small business trusts, however, create complexity. The portion of the trust that consists of stock in an S corporation is treated as a separate trust for purposes of computing the income tax attributable to the S corporation stock held by the trust (and is taxed at the highest individual rate).

In addition, having both the qualified subchapter S trust rules and the electing small business trust rules as permitted shareholders is a source of complexity for taxpayers.

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[514] An electing small business trust is defined in section 1361(e).

[515] Sec. 641(c)(1).

[516] Sec. 641(c)(2)(A).

[517] Sec. 641(c)(3).

Recommendation for Simplification

The Joint Committee staff recommends that the special rules for the taxation of electing small business trusts should be eliminated and that the regular rates of Subchapter J should apply to these trusts and their beneficiaries. Also, no election to be a qualified subchapter S trust should be allowed in the future.

Trust income attributable to ownership of interests in business entities other than S corporations (i.e., C corporations, partnerships, including limited liability companies, and proprietorships) and to ownership of other assets are subject to the rules of Subchapter J of the Internal Revenue Code of 1986. Under these rules, certain trusts are treated as grantor trusts whose assets are treated as owned directly by a taxpayer (usually the grantor). Nongrantor trusts are subject to the rules allocating income between the trust and its beneficiaries based on distributions; a tax is imposed on a nongrantor trust's income at highly graduated rates.

As originally enacted in 1958, Subchapter S did not permit any trust to be a shareholder in an S corporation. This policy changed over the years, however, and in 1981, to facilitate the greater use of S corporations by businesses, Subchapter S was expanded to allow the ownership of S corporation stock by qualified subchapter S trusts.[518] The qualified subchapter S trust rules permit, however, only one income beneficiary to whom the trust income must be distributed currently. Thus, they did not permit any trust arrangement under which income or principal may be distributed to more than one beneficiary or be accumulated. To accomplish these objectives, taxpayers utilized multiple trust arrangements.

In 1996, Congress enacted the electing small business trust rules in response to the business limitations imposed by the QSST rules. Congress believed that a trust that provides for income accumulation or distribution to a class of individuals should be allowed to hold S corporation stock.[519] The qualified subchapter S trust rules, however, were retained.

The presence of different rules for taxing S corporation income allocated to a trust from the taxation of all other trust income creates complexity. A qualified subchapter S trust's taxable income is taxed to the beneficiary of the trust, notwithstanding that under the normal trust rules a portion of the income would be taxable to the trust. In contrast, an electing small business trust is taxed at the highest individual rate notwithstanding that income has been distributed to beneficiaries. The qualified subchapter S trust rules were adopted to ensure that the S corporation income allocated to the trust's shares in the S corporation was taxed at the beneficiary's income tax rates; the electing small business trust rules were adopted to ensure that S corporation income allocated to the trust's shares in the S corporation was taxed at the highest individual income tax rate.

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[518] *See*, Joint Committee on Taxation, *General Explanation of the Economic Recovery Tax Act of 1981* (JCS-71-81), Dec. 31, 1981, at 147.

[519] *See*, S. Rep. No. 104-281 (June 18, 1996), at 46.

If the rules of Subchapter J applied to all trust income, then the qualified subchapter S trust rules could be eliminated. Taxpayers and the IRS would not have to learn and apply these special rules, and transactional simplification would result by virtue of eliminating the need for multiple trust arrangements. Finally, it is unclear that there is any underlying policy reason to treat a trust's share of S corporation income differently from, for example, its share of partnership income.

VI. GENERAL BUSINESS ISSUES

A. Section 1031

1. Tax-free rollover of like-kind property

Present Law

In general

An exchange of property, like a sale, generally is a taxable transaction. However, present law provides that no gain or loss is recognized if property held for productive use in the taxpayer's trade or business, or property held for investment purposes, is exchanged for property of a like kind that is also held for productive use in a trade or business or for investment.[520] This provision does not apply to exchanges of stock in trade or other property held primarily for sale, to stocks, bonds, partnership interests, choses in action, certificates of trust or beneficial interest, other securities or evidences of indebtedness or interest, or to certain exchanges involving livestock or involving foreign property.

The nonrecognition of gain in a like-kind exchange applies only to the extent that like-kind property is received in the exchange. For example, if a taxpayer holding land A having a basis of $40,000 and a fair market value of $100,000 exchanges the property for land B worth $90,000 plus $10,000 in cash, the taxpayer would recognize $10,000 of gain on the transaction, which would be includable in income. The remaining $50,000 of gain would be deferred until the taxpayer disposes of land B in a taxable sale or exchange. No losses may be recognized from a like-kind exchange.

Deferred like-kind exchanges

A like-kind exchange does not require that the properties be exchanged simultaneously. Rather, present law requires that the property to be received in the exchange be received not more than 180 days after the date on which the taxpayer relinquishes the original property (but in no event later than the due date (including extensions) of the taxpayer's income tax return for the taxable year in which the transfer of the relinquished property occurs). In addition, the taxpayer must identify the property to be received within 45 days after the date on which the taxpayer transfers the property relinquished in the exchange.

The Treasury Department has issued regulations[521] providing guidance and safe harbors for taxpayers engaging in deferred like-kind exchanges. These regulations allow a taxpayer who wishes to sell appreciated property and reinvest the proceeds in other like-kind property to engage in "three-way" exchanges. For example, if taxpayer A wishes to sell his appreciated apartment building and acquire a commercial building, taxpayer A may transfer his apartment building to buyer B. Buyer B (directly or through an intermediary) agrees to purchase from

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[520] Sec. 1031.

[521] Treas. Reg. sec. 1.1031(k)-1(a) through (o).

owner C the commercial building that taxpayer A has designated. Buyer B then transfers title to the newly acquired commercial building to taxpayer A, completing the tax-free like-kind exchange. The economics of these transactions (taxes aside) are the same as if taxpayer A had sold the apartment building to Buyer B and used the proceeds to purchase the commercial building from owner C. However, a transaction in which the taxpayer receives the proceeds of the sale and subsequently purchases like-kind property would be taxable to the taxpayer under general tax principles.

In order for a three-way exchange to qualify for tax-free treatment, the regulations prescribe detailed rules regarding identification of the replacement property, rules allowing the seller to receive security for performance by the buyer without the seller being technically in receipt of money or other property, and rules relating to whether a person is an agent of the taxpayer or is a qualified intermediary whose receipt of money or other property is not attributed to the taxpayer.

In addition, the IRS recently released a revenue procedure[522] providing that if certain formulaic requirements are satisfied, the IRS will not challenge deferred exchanges where the replacement property is acquired prior to the disposition of the relinquished property.[523] The revenue procedure provides that the taxpayer will not be considered the owner of the property, for purposes of determining if the property qualifies as replacement property under section 1031, so long as the taxpayer satisfies the stated requirements of the revenue procedure. This treatment is irrespective of whether general tax principles would consider the taxpayer as the owner of the property for federal income tax purposes.

The rules prescribed in the regulations and the revenue procedure provide safe harbors that allow taxpayers to comply with the "exchange" requirement of present law. However, these rules are quite complicated and the failure to comply may result in a taxable transaction. Additionally, these rules impose compliance burdens and additional costs to taxpayers.

Legislative background

The like-kind exchange provisions were originally enacted in the Revenue Act of 1921 and have remained largely unchanged since the early 1920's. The Tax Reform Act of 1984 added the provisions regarding deferred exchanges in response to the case of *Starker v. United States* [524] that allowed a 5-year period to acquire the replacement property. The Omnibus Budget Reconciliation Act of 1989 added rules preventing certain related party exchange transactions to be used to avoid gain recognition. The definition of like-kind property has been modified legislatively to address issues relating to targeted types of property.

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[522] Rev. Proc. 2000-37, 2000-40 I.R.B. 308.

[523] The preamble to the 1991 final regulations under section 1031 stated that regulations would not be applicable to exchanges where the replacement property is acquired prior to the disposition of the relinquished property. T.D. 8346, 1991-1 C.B. 150.

[524] 602 F. 2d 1341 (9th Cir. 1979).

Sources of Complexity

Present law allows taxpayers with an appreciated business or investment asset to dispose of the asset and acquire another like-kind business or investment asset without incurring a tax if the taxpayer complies with a series of complicated rules treating the entire transaction as an exchange. These rules elevate the form of the transaction over its substance. Taxpayers incur additional costs complying with these rules with no resulting non-tax benefit (other than the fees received by the facilitators of the transaction).

Recommendation for Simplification

The Joint Committee staff recommends that a taxpayer should be permitted to elect to "roll over" gain from the disposition of appreciated business or investment property described in section 1031, if like-kind property is acquired by the taxpayer within 180 days before or after the date of disposition (but not later than the due date of the taxpayer's income tax return). The determination of whether properties are considered to be of a like kind would be the same as under present law.

The recommendation would reduce complexity by allowing taxpayers wishing to reinvest the proceeds from the sale of business or investment property into other like-kind property to do so directly without engaging in complicated "exchanges" designed to meet the statutory and regulatory rules regarding deferred exchanges.

Although this recommendation would permit a taxpayer to receive the funds for the period of time between the sale of the property and the purchase of the replacement property or to acquire the replacement property prior to the disposition of the relinquished property, the substance is not significantly different than using a "qualified intermediary" or "qualified exchange accommodation arrangement" in accordance with the rules under the regulations or revenue procedure. Eliminating these intermediary arrangements will permit taxpayers to simplify these transactions and to reduce transaction costs.

Under the recommendation, gain would be recognized to the extent any proceeds are not reinvested in eligible replacement property. For example, assume a calendar year taxpayer on December 1, 2001, sells for $100,000 investment land A with a basis of $40,000, and purchases investment land B for $90,000 on February 1, 2002. The taxpayer would be required to recognize $10,000 of gain on December 1, 2001. The remaining $50,000 of gain would be deferred until the taxpayer disposes of land B in a taxable sale or exchange.

Although present-law section 1031 does not permit the taxpayer to receive sales proceeds without the recognition of taxable gain, other provisions do permit such receipt, while deferring gain recognition, if qualified replacement property is acquired during the required time frame. For example, both section 1033, regarding involuntary conversions, and section 1034 (prior to its repeal), regarding rollover gain on sale of a principal residence, permitted the deferral of gain recognition upon the receipt of sales proceeds, without the complexity of "intermediaries." In addition, recently-enacted sections 1044 and 1045, regarding rollover of publicly traded securities gain into specialized small business investment companies, and rollover of gain from

qualified small business stock to another qualified small business stock, respectively, permit taxpayers to receive sales proceeds without current recognition of gain if the reinvestment requirements are satisfied.

2. Property held for use in trade or business or held for investment in a like-kind exchange

Present Law

In general

An exchange of property, like a sale, generally is a taxable transaction. However, present law provides that no gain or loss is recognized if property held for productive use in the taxpayer's trade or business, or property held for investment purposes, is exchanged for property of a like kind that is also held for productive use in a trade or business or for investment.[525] This provision does not apply to exchanges of stock in trade or other property held primarily for sale, or to stocks, bonds, partnership interests, choses in action, certificates of trust or beneficial interest, other securities or evidences of indebtedness or interest, or to certain exchanges involving livestock or involving foreign property.

Property held for productive use in trade or business or held for investment

The nonrecognition of gain applies only if property held for productive use in the taxpayer's trade or business, or property held for investment purposes, is exchanged for property of a like kind that is also held for productive use in a trade or business or held for investment (the "holding requirement"). There is significant uncertainty as to whether a taxpayer satisfies the holding requirement when property involved in a like-kind exchange is received shortly before, or transferred shortly after, the exchange by the taxpayer (e.g. distribution of property from a partnership followed by the taxpayer's exchange of such property for like-kind property or contribution by the taxpayer of property received in an exchange to a corporation immediately after the exchange).

The IRS has ruled that a taxpayer's contribution of property received in a like-kind exchange to a controlled corporation immediately after the exchange does not satisfy the holding requirement of section 1031.[526] Similarly, the IRS has ruled that a taxpayer's exchange of property that it received immediately prior to the exchange (as part of a tax-free liquidation of a wholly-owned corporation) does not satisfy the holding requirement.[527] Additionally, numerous cases have held that the intent of the taxpayers at the time of the exchange to liquidate the

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[525] Sec. 1031.

[526] Rev. Rul. 75-292, 1975-2 C.B. 333.

[527] Rev. Rul. 77-337, 1977-2 C.B. 305. See also Rev. Rul. 77-297, 1977-2 C.B. 304 (providing that an acquisition of property solely for the purpose of exchanging such property for like kind property does not meet the holding requirement of section 1031).

replacement property prevents the exchange from satisfying the holding requirement of section 1031.[528]

In slightly different factual situations, courts have concluded that taxpayers have satisfied the holding requirement of section 1031. For example, a taxpayer's contribution of an undivided interest in real property to a general partnership immediately following the receipt of such property by the taxpayer as part of a like-kind exchange was considered to satisfy the holding requirement.[529] The court concluded that the taxpayer both intended to and in fact did continue to hold the acquired property, the contribution to the partnership being a change in the form of ownership rather than a liquidation of ownership. Similarly, a liquidation of a wholly-owned corporation (under old section 333) followed shortly by an exchange of the property received in liquidation for like-kind property satisfied the holding requirement when the plan of liquidation was adopted without an intent by the shareholder to subsequently exchange the property.[530] The court held that if a taxpayer owns property and does not intend to liquidate or to use the property for personal pursuits, then the property is treated as satisfying the holding requirement.

More recently, the IRS concluded in a letter ruling that a taxpayer's liquidation into its parent company (under section 332), followed by the parent's merger (under section 368(a)(1)(A)) into another corporation shortly after taxpayer's receipt of replacement property, will not affect whether the holding requirement is met.[531] Based on section 381, the ruling concluded that for purposes of section 1031(a)(1) there is a carryover of tax attributes to the acquiring corporation following both a section 332 liquidation and section 368(a)(1)(A) reorganization. Thus, if the taxpayer (i.e., the surviving corporation after the liquidation and merger) satisfies the holding requirement, the exchange is eligible for section 1031 treatment.

Sources of Complexity

Under present law, there is significant confusion and uncertainty as to whether a taxpayer satisfies the holding requirement when property involved in a like-kind exchange is received by the taxpayer shortly before, or transferred shortly after, an exchange. The case law and administrative guidance indicates that alternative analyses have been used in making the determination of whether the holding requirement is satisfied. The uncertainty causes complexity for taxpayers in compliance and can result in unnecessary additional costs.

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[528] *See Regals Realty Co. v. Commissioner*, 127 F.2d 931 (2nd Cir. 1942) (intent to sell); *Click v. Commissioner*, 78 T.C. 225 (1982) (intent to give as gift); *Lindsley v. Commissioner*, T.C. Memo 1983-729 (intent to give to charity).

[529] *Magneson v. Commissioner*, 753 F.2d 1490 (9th Cir. 1985), aff'g 81 T.C. 767 (1983).

[530] *Bolker v. Commissioner*, 760 F.2d 1039 (9th Cir. 1985), aff'g 81 T.C. 782 (1983). See also *Bonny B. Maloney and Robert S. Maloney v. Commissioner*, 93 T.C. 89 (1989) (providing that an exchange by a corporation of property for other like kind property followed by a liquidation under old section 333 satisfies the requisite requirements of section 1031).

[531] PLR 9850001.

Recommendation for Simplification

The Joint Committee staff recommends that, for purposes of determining whether property satisfies the holding requirement under the section 1031 like-kind exchange rules, a taxpayer's holding period and use of property should include the holding period of and use of property by the transferor, in the case of property: (1) contributed to a corporation or partnership in a transaction described in section 351 or 721; (2) acquired by a corporation in connection with a transaction qualifying as a reorganization under section 368; (3) distributed by a partnership to a partner; or (4) distributed by a corporation in a transaction to which section 332 applies. In addition, the Joint Committee staff recommends that property whose use changes should not qualify for like-kind exchange treatment unless it is held for productive use in a trade or business or investment for a specified period of time.

The proposal focuses the holding requirement on the use of the property rather than the legal form in which the property is owned. Focusing on the use of the property would allow taxpayers to avoid engaging in transactions solely to meet the holding requirement under current law. Rather, taxpayers could structure their trade or business or investments in the most efficient manner, but would qualify for exchange treatment only if the property is to be held for productive use in a trade or business or held for investment. The proposal also would reduce complexity by removing the confusion and uncertainty under section 1031 with respect to whether a taxpayer is considered to hold property for productive use in a trade or business or for investment when the property has been recently transferred.

Additionally, under the proposal, property whose use changes would not qualify for like-kind exchange treatment unless it is held for productive use in a trade or business or for investment for a specified period of time. This requirement would prevent (1) relinquished property from being converted from personal use to investment (or trade or business) use shortly before an exchange, or (2) replacement property from being converted from investment (or trade or business) use to personal use shortly after an exchange.

B. Low-Income Housing Tax Credit

Present Law

The Code provides a tax credit to owners of certain qualified low-income rental housing. This credit is payable over ten years however, the property must satisfy the credit requirements for at least a 15-year period (the "initial compliance period"). At the end of the initial compliance period, the owners of the property must: (1) satisfy the credit requirements for an additional 15-year period but may apply for a second credit allocation from the allocating agency; or (2) allow either the tenants or a non-profit organization an opportunity to purchase the property under a mandatory right of first refusal. The purchasers under this right of first refusal have the option to apply separately for the credit.

Sources of Complexity

The difference between the payout period and compliance period for the credit requires complex recapture rules. Conforming the payout period (10 years) to the compliance period (15 years) would eliminate the need for the recapture rules.

Recommendation for Simplification

The Joint Committee staff recommends conforming the payout period to the initial compliance period under the low-income housing credit.

The payout period should be lengthened to 15 years while retaining the present-value calculation. In this way, the present value for the low-income housing credit tax benefit would remain the same.

The present-law recapture rules require the measurement of the accelerated portion of the low-income housing credit claimed by a taxpayer. The accelerated portion of the tax benefit is recaptured in the event of a disposition of the property (or the taxpayer's interest therein) prior to the end of the initial compliance period. The accelerated portion is the amount claimed in excess of the amount that would have been claimed by the taxpayer if the credit were computed on a pro-rata basis over the 15-year initial compliance period. For example, if a taxpayer is eligible for a $150 low-income housing credit with respect to a property, the taxpayer must calculate both the accelerated portion of the credit and the portion of the credit that would have been allowable under a 15-year pro rata allocation. The pro rata portion is computed by dividing the total credit by the initial compliance period ($150/15 years= $10 annually). Therefore, if the taxpayer disposes of the property at the end of the tenth year, the taxpayer must recapture $50 of credit ($150- $100). The $100 amount is the amount of the credit that would have been allowed on a pro rata basis times the number of years of compliance (10 times $10).

The recommendation would eliminate the calculation under the present-law recapture rules in favor of a simpler pro rata rule. The recommendation would also change the calculation of the present value of the stream of tax benefits to take into account the longer stream of payments. Therefore, the taxpayer would be held harmless in a present-value sense despite the longer payout period. In the example above, the total credit would be increased from $150 to a higher amount based upon the present-value calculation already in the statute.

C. Rehabilitation Tax Credit

Present Law

Present law provides a two-tier tax credit for rehabilitation expenditures.

A 20-percent credit is provided for rehabilitation expenditures with respect to a certified historic structure. For this purpose, a certified historic structure means any building that is listed in the National Register, or that is located in a registered historic district and is certified by the Secretary of the Interior to the Secretary of the Treasury as being of historic significance to the district.

A 10-percent credit is provided for rehabilitation expenditures with respect to buildings first placed in service before 1936. The pre-1936 building must meet certain requirements in order for expenditures with respect to it to qualify for the rehabilitation tax credit. In the rehabilitation process, certain walls and structures must have been retained. Specifically, (1) 50 percent or more of the existing external walls must be retained in place as internal or external walls, (2) 75 percent or more of the existing external walls of the building must be retained in place as internal or external walls, and (3) 75 percent or more of the existing internal structural framework of the building must be retained in place. Further, if the building has been substantially rehabilitated, it must have been placed in service before the beginning of the rehabilitation. A building is treated as having been substantially rehabilitated only if the rehabilitation expenditures during the 24-month period selected by the taxpayer and ending within the taxable year exceed the greater of (1) the adjusted basis of the building (and its structural components), or $5,000.

When the rehabilitation credit was enacted, it applied both to buildings that were old (20 years old, as enacted), and to buildings that were certified historic structures. The wall-retention requirement was stated to be for the purpose of preventing new construction or enlargement of an existing building to be treated as rehabilitation.[532] When changes were made to the rehabilitation credit in 1986,[533] the wall-retention requirement ceased to apply to the rehabilitation of certified historic structures.[534]

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[532] *See* Joint Committee on Taxation, *General Explanation of the Revenue Act of 1978* (JCS-7-79), March 12, 1979, 157-158.

[533] Intervening changes had been made in 1981 to make the credit a three-tier credit: 15 percent for nonresidential buildings at least 30 years old, 20 percent for nonresidential buildings at least 40 years old, and 25 percent for certified historic structures. *See* Joint Committee on Taxation, *General Explanation of the Economic Recovery Tax Act of 1981* (JCS-71-81), December 29, 1981, 111-116. In 1986, the credit was changed again to a two-tier credit as under present law. *See* Joint Committee on Taxation, *General Explanation of the Tax Reform Act of 1986* (Pub. Law No. 99-514), May 4, 1987, 148-152.

[534] The legislative history to the 1986 Act did, however, state that rehabilitations of certified historic structures "must continue to be true rehabilitations, however, and not substantially new construction. Therefore, the Secretary of the Interior is expected to continue

Sources of Complexity

The detailed rules relating to retention of minimum percentages of walls and structural components, and minimum rehabilitation expenditures over a particular period under the 10-percent credit provide a potential trap for the unwary, and add significant complexity to the tax law. The 10-percent credit imposes documentation and record-keeping requirements upon taxpayers, as well as requiring an assessment of which walls and structural components to retain. None of these rules are applicable under the 20-percent credit, which requires only that the rehabilitated building be a certified historic structure. Further, the category of buildings placed in service before 1936 likely includes many buildings that are certified historic structures, creating duplication. Considerable simplification could be achieved by eliminating the 10-percent credit, and retaining only the 20-percent rehabilitation credit.

Recommendation for Simplfication

The Joint Committee staff recommends that the 10-percent credit for rehabilitation expenditures with respect to buildings first placed in service before 1936 should be repealed. Thus, the rehabilitation credit would not be a two-tier credit, but rather, would provide only a 20-percent credit with respect to certified historic structures.

The proposal would achieve simplification in two respects. First, the rehabilitation credit would be made conceptually simpler by targeting it solely to buildings that have been certified as historic, rather than permitting two unrelated yet potentially overlapping categories of buildings -- old ones and historic ones -- to qualify for two different levels of credit. Second, complexity would be reduced by eliminating 10-percent credit's additional record-keeping burden, as well as its wall-retention requirements which impose limitations on how the renovation construction is done.

Some might argue that the repeal of the 10-percent credit would represent a significant policy shift extending beyond the goal of simplification. The 10-percent credit arguably serves a social policy goal that is distinguishable from that of the 20-percent credit, namely, to promote efficient use of existing building stock by rehabilitating old buildings rather than wastefully tearing them down and rebuilding at greater cost. The purpose stated for providing the credit when it was first enacted in 1978 to address a "concern about the declining usefulness of existing older buildings throughout the country, primarily in central cities and older neighborhoods of all communities. . . . The Congress believed that it was appropriate now to extend the initial policy objective of the investment credit to enable business to rehabilitate and modernize existing

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generally to deny certification to rehabilitations if less than 75 percent of the external walls are retained in place." *See* Joint Committee on Taxation, *General Explanation of the Tax Reform Act of 1986*, *supra*, at 151; S. Rep. 99-313 (May 29, 1986) at 754-755.

structures."[535] It could be argued that limiting the credit to certified historic structures would narrow its function inconsistently with its original purpose.

On the other hand, it could be argued that the 10-credit duplicates the function of the 20-percent credit in a less efficient, more burdensome manner both for taxpayers, and for tax administration. This is particularly true since 1986, when the credit for old buildings that were not certified historic structures was limited to buildings placed in service before 1936 (then, buildings at least 50 years old, and in 2001, buildings at least 65 years old). Thus, repealing the 10-percent credit would not be such a significant policy change as it might have been to eliminate the credit for non-historic buildings in the form it was originally enacted in 1978. At that time, non-historic structures had only to be at least 20 years old. The credit for non-historic buildings as enacted in 1978 probably included significant building stock that would not have constituted certified historic structures. As the building age requirement of the current 10-percent credit has increased through legislative change and by the passage of time, arguably it would not represent a significant policy shift to eliminate the 10-percent credit.

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[535] *See* Joint Committee on Taxation, *General Explanation of the Revenue Act of 1978* (JCS-7-79), March 12, 1979, 155.

D. Orphan Drug Tax Credit

Present Law

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

Sources of Complexity

The approval of a drug for human clinical testing and designation as a potential treatment for a rare disease or disorder require separate reviews within the Food and Drug Administration. As a result, in some cases, a taxpayer may be permitted to begin human clinical testing prior to a drug being designated as a potential treatment for a rare disease or disorder. In such situations the taxpayer must bifurcate those expenses occurring prior to and after designation as a qualifying drug. This complicates record keeping both for purposes of the credit and for purposes of any deduction allowed for clinical testing expenses.[536]

Recommendation for Simplification

The Joint Committee staff recommends that the Congress should expand the definition of qualifying expenses to include those expenses related to human clinical testing incurred after the date on which the taxpayer files an application with the Food and Drug Administration for designation of the drug under section 526 of the Federal Food, Drug, and Cosmetic Act as a potential treatment for a rare disease or disorder. As under present law, the credit could be claimed only for such expenses related to drugs designated as a potential treatment for a rare disease or disorder by the Food and Drug Administration in accordance with section 526 of such Act.

The Food and Drug Administration is required to approve drugs for human clinical testing. Such approval creates a unique starting point from which human clinical testing expenses can be measured. The proposal would reduce complexity by treating all human clinical trial expenses in the same manner for purposes of the credit and any allowable deduction.

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[536] Under section 280C, no deduction is allowed for an amount equal to the credit claimed for the tax year. Similar reduction occurs in any amount that the taxpayer charges to the capital account.

E. Work Opportunity Tax Credit and Welfare-To-Work Tax Credit

Present Law

Work opportunity tax credit

Calculation of the credit

The work opportunity tax credit is available on an elective basis for employers hiring individuals from one or more of eight targeted groups.[537] The credit equals 40 percent (25 percent for employment of 400 hours or less) of qualified first-year wages. Generally, the maximum credit per employee is $2,400 (40 percent of the first $6,000 of qualified first-year wages). With respect to qualified summer youth employees, the maximum credit is $1,200 (40 percent of the first $3,000 of qualified first-year wages).

Qualified wages

Generally, qualified first-year wages are qualified wages (not in excess of $6,000) attributable to service rendered by a member of a targeted group during the one-year period beginning with the day the individual began work for the employer. Generally qualified wages are defined as cash wages paid by the employer to a member of a targeted group. 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) certain families eligible to receive benefits under the Temporary Assistance for Needy Families 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 qualified wages paid to employees who work less than 120 hours in the first year of employment.

Coordination of the work opportunity tax credit and the welfare-to-work tax credit

An employer cannot claim the work opportunity tax credit with respect to wages of any employee on which the employer claims the welfare-to-work tax credit.

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[537] Sec. 51.

Other rules

The work opportunity tax credit is not allowed for wages paid to a relative or dependent of the taxpayer. Similarity wages paid to replacement workers during a strike or lockout are not eligible for the work opportunity tax credit. Wages paid to any employee during any period for which the employer received on-the-job training program payments with respect to that employee are not eligible for the work opportunity tax credit. The work opportunity tax credit generally is not allowed for wages paid to individuals who had previously been employed by the employer. In addition, many other technical rules apply.

Welfare-to-work tax credit

Calculation of the credit

The welfare-to-work tax credit is available on an elective basis to employers of qualified long-term family assistance recipients during the first two years of employment.[538] The maximum credit is 35 percent of the first $10,000 of qualified first-year wages and 50 percent of the first $10,000 of qualified second-year wages. The maximum credit is $8,500 per qualified employee.

Qualified wages

Qualified first-year wages are defined as qualified wages (not in excess of $10,000) attributable to service rendered by a member of the targeted group during the one-year period beginning with the day the individual began work for the employer. Qualified second-year wages are defined as qualified wages (not in excess of $10,000) attributable to service rendered by a member of the targeted group during the one-year period beginning immediately after the first year of that individual's employment for the employer.

Qualified wages for purposes of the welfare-to-work tax credit are defined more broadly than the work opportunity tax credit. Unlike the definition of wages for the work opportunity tax credit which includes simply cash wages, the definition of wages for the welfare-to-work tax credit includes cash wages paid to an employee plus amounts paid by the employer for: (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 employer's deduction for wages is reduced by the amount of the credit.

Targeted group eligible for the credit

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 such family assistance for a total of at least 18 months (whether or not consecutive) after August 5, 1997 (the date of enactment of the welfare-to-work

[538] Sec. 51A.

tax 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.

Minimum employment period

No credit is allowed for qualified wages paid to a member of the targeted group unless they work at least 400 hours or 180 days in the first year of employment.

Coordination of the work opportunity tax credit and the welfare-to-work tax credit

An employer cannot claim the work opportunity tax credit with respect to wages of any employee on which the employer claims the welfare-to-work tax credit.

Other rules

The welfare-to-work tax credit incorporates directly or by reference many of these other rules contained on the work opportunity tax credit.

Sources of Complexity

Employers of members of the targeted groups must comply with two different though very similar sets of rules to determine the amount of their work opportunity tax credit and welfare-to-work tax credit. Some large employers may be eligible for one or both credits with respect to a fraction of their employees, yet fail to claim the credits due to their complexity. Also, most small employers do not claim either credit. While the certification process may account for much of the perceived complexity of the two credits, the other differences in the credit requirements (e.g., definition of qualified wages and minimum employment rules) probably act as a disincentive to employer participation. The fact that so many members of one or more targeted groups under the work opportunity tax credit also qualify as qualified long-term family assistance recipients only exacerbates this problem. In that instance, an employer must calculate both the work opportunity tax credit and welfare-to-work tax credit with respect to that employee to determine which credit is most advantageous to claim on the first year of employment for that individual.

Combining the credits and harmonizing the rules would eliminate burdensome calculations and often-duplicative compliance responsibilities. Each employer would be able to look to a uniform set of rules with regard to the employment of members of any of the targeted groups.

Recommendation for Simplification

The Joint Committee staff recommends that the work opportunity tax credit and welfare-to-work tax credit should be combined.

Table 18, below, summarizes the provisions of present law relating to the work opportunity tax credit and the welfare-to-work tax credit and the proposed combined credit. The

combined credit should apply to qualified employment of members of one or more of the eight targeted groups eligible for the work opportunity tax credit or the targeted group eligible for the welfare-to-work tax credit (the qualified long-term family assistance recipients). The combined credit should provide a uniform maximum credit for qualified first-year employment of a member of any of the nine targeted categories. Also, the combined credit could provide a credit for qualified second-year employment in appropriate circumstances.

The definition of qualified wages for purposes of the combined credit should adopt the definition in the present-law welfare-to-work tax credit. Specifically, qualified wages should be cash wages paid to an employee plus amounts paid by the employer for: (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 present-law definitions of qualified first-year wages and qualified second-year wages currently applicable for the respective targeted groups should be retained. Also, the employer's deduction for wages should continue to be reduced by the amount of the credit.

The minimum employment period for the combined credit should be made uniform for members of all nine targeted groups.

Table 18.--Summary Of Targeted Employment Tax Credits

Provision	Eligibility	Targeted Groups	Maximum First-Year Credit	Maximum Second-Year Credit	Rules for Short-Term Employees	Definition of Qualified Wages
Work Opportunity Tax Credit	Employers of individuals who are members of one or more of eight targeted groups.	The eight targeted groups are: (1) certain 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.	The maximum credit equals $2,400 (40% of the first $6,000 of qualified first-year wages). In the case of qualified summer youth employees, the maximum credit is $1,200 (40% of the first $3,000 of qualified first-year wages).	None	No credit is allowed for qualified wages paid to employees that work less than 120 hours in the first year of employment. For employees that work at least 120 hours but less than 400 hours in the first year of employment, the credit percentage is reduced from 40% to25%.	Generally, qualified wages are defined as cash wages paid by the employer to a member of a targeted group.
Welfare-to-Work Tax Credit	Employers of individuals who are members of a single targeted group.	The targeted group is composed of qualified long-term family assistance recipients (i.e., members of certain families receiving TANF benefits on a	The maximum credit equals $3,500 (35% of the first $10,000 of qualified first-year wages).	The maximum credit equals $5,000 (50% of the first $10,000 of qualified second-year wages).	No credit is allowed for qualified wages paid to an employee unless that employee works for at least 400 hours or 180	Generally, qualified wages includes the work opportunity tax credit definition of wages plus amounts paid by the employer for:

Table 18.--Summary Of Targeted Employment Tax Credits

Provision	Eligibility	Targeted Groups	Maximum First-Year Credit	Maximum Second-Year Credit	Rules for Short-Term Employees	Definition of Qualified Wages
		long-term basis).			days in the first year of employment.	(1) educational assistance excludible under a section 127 program; (2) certain health plan coverage for an employee; and (3) dependent care assistance excludible under section 129.
Proposed Combined Credit	Employers of individuals who are members of one or more of the nine targeted groups.	The combined credit would apply to qualified wages paid to members of any of the nine targeted groups eligible for the work opportunity tax credit and welfare-to-work tax credit, respectively.	The maximum credit would be made uniform. Options include: (1) using the work opportunity tax credit maximum in all cases; (2) using the welfare-to-work tax credit maximum in all cases; or (3) using some other percentage.	If the second year credit is retained, then a decision whether to retain the present-law welfare-to-work tax credit maximum or apply another maximum credit calculation must be made.	A uniform rule would be applied for short-term employment of members of one or more of the nine targeted groups. Options include: (1) using the work opportunity tax credit rules; (2) using the welfare-to-work tax credit rules, or (3) creating a new rule.	The combined credit would use the expanded definition of qualified wages from the welfare-to-work tax credit.

F. Indian Employment Tax Credit

Present Law

Businesses may claim an employment tax credit for certain wages and health insurance costs incurred for employees who are qualified members of an Indian tribe.[539] The tax credit equals 20 percent of the excess of eligible qualified wages and health insurance costs (up to the first $20,000 of such costs) that an employer paid or incurred during the tax year over the amount of these costs that an employer paid or incurred during 1993.

The term "qualified wages" means wages paid or incurred by an employer for services performed by a qualified employee. Qualified wages do not include wages attributable to service rendered during the one-year period beginning with the day the individual begins work for the employer if any portion of such wages is taken into account in determining the work opportunity tax credit under section 51.

Qualified health insurance costs include any amount paid or incurred by an employer for health insurance to the extent such amount is attributable to coverage provided to a qualified employee.

The requirements for a qualified employee are that (1) substantially all of the services performed by the employee are performed within an Indian reservation, and (2) the employee lives on or near the reservation in which the services are performed and (3) the employee is an enrolled member of an Indian tribe or the spouse of an enrolled member. Individuals receiving more than $30,000 (inflation adjusted) are not qualified employees. Qualified employee also does not include (1) certain related individuals;[540] (2) any five-percent owner;[541] or (3) any individual if the services performed by the individual for the employer involve (i) the conduct of class I, II or III gaming or (ii) are performed in a building housing such gaming activity.[542]

In addition, there are special rules and exceptions that apply when an employee is terminated "before the day 1 year after the day on which such employee began work for the employer," for controlled groups, and for short taxable years.[543]

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[539] Sec. 45A.

[540] *See* sec. 45A(c)(5)(A) (cross-referencing subparagraphs (A), (B), and (C) of sec. 51(i)(1)).

[541] Sec. 45A(c)(5)(B).

[542] Sec. 45A(c)(5)(C).

[543] See sec. 45A(d) and (e).

An employer's deduction otherwise allowed for wages is reduced by the amount of the credit claimed for the taxable year. The credit is not available for taxable years beginning after 2003.

The Indian employment credit is scheduled to expire in 2003.[544]

Sources of Complexity

Present law is complex because the amount of the credit is calculated by reference to amounts paid by the employer or the employer's predecessor in 1993. This requires the maintenance of 1993 records for the 10-year duration of the credit, plus an additional three years in case of an audit of a credit taken in 2003.[545]

Recommendation for Simplification

The Joint Committee staff recommends that the Indian employment credit should be calculated without reference to amounts paid by the employer in 1993.

In addition to the Indian employment credit, the Code contains several other employment credits, including the empowerment zone employment credit, the renewal community employment credit, and the work opportunity tax credit. Like the Indian employment credit, these credits serve to encourage the hiring of certain targeted populations as employees. Unlike the Indian employment credit, these credits do not have a base year amount that must be exceeded before the credit is available.

For example, the empowerment zone employment credit permits a 20-percent credit to employers for the first $15,000 (i.e., a maximum credit of $3,000 per each qualified zone employee) of qualified wages paid to each employee who (1) is a resident of the empowerment zone, and (2) performs substantially all employment services within the empowerment zone in a trade or business of the employer.[546] Similarly, the renewal community employment credit offers a 15-percent wage credit to employers for the first $10,000 of qualified wages paid to each employee who is (1) a resident of the renewal community, and (2) performs substantially all employment services with the renewal community in a trade or business of the employer.[547]

The work opportunity tax credit (sec. 51) is available on an elective basis for employers hiring individuals from one or more of eight targeted groups. The credit generally is equal to 40 percent (25 percent for employment of 400 hours or less) of qualified wages. Generally, no more than $6,000 of wages during the first year of employment is permitted to be taken into account

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[544] H.R. 224, introduced January 3, 2001, would permanently extend the credit.

[545] Generally, the IRS has three years after a return is filed to assess a tax. Sec. 6501(a).

[546] Sec. 1396.

[547] Sec. 1400H.

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 $1,200 (40 percent of up to $3,000 of qualified first-year wages).[548]

The Joint Committee staff believes that simplification would be achieved by eliminating the incremental aspect of the Indian employment credit. The taxpayer claiming the credit would not have to refer to a base year and therefore would not have to retain 1993 business records. The simplification achieved would be more significant if the credit were to be made permanent. If the credit were extended permanently without implementing the Joint Committee staff recommendation, taxpayers would be required to retain the 1993 records indefinitely.

The proposal would more closely conform the credit to other targeted wage credits, such as the empowerment zone employment credit, which do not have base year requirements. To compensate for the absence of a base year computation, the applicable percentage could be adjusted.

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[548] The Code also provides a tax credit to employers on the first $20,000 of eligible wages paid to qualified long-term family assistance recipients during the first two years of employment, the welfare-to-work credit. Sec. 51A. 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. *See* Section VI. E. of this Part, above.

G. Electric Vehicle Credit and Clean Fuel Vehicle Deduction

Present Law

Taxpayers may claim a credit of 10 percent of the cost of an electric vehicle up to a maximum credit of $4,000 (sec. 30). Taxpayers may claim an immediate deduction (expensing) for up to $2,000 for an automobile or light truck and up to $50,000 of the cost of a qualified clean-fuel vehicle which is a truck or van with a gross vehicle weight greater than 13 tons or a bus with a seating capacity of at least 20 adults (sec. 179A).[549] For section 30, a qualified electric vehicle is any motor vehicle powered primarily by an electric motor drawing current from rechargeable batteries, fuel cells, or other portable sources of electrical current. The original use of the vehicle must commence with the taxpayer. For section 179A, a qualified clean-fuel vehicle is any vehicle that meets certain environmental standards, propelled by a clean-burning fuel.[550] The original use of the vehicle must commence with the taxpayer.

A clean-fuel vehicle cannot be any vehicle that is a qualified electric vehicle for purposes of section 30. Thus, for purposes of the deduction permitted under section 179A, electric cars, trucks, vans, or buses are not qualified clean-fuel vehicles if the motor vehicle is powered primarily by electricity. The incremental cost of so-called "hybrid" vehicles may qualify for an immediate deduction under section 179A because electricity is a qualified clean-burning fuel. The retrofitting of a vehicle to be powered primarily by electricity generally would qualify for expensing under section 179A, but may not qualify for the credit under section 30.

The credit under section 30 expires for property placed in service after December 31, 2004. For property placed in service in calendar year 2002, the maximum credit allowed is $3,000. For property placed in service in calendar year 2003, the maximum credit allowed is $2,000. For property placed in service in 2004, the maximum credit allowed is $1,000.

Expensing under section 179A expires for property placed in service after December 31, 2004. For property placed in service in calendar year 2002, the maximum amount on which the taxpayer may claim an immediate deduction is reduced by 25 percent (*e.g.*, to $1,500 in the case of an automobile or light truck). For property placed in service in calendar year 2002, the maximum amount on which the taxpayer may claim an immediate deduction is reduced by 50 percent (*e.g.*, to $1,000 in the case of an automobile or light truck). For property placed in service in calendar year 2004, the maximum amount on which the taxpayer may claim an immediate deduction is reduced by 75 percent (*e.g.*, to $500 in the case of an automobile or light truck).

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[549] In addition, section 179A permits expensing of up to $100,000 of clean-fuel vehicle refueling property per location.

[550] Clean fuels comprise natural gas, liquefied natural gas, liquefied petroleum gas, hydrogen, electricity, and any other fuel at least 85 percent of which is one or more of methanol, ethanol, any other alcohol, or ether.

Sources of Complexity

While it generally is clear under present law what property qualifies for the deduction and what property qualifies for the credit these two sections provide disparate tax benefits for different types of clean fuels and, in the case of electricity, depending upon whether the vehicle primarily is powered by electricity or is a hybrid vehicle. The tax credit generally may be claimed by business and non-business taxpayers. The immediate deduction generally may be claimed only by business taxpayers. This disparate treatment for vehicles that otherwise promote the same policy goal of providing transportation with fewer polluting emissions may complicate the taxpayer's choice of such alternative vehicles.

Recommendation for Simplification

The Joint Committee staff recommends that, should Congress choose to extend tax benefits to such reduced emissions vehicles, the tax benefit should be a deduction of qualified expenses related to all such qualifying vehicles.

Fewer tax benefit options for a similar policy goal simplifies the taxpayer's decision. If taxpayers were to choose different vehicles employing different technologies, a single tax benefit applicable to all such vehicles would reduce compliance burdens. The IRS informs the Joint Committee staff that a deduction generally is simpler for taxpayers than the computation of a tax credit.

VII. ACCOUNTING AND COST RECOVERY PROVISIONS

A. Structural Issues Relating to Accounting for Capital Expenditures

Present Law

Current and capital expenditures

Section 162 generally allows a deduction for ordinary and necessary expenses paid or incurred in carrying on any trade or business. A capital expenditure, however, generally is not currently deductible. Capital expenditures generally are recovered over an appropriate period. Section 263 defines a capital expenditure as any amount paid for new buildings or for permanent improvements or betterments made to increase the value of any property or estate. A capital expenditure also includes any amount expended for restoring property or in making good the exhaustion thereof for which an allowance (for depreciation, amortization or depletion) is or has been made. Treasury regulations state that capital expenditures generally include amounts paid or incurred "to add to the value, or substantially prolong the useful life, of property owned by the taxpayer, such as plant or equipment, or to adapt property to a new or different use."[551] Treasury regulations also state that capital expenditures generally include "the cost of acquisition, construction, or erection of buildings, machinery and equipment, furniture and fixtures, and similar property having a useful life substantially beyond the taxable year."[552]

In 1974, the Supreme Court stated that the "purpose of section 263 is to reflect the basic principle that a capital expenditure may not be deducted from current income. It serves to prevent a taxpayer from utilizing currently a deduction properly attributable, through amortization, to later tax years when the capital asset becomes income producing."[553] The courts also have recognized that, although an expenditure may provide some future benefit, the amount of the expenditure may be so small as not to warrant capitalization. For example, a taxpayer was permitted a current deduction for capital costs of less than $500 per item because requiring capitalization would be a significant burden on the taxpayer.[554] Moreover, the court held, any distortion of income would be minimal and that "no provision in the Code is so inflexible as to call for that intractable a result."[555]

In 1992, the Supreme Court again addressed the issue of capitalization. In *INDOPCO v. Commissioner,*[556] the taxpayer, a corporation, incurred legal and professional fees as the result of

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[551] Treas. Reg. sec. 1.263(a)-1(b).

[552] Treas. Reg. sec. 1.263(a)-2(a).

[553] *Commissioner v. Idaho Power Co.*, 418 U.S. 1, 16 (1974).

[554] *Cincinnati, New Orleans & Texas Pacific Ry. Co. v. United States,* 424 F.2d 563 (Ct. Cl. 1970).

[555] *Id.* at 572.

[556] 503 U.S. 79 (1992).

being the target of a friendly acquisition. The Court required the taxpayer to capitalize these fees, because it concluded that the costs created significant long-term benefits. The Court specifically rejected the taxpayer's position that only expenditures that create or enhance a separate and distinct asset are capital expenditures.[557] In addition, the Court stated, "[a]lthough the mere presence of an incidental future benefit -- 'some future aspect' -- may not warrant capitalization, a taxpayer's realization of benefits beyond the year in which the expenditure is incurred is undeniably important in determining whether the appropriate tax treatment is immediate deduction or capitalization."[558]

Depreciation

A taxpayer generally must capitalize the cost of property used in a trade or business. The capitalized cost of business property that is subject to exhaustion, wear and tear, or obsolescence may be recovered over time through allowances for depreciation (sec. 167). Depreciation allowances for tangible property placed in service after 1986 generally are determined under the Modified Accelerated Cost Recovery System of section 168, which provides that depreciation is computed by applying specific recovery periods, placed-in-service conventions, and depreciation methods to the cost of various types of depreciable property. Intangible property acquired after July 25, 1991, generally is amortized under section 197, which provides a 15-year recovery period and applies the straight-line method to the cost of applicable property.

Under the Modified Accelerated Cost Recovery System, depreciable recovery property is divided into ten classes (3-year property, 5-year property, 7-year property, 10-year property, 15-year property, 20-year property, 25-year property, 27.5-year residential rental property, 39-year nonresidential real property, and 50-year railroad grading and tunnel bores). The class life of certain assets is provided by statute. The class life of other personal property is determined by reference to their class lives. The 200-percent declining balance method of depreciation is used for 3-year, 5-year, 7-year and 10-year property; the 150-percent declining balance method is used for 15-year and 20-year property and any property used in a farming business; and the straight-line method is used for other property, including most depreciable property.

Analysis

Current and capital expenditures

The distinction between a capital expenditure and a current expense is important because the former should be deducted only over its useful life, while the latter can be immediately deducted. Immediate deduction of a capital expenditure can significantly reduce a taxpayer's effective tax rate, whereas expenses that are incorrectly classified as capital expenditures can result in the taxpayer being overtaxed on its income in the year of the expenditure.

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[557] The taxpayer's argument was in part based upon its interpretation of the Supreme Court's decision in *Commissioner v. Lincoln Savings & Loan Ass'n*, 403 U.S. 345 (1971), which held that only expenditures that create or enhance a separate and distinct asset are to be capitalized.

[558] *INDOPCO,* 503 U.S. at 87.

Whether an expenditure is deductible or required to be capitalized has been a source of litigation between taxpayers and the Internal Revenue Service for many years.[559] Moreover, this issue arguably has become more visible after the *INDOPCO* decision. Since issuance of that decision, courts have decided more than 25 cases dealing with this issue. In addition, the IRS has issued numerous rulings on this issue. Despite the guidance provided by the IRS and decisions reached by the courts, distinguishing a capital expenditure from a current expense continues to be uncertain and a source of significant disputes.

Under present law, the determination of whether an expenditure is deductible or required to be capitalized is based primarily on the facts and circumstances of each case. The courts and the IRS have used various factors in making such a determination. No one factor is determinative and, consequently, there can be disagreements as to the proper tax treatment of the expenditure. The Supreme Court, recognizing the difficulty in performing such an analysis, stated that "the 'decisive distinctions' between current expense and capital expenditures 'are those of degree and not of kind'..."[560]

The courts also have recognized that, although an expenditure may provide some future benefit, the benefit may not warrant capitalization. In *Encyclopaedia Britannica,* the court stated "[i]f one really takes seriously the concept of a capital expenditure as anything that yields income, actual or imputed, beyond the period ... in which the expenditure is made, the result will be to force the capitalization of virtually every business expense. It is a result courts naturally shy away from. ... It would require capitalizing every salesman's salary, since his selling activities create goodwill for the company and goodwill is an asset yielding income beyond the year in which the salary expense is incurred. The administrative costs of conceptual rigor are too great."[561]

Because of the broad range of expenditures that potentially are capitalizable[562] and the factual nature of such a determination, developing a uniform legislative rule that could be administered objectively or mechanically may not be feasible. The Supreme Court reached such a conclusion in 1933. In discussing whether an item was a capital expenditure or current expense, he stated, "[o]ne struggles in vain for any verbal formula that will supply a ready

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[559] See, e.g., *Deputy v. DuPont*, 308 U.S. 488 (1939); *Welch v. Helvering*, 290 U.S. 111 (1933); *Encyclopaedia Britannica, Inc. v. Commissioner*, 685 F.2d 212 (7th Cir. 1982); *Briarcliff Candy Corp. v. Commissioner*, 475 F.2d 775 (2nd Cir. 1973); *Plainfield-Union Water Corp. v. Commissioner*, 39 T.C. 333 (1962); *LaSalle Trucking Co. v. Commissioner*, T.C. Memo. 1963-274.

[560] *INDOPCO*, 503 U.S. at 86.

[561] *Encyclopaedia Britannica,* 685 F.2d at 217.

[562] The list of expenditures in which capitalization issues have arisen include, for example, repairs and maintenance, investigatory (both internal and external) costs, removal costs, pre-opening costs, process improvement costs, loan origination costs, employee training costs, remediation costs, and package design costs.

touchstone. The standard set up by the statute is not a rule of law; it is rather a way of life. Life in all its fullness must supply the answer to the riddle."[563]

Similarly, because of the vast variety of expenditures that would need to be categorized, an attempt to provide separate rules for different types of expenditures could be unproductive in removing uncertainty. Attempts to create separate rules by legislation for different types of expenditures would be cumbersome at best, and difficult to do fairly and clearly. It is even possible that uncertainty may be increased by the adoption of statutory rules.

On the other hand, certain expenditures are sufficiently similar that they should be treated alike for Federal income tax purposes. Guidance with respect to such expenditures may more appropriately be provided administratively by the Treasury Department rather than through legislative rules, which generally are less detailed than administrative guidance. Administrative guidance can be much more comprehensive than are legislative rules. In addition, administrative guidance generally is more flexible than legislative rules in responding to changing factors that could alter the analysis of whether an expenditure is a current expense or a capital expenditure.

As mentioned above, the IRS has provided significant administrative guidance for specific factual situations.[564] This guidance has provided a significant degree of clarity to taxpayers with respect to similar expenditures. Additionally, the analysis in this guidance has indirectly assisted taxpayers in evaluating the proper treatment of other types of expenditures not specifically addressed in guidance. However, some have argued that the benefits to taxpayers with other types of expenditures are limited because the administrative guidance at times appears to conflict with other administrative guidance and court decisions, thus resulting in some confusion. The fact that some of the guidance may appear to be conflicting is something the Supreme Court recognized as inevitable on this issue. The Court stated, "because each case 'turns on special facts' ... the cases sometimes appear difficult to harmonize."[565] The Court's recognition of this problem may emphasize the need for additional administrative guidance on different types of expenditures to minimize taxpayer and IRS complexities associated with interpreting the existing guidance to expenditures not specifically addressed.

In addition to issuing specific guidance, the Treasury Department could issue more general guidance that may assist taxpayers in evaluating whether an expenditure should be capitalized or deducted. Although significant guidance has been issued in other forms by the Treasury Department, the Treasury Department has not altered its regulatory guidance under

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[563] *Welch,* 290 U.S. at 114.

[564] The IRS has issued some guidance in the form of revenue rulings, but a significant amount of the guidance is in the form of sources that may not be relied upon by other taxpayers (e.g., private letter rulings, field service advice, and technical advice memoranda). Although these sources may not be relied upon, they may give an indication of the current view of the IRS on a particular item.

[565] *INDOPCO,* 503 U.S. at 86.

section 263 since 1958 (except for special rules for railroad rolling stock). The issuance of regulations that address capitalization issues will not resolve the complexity in this area, but it could potentially provide taxpayers and the IRS a standard framework of relevant factors for use in evaluating capitalization issues. It also may assist in limiting the possibility of conflicting analysis in the development of specific non-regulatory administrative guidance. The Treasury Department and IRS 2000 Priority Guidance Plan indicates that proposed regulations under section 162 and section 263 regarding deduction and capitalization of expenditures is a priority.

Based on these concerns, the Joint Committee staff makes no recommendation on this issue. The Joint Committee staff believes that the IRS and Treasury Department should continue to issue guidance regarding capitalization or deduction and to issue such guidance in as timely a manner as practicable.

Depreciation

The present-law depreciation rules require the use of several property class lives and depreciation recovery schedules. Arguably, these rules could be simplified by combining depreciation schedules or modifying property class lives. Moreover, it may be argued that property class lives are outdated. For example, present-law class lives may not properly address modern technological equipment.

In the Tax and Trade Relief Extension Act of 1998,[566] the Congress expressed its concern that the present-law depreciation rules measure income improperly, may create competitive disadvantages, and may result in an inefficient allocation of investment capital in certain cases. The Congress believed that the manner in which recovery periods and methods are determined should be examined to determine if improvements could be made.[567] Thus, the Congress directed the Treasury Department to conduct a comprehensive study of recovery periods and depreciation methods by March 31, 2000.[568]

In July 2000, the Treasury Department issued the study required by the Tax and Trade Relief Extension Act of 1998.[569] In its study, the Treasury Department noted that class lives, for example, often lead to controversies between taxpayers and the government and makes the introduction of new assets or changes in class lives to existing assets difficult.

In the study, the Treasury Department identified some of the concerns associated with modifying the existing depreciation regime. For example, adopting a system based on economic depreciation with indexing for inflation could create new complexities in measuring depreciation deductions from year to year. In addition, modifying the present-law class lives may be an

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[566] Pub. Law No. 105-277 (1998).

[567] H.R. Rep. 105-817 (October 12, 1998), at 53.

[568] Pub. Law No. 105-277, sec. 2022 (1998).

[569] Department of the Treasury, *Report to The Congress on Depreciation Recovery Periods and Methods*, July 2000.

overwhelming project, because it could require an asset-by-asset study in order to determine the class lives of new and existing assets. The Joint Committee staff makes no recommendation as to modifying the overall depreciation regime, or recovery periods or methods for particular classes of assets, because of the inherent policy determinations and factual inquiries involved.

B. Cash Method of Accounting for Small Businesses

Present Law

Section 446

Section 446(c) of the Code generally allows a taxpayer to choose the method of accounting it will use to compute its taxable income if such method clearly reflects the income of the taxpayer. A taxpayer may adopt any one of the permissible methods for each separate trade or business, subject to certain restrictions. Permissible methods include the cash receipts and disbursements method ("cash method"), an accrual method, or any other method (including a hybrid method) permitted under regulations prescribed by the Secretary of the Treasury. The regulations under section 446 require that a taxpayer use an accrual method of accounting with regard to purchases and sales of merchandise whenever section 471 requires the taxpayer to account for such items as inventory.[570]

Section 471

In general, section 471 provides that whenever, in the opinion of the Secretary of the Treasury, the use of inventories is necessary to clearly determine the income of the taxpayer, inventories must be taken by the taxpayer. The regulations under section 471 require a taxpayer to account for inventories when the production, purchase, or sale of merchandise is an income-producing factor in the taxpayer's business.[571]

Section 448

Section 448 generally provides that the cash method of accounting may not be used by any C corporation, by any partnership that has a C corporation as a partner, or by a tax-exempt trust with unrelated business income. Exceptions are made for farming businesses and qualified personal service corporations. Additionally, an exception is provided for C corporations and partnerships that have a C corporation as a partner if the average annual gross receipts of the taxpayer is $5 million or less for all prior taxable years (including the prior taxable years of any predecessor of the entity). In addition, section 448 precludes the use of the cash method of accounting by any tax shelter.

Section 447

A corporation (or a partnership with a corporate partner) engaged in the trade or business of farming must use an accrual method of accounting for such activities unless such corporation (or partnership), for each prior taxable year beginning after December 31, 1975, did not have gross receipts exceeding $1 million. This rule does not apply to a family farm corporation.

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[570] Treas. Reg. sec. 1.446-1(c)(2).

[571] Treas. Reg. sec. 1.471-1.

A family farm corporation (or a partnership with a family corporation as a partner) is required to use an accrual method of accounting for its farming business unless, for each prior taxable year beginning after December 31, 1985, such corporation (and any predecessor corporation) did not have gross receipts exceeding $25 million. A family corporation is one in which 50 percent or more of the stock of the corporation is held by one (or in some limited cases, two or three) families.

Revenue Procedure 2001-10

The IRS has ruled that, as a matter of administrative convenience, a qualifying taxpayer with average annual gross receipts of $1 million or less will be permitted to use the cash method of accounting and will not be required to use an accrual method of accounting for purchases and sales of merchandise.[572] A taxpayer that elects not to account for inventory under section 471 is required to treat such items in the same manner as a material or supply that is not incidental under Treas. Reg. sec. 1.162-3. That regulation requires taxpayers carrying materials and supplies (other than incidental materials and supplies) on hand to deduct the cost of materials and supplies only in the amount that they are actually consumed and used in operations during the tax year.

Sources of Complexity

Present law requires the determination of inventories and the use of an accrual method of accounting whenever the production, purchase, or sale of merchandise is an income-producing factor in the taxpayer's business. Whether an item is considered to be the purchase or sale of merchandise has resulted in litigation between the IRS and taxpayers. Because the court decisions are not entirely consistent, taxpayers in certain situations cannot easily determine whether or not they have merchandise inventory that would require the use of an accrual method of accounting. In some of these cases, the costs and burdens of litigation can be substantial. In addition, the use of an accrual method of accounting, although generally regarded as a more accurate measure of income, subjects many small business taxpayers to complex rules resulting in substantially higher costs of tax compliance to these taxpayers.

Recommendation for Simplification

The Joint Committee staff recommends that a taxpayer with less than $5 million of average annual gross receipts should be permitted to use the cash method of accounting and should not be required to use an accrual method of accounting for purchases and sales of merchandise under section 471. A taxpayer that elects not to account for inventory under section 471 should be required to treat inventory as a material or supply that is deductible only in the amount that it is actually consumed and used in operations during the tax year. The recommendations would not apply to tax shelters and would not alter the rules for family farm corporations.

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[572] Rev. Proc. 2001-10, 2001-2 I.R.B. 272, modifying Rev. Proc. 2000-22, 2000-20, I.R.B. 1008.

Permitting taxpayers with less than $5 million of average annual gross receipts to use the cash method of accounting would provide considerable simplification to such businesses. Many small businesses keep their books and records on the cash method of accounting for financial reporting purposes. A requirement to use an accrual method of accounting for tax purposes may require such businesses to hire outside consultants (e.g., accountants or attorneys) to convert their internal records to an accrual method of accounting or to advise them on the requirements of tax provisions (e.g., inventory capitalization rules or the constructive receipt doctrine). Incurring such costs results in higher tax compliance costs to these taxpayers while providing no substantial benefits to the business.

The Congress recognized this burden in the Tax Reform Act of 1986, which required many taxpayers to switch to an accrual method of accounting, when it stated that "the Congress believes that small businesses should be allowed to continue to use the cash method of accounting in order to avoid the higher cost of compliance which will result if they are forced to change from the cash method."[573] The Joint Committee staff recommendation is consistent with that Congressional intent and provides an objective test to determine if a small business taxpayer qualifies to use the cash method of accounting.[574]

Under present law, disputes have arisen concerning whether supplies and merchandise used in the taxpayer's trade or business are considered a material income-producing factor requiring the use of an accrual method of accounting. These disputes can place a significant economic burden upon many small business taxpayers who must pay legal bills to challenge the IRS in court as well as potential past due taxes, interest and penalties if the court determines that they were not eligible to use the cash method of accounting. Although the recommendation would not eliminate this type of dispute for large taxpayers, it would eliminate it for small taxpayers where the economic burden is arguably greatest.

In making this recommendation, the Joint Committee staff recognizes that the cash method of accounting, compared to an accrual method of accounting, may not reflect as accurately the economic results of a taxpayer's trade or business over a taxable year. Under the cash method of accounting, a taxpayer generally recognizes items of income and expense based on the taxable year in which funds are received or disbursed. This may result in the recognition of income and expense without regard to the taxable year in which the economic events giving rise to the items occurred and a potential mismatching of income with related expenses. Although this potential exists, the Joint Committee staff believes that the proposal minimizes any significant mismatch of income and expense by limiting the proposal to small taxpayers.

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[573] H. Rep. 99-426, (Dec. 7, 1985). See also Joint Committee on Taxation, *General Explanation of the Tax Reform Act of 1986* (JCS 10-87), May 4, 1987.

[574] A proposal similar to the recommendation, but limited to taxpayers with gross receipts less than $2.5 million was contained in H.R. 2614 as passed by the House of Representatives. See H. Rep. 106-1004 (October 26, 2000), at 28. In addition, a proposal to permit a taxpayer with less than $5 million gross receipts to use the cash method of accounting is contained in the *National Taxpayer Advocate's FY 2000 Annual Report to Congress*, Publication 2104 (Rev. 12-2000), at 92.

In addition, the recommendation provides that a taxpayer meeting the average annual gross receipts test is not required to account for inventories under section 471. If a taxpayer does not account for inventory under section 471, the taxpayer is required to treat such inventory in the same manner as a material or supply that is not incidental. Thus, any taxpayer who treats inventory as a material or supply must include in expense the charges for materials and supplies only in the amount that they are actually consumed and used in operation during the taxable year for which the return is made. If a taxpayer elects this treatment, direct and indirect labor costs, production costs, and other costs that would normally be required to be capitalized under either section 471 or section 263A would not be required to be capitalized. The Joint Committee staff believes that requiring capitalization of the materials and supplies while permitting expensing of other associated costs provides a fair tradeoff of the potential mismatch of income and expense.

C. Amortization of Organization Expenditures

Present Law

Section 248 provides that a corporation may elect to amortize organizational expenditures over not less than a 60-month period, beginning with the month in which the corporation begins business. Similarly, section 709 provides that a partnership may elect to amortize organizational expenditures over not less than a 60-month period, beginning with the month in which the partnership begins business. In either case, if an election is not made, organizational expenditures must be capitalized and are recovered only on the disposition or abandonment of the enterprise.

Organizational expenditures can include, for example, legal services incident to the organization of the entity such as drafting the charter or partnership agreements; costs of necessary meetings; and fees paid for other expenses of organization. They do not include expenditures in connection with issuing or selling stock or partnership interests such as commissions, professional fees, registration fees, and printing costs. Such expenditures for raising equity capital are not deductible.

Sources of Complexity

Sections 248 and 709 permit corporations and partnerships, respectively, to elect to amortize organizational expenses. Having two separate code provisions, based on the choice of entity, for the treatment of organization costs is unnecessary. In addition, the existing statutory provisions do not provide for the tax treatment of organizational expenditures incurred with the formation of legal entities that are treated as disregarded entities for Federal income tax purposes (certain single-member limited liability companies).

Recommendation for Simplification

The Joint Committee staff recommends that the rules and requirements to elect to amortize organizational costs should be codified in a single Code provision irrespective of the choice of entity chosen by the taxpayer. In addition, entities that are, or elect to be, disregarded for Federal income tax purposes should be permitted to recover organizational costs over 60 months.

Sections 248 and 709 are parallel provisions designed to permit a taxpayer to amortize organizational expenses over a 60-month period. The regulations under the two sections reflect similar definitions and rules regarding the types of expenditures that qualify as organizational expenses and the methodology for electing to treat such expenses as deferred expenses. Additionally, since the enactment of sections 248 and 709, the Treasury Department has issued regulations permitting a taxpayer to disregard certain entities for Federal income tax purposes (the "check-the-box regulations").[575] The check-the-box regulations permit taxpayers to elect to

[575] Treas. Reg. sec. 301.7701-3.

disregard certain legal entities and instead treat the operation of such an entity as a division of the taxpayer. Arguably, any organizational costs incurred related to a disregarded entity may require capitalization without the benefit of amortization under either section 248 or 709.

The Joint Committee staff recommendation would provide for one provision governing the treatment of organizational costs all types of entities, including legal entities disregarded for Federal income tax purposes.

D. Depreciation--Mid-Quarter Convention

Present Law

The placed-in-service conventions determine the point in time during the year that the property is considered placed in service and direct when depreciation for an asset begins or ends. Statutorily prescribed depreciation conventions for depreciable recovery property include the half-year, mid-month, and mid-quarter conventions.

Half-year convention

The statutory schedules for personal property reflect a half-year convention, which results in a half-year depreciation allowance for the first recovery year, regardless of when property is placed in service during the year. The half-year convention treats all property placed in service during any taxable year (or disposed of during any taxable year) as placed in service (or disposed of) on the mid-point of such taxable year.

Mid-month convention

Using a mid-month convention, real property placed in service or disposed of at any time during a month is treated as having been placed in service or disposed of in the middle of the month. The mid-month convention treats all property placed in service during any month (or disposed of during any month) as placed in service (or disposed of) on the mid-point of such month.

Mid-quarter convention

If the aggregate depreciable basis of certain property that is placed in service during the last three months of any taxable year exceed 40 percent of the aggregate depreciable bases of all property that is placed in service during the entire taxable year, then a mid-quarter convention applies to the property that is placed in service during that taxable year. The mid-quarter convention treats all property placed in service during any quarter (or disposed of during any month) as placed in service (or disposed of) on the mid-point of such quarter. For purposes of the 40-percent limitation, all the members of an affiliated group (within the meaning of sec. 1504 including the rules of sec. 1504(b)) are treated as one taxpayer.[576] Nonresidential real property, residential rental property, and railroad grading and tunnel bores are not subject to the mid-quarter convention, nor is such property (or property placed in service and disposed of during the taxable year) taken into account for purposes of determining whether the mid-quarter convention applies.

Sources of Complexity

The mid-quarter convention requires an analysis of the aggregate depreciable basis of property placed in service during the last three months of any taxable year. This calculation can be complex and burdensome, because it requires taxpayers to wait until after the end of the

[576] Treas. Reg. sec. 1.168(d)-1(b)(5).

taxable year to determine the proper placed-in-service convention to use in calculating depreciation for its assets during the taxable year.

Recommendation for Simplification

The Joint Committee staff recommends that the mid-quarter convention for depreciable property should be eliminated.

Taxpayers with property placed in service during the taxable year must wait until after the end of the taxable year to determine whether to use the half-year convention or mid-quarter convention, because only after the year has ended will such taxpayers know with certainty whether property with 40 percent of the aggregate depreciable basis of all property was placed in service during the last three months of the taxable year. Moreover, because property that was acquired and disposed of during the same taxable year is not considered for purposes of the 40-percent limitation, taxpayers also will not know until after the taxable year whether such property is included in the mid-quarter calculation.

Taxpayers required to account for depreciation under the mid-quarter convention may, in practice, utilize multiple placed-in service conventions throughout the taxable year. For example, a taxpayer may use the half-year convention for personal property in general until it becomes apparent after the end of the taxable year that the mid-quarter convention is required. Thus, such taxpayers would be required to account for depreciation under two placed-in-service conventions.

While advanced software packages may lessen the burden of recordkeeping and calculations required by the mid-quarter convention, taxpayers must nonetheless make such calculations. Complexity would be reduced if taxpayers were required to use only one convention method for such depreciable recovery property. If the mid-quarter convention were eliminated, all taxpayers would be subject to the half-year convention, which provides a one-half year depreciation deduction for all subject property placed in service during the taxable year.

VIII. FINANCIAL PRODUCTS AND INSTITUTIONS

A. Structural Issues Relating to Financial Products and Institutions

Tax treatment of economically similar financial instruments

The present law tax treatment of financial instruments is governed by a patchwork of statutory rules located throughout the Code. Because the various rules have been developed in a piecemeal fashion, they often provide inconsistent tax treatment for economically similar -- or even equivalent -- financial instruments and transactions.[577] Cash flows associated with similar financial instruments are also potentially taxed differently depending upon the categorization of the financial instrument. Even with the array of complex and overlapping tax rules, there are no clear rules for some financial instruments. Moreover, the incremental approach to developing tax rules for financial instruments generally has not kept pace with the maturation of capital markets and the accompanying innovation in the development of hybrid or synthetic financial instruments. In any case, the complexity and inconsistency that characterizes the tax treatment of many financial instruments ultimately can be attributed to the absence of a comprehensive effort to establish a sound framework of fundamental tax rules governing financial instruments. Without a consistent set of basic rules, the tax treatment of financial instruments likely will continue to be plagued with complexity that leads to unpredictable results and a high level of taxpayer selectivity.

The tax treatment of economically similar financial instruments is highly contextual and largely depends upon a superficial classification of the financial instrument, the status of the taxpayer, and the financial market in which the financial instrument is created or traded. Many financial instruments do not fit squarely within any particular category that is governed by specific rules or, alternatively, fit within multiple categories that may be governed by inconsistent rules. As a result, a practical determination of which rules are applicable to a given transaction is often complicated and inexact because the tax rules often draw precise distinctions among economically similar financial instruments. For well-advised taxpayers, the existing rules provide opportunities to structure synthetic financial instruments and transactions that achieve desired tax results with little or no impact on the underlying economics of the instrument or transaction. The rules can also have the unintended effect of encouraging holders and issuers to take inconsistent positions in connection with the same instrument or transaction. The disparate treatment of economically similar financial instruments is of particular concern in analyzing the tax treatment of payment and receipt of investment returns with regard to character, timing and source.

The character of investment returns on financial instruments or transactions is important because of preferential tax rates on capital gains for individual taxpayers and limitations on the

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[577] *See* Taylor & Wollman, *Why Can't We All Just Get Along: Finding Consistent Solutions to the Treatment of Derivatives and Other Problems*, 53 Tax Lawyer 95 (Fall 1999) (stating that "[s]ome of the day-to-day complexity in the tax law results from the accretion over a period of year of different answers to essentially similar problems") [hereinafter "Taylor & Wollman"].

ability to offset capital losses against ordinary income. While section 1221 continues to be the starting point for determining the character of investment returns on financial instruments, the application of section 1221 to financial instruments has largely been superseded by other specific rules.[578] Some of these rules are the product of a narrow policy decision concerning a limited category of financial instruments, while other rules are intended to eliminate an unwarranted tax result with regard to the character of investment returns on particular financial instruments or the status of the taxpayer holding the financial instrument.

The timing of investment returns on financial instruments or transactions has been particularly problematic because of the relative ease with which the design of financial instruments can be tailored to produce a desirable result, or because of asymmetries between or among parties to a financial instrument or transaction. Consequently, numerous specific rules that apply to the timing of investment returns on financial instruments have significantly modified the general principles for the realization of gain or loss (sec. 1001) and the timing of income or deductions (secs. 451 and 461).[579] Although these rules have been developed on a case-by-case basis, they indicate that traditional realization principles can no longer rationally address the tax treatment of investment returns on financial instruments.[580] Consideration could be given to expanding the mark-to-market, accrual, and integration principles that currently apply to financial instruments on a limited basis.[581] However, these rules can themselves be a source of complexity and additional taxpayer compliance burdens.[582] Alternatively,

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[578] *See, e.g.*, sec. 475 (ordinary treatment of mark-to-market gains or losses on dealer securities and commodities and trader commodities); sec. 1236 (ordinary treatment of gains or losses on dealer securities); sec. 1258 (ordinary treatment of gains on conversion transactions); sec. 1260 (ordinary treatment of gains on constructive ownership transactions); sec. 1276 (ordinary treatment of gains on market discount bonds).

[579] *See, e.g.*, sec. 163(e) (original issue discount and applicable high yield discount obligations); sec. 263(g) (straddle costs); sec. 475 (mark-to-market of certain dealer securities); sec. 1091 (wash sales); sec. 1092 (straddles); sec. 1256 (mark-to-market of certain exchange-traded securities); sec. 1259 (constructive sales of appreciated financial positions); sec. 1272 (original issue discount).

[580] *See* Taylor & Wollman at 118-120 (discussing inconsistent timing rules for derivatives).

[581] For fiscal years beginning after June 15, 2000, many companies are now required to mark derivative financial instruments to market for financial reporting purposes because of the implementation of Statement of Financial Accounting Standards No. 133, *Accounting for Derivative Instruments and Hedging Activities*. Statement of Financial Accounting Standards No. 133 generally requires reporting companies to carry derivative financial instruments at fair value and provides special matching rules for hedging activities.

[582] On the other hand, expanding the market-to-market tax rules -- in coordination with certain changes to the hedging tax rules -- could actually reduce the complexity that now exists because of divergences between present law tax rules and Statement of Financial Accounting Standards No. 133.

consideration should be given to establishing a comprehensive set of fundamental rules that would coordinate the tax treatment of financial instruments on the basis of their core components.[583]

Finally, the sourcing and allocation of investment returns on financial instruments or transactions has become increasingly important because of the growth of financial instruments and transactions in international capital markets. In addition to determining the U.S. income tax liability of parties to a financial instrument or transaction, the sourcing of investment returns on cross-border financial instruments is essential for purposes of applying U.S. tax withholding requirements. As they pertain to financial instruments, the sourcing rules have largely become elective because they provide anomalous tax results based upon semantic classifications of financial instruments rather than their underlying economics. For instance, dividend payments on stock are generally sourced to the residence of the payor,[584] while periodic payments on an economically similar notional principal contract involving the same stock is generally sourced to the residence of the recipient.[585] Rationalizing the sourcing and allocation rules to provide more consistent treatment of economically similar financial instruments would mitigate the need to introduce further complexity in order to rectify the high level of taxpayer electivity that exists under the current sourcing rules.[586]

Comprehensive reform of the tax rules pertaining to financial instruments and transactions could provide simplification and consistent treatment of taxpayers in economically similar or equivalent circumstances. However, simplifying these rules would implicate certain tax policy issues beyond simplification. In view of these concerns, the Joint Committee staff makes no recommendations regarding the fundamental tax treatment of financial instruments and transactions.

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[583] Developing component-based rules would likely involve a considerable expansion of bifurcation principles that have previously been applied only in very narrow circumstances. *See, e.g.*, sec. 163(e)(5) (applicable high yield discount obligations), Treas. Reg. Sec. 1.1273-2(h) (investment units); *Farley Realty Corp. v. Commissioner*, 279 F.2d 701 (2d Cir. 1960) (debt instrument with equity rights); *Richmond, Fredericksburg & Potomac R.R. Co. v. Commissioner*, 529 F.2d 917 (4th Cir. 1975) ("guaranteed stock").

[584] Sec. 861(a)(2)(A).

[585] Treas. Reg. secs. 1.863-7(b)(1) and 1.988-4(a).

[586] *See* Taylor & Wollman at 113-118 ("The crucial point is not so much that one set of source rules is better than the other, but simply that with no seeming purpose the rules are different, depending on the instrument that is involved.").

B. Modification of the Straddle Rules

Present Law

A "straddle" generally refers to offsetting positions (sometimes referred to as "legs" of the straddle) with respect to actively traded personal property. Positions are offsetting if there is a substantial diminution in the risk of loss from holding one position by reason of holding one or more other positions in personal property. A "position" is an interest (including a futures or forward contract or option) in personal property. When a taxpayer realizes a loss with respect to a position in a straddle, the taxpayer may recognize that loss for any taxable year only to the extent that the loss exceeds the unrecognized gain (if any) with respect to offsetting positions in the straddle.[587] Deferred losses are carried forward to the succeeding taxable year and are subject to the same limitation with respect to unrecognized gain in offsetting positions.

The straddle rules generally do not apply to positions in stock. However, the straddle rules apply where one of the positions is stock and at least one of the offsetting positions is (1) an option with respect to the stock, (2) a securities futures contract (as defined in section 1234B) with respect to the stock, or (3) a position with respect to substantially similar or related property (other than stock) as defined in Treasury regulations. In addition, the straddle rules apply to stock of a corporation formed or availed of to take positions in personal property that offset positions taken by any shareholder.

When one position with respect to personal property offsets only a portion of one or more other positions (the "unbalanced straddle" problem), the Treasury Secretary is directed to prescribe by regulations the method for determining the portion of such other positions that is to be taken into account for purposes of the straddle rules.[588] To date, no such regulations have been promulgated.

The straddle rules were adopted in 1981 as a measure to address certain tax shelter transactions that were viewed as lacking economic substance. Specifically, Congress was concerned with the use of commodity straddles to defer tax from one year to the next year and to convert short-term capital gain into long-term capital gain (or to convert ordinary income into short- or long-term capital gain), without any significant economic risk. In a simple commodity straddle, the taxpayer takes equal long and short positions in commodity futures contracts with slightly different delivery dates. The two positions are expected to move in opposite directions but with approximately equal absolute changes. By maintaining balanced positions, the taxpayer has minimized (if not eliminated) any risk of loss. At year end, the taxpayer will choose to recognize the loss on the loss leg of the straddle, but not the gain on the gain leg. The taxpayer then will re-enter into a similar offsetting position to hedge its risk with respect to the retained gain leg until such time when the gain leg is recognized in the following year. The loss shelters income in year one. The gain can be aged to be long-term capital gain in year two (thus taxed at

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[587] Sec. 1092.

[588] Sec. 1092(c)(2)(B).

a lower rate), and the taxpayer benefits from the deferral of tax. The straddle rules eliminate this technique.

Sources of Complexity

The effect of the straddle rules with respect to unbalanced straddles (i.e., deferring the loss as long as there is any unrecognized gain in any offsetting position – even if enough gain is recognized to absorb the entire loss) creates an additional level of complexity and uncertainty for taxpayers who must apply the straddle rules. This complexity may not be a necessary component of addressing the abuse that the straddle rules are intended to target. The stock exception in the straddle rules is very complex and, as amended by Congress and interpreted by the Treasury, has become narrow in scope. To the extent that the basic application of the straddle rules is simplified, the stock exception may not be necessary.

Recommendation for Simplification

The Joint Committee staff recommends that the general loss deferral rule of the straddle rules should be modified. Under the new rule, taxpayers would be permitted to identify the offsetting positions that are components of a straddle at the time the taxpayer enters into a transaction that creates a straddle, including an unbalanced straddle.[589] Straddle period losses would be allocated to the identified offsetting positions in proportion to the offsetting straddle period gains and would be capitalized into the basis of the offsetting position.[590] The identified straddle rules of present law would be eliminated.

The Joint Committee staff recommends the elimination of the exception for stock in the definition of personal property. Thus, offsetting positions involving actively traded stock would generally constitute a straddle.[591]

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[589] Additional rules would be necessary to address situations in which a proper identification was not timely made or was inappropriately made.

[590] Physical settlement of a leg of a straddle (such as an option, for example) can be used to circumvent the straddle rules (because there technically is no "loss" to capitalize). It may be helpful in this regard to require that a physically settled leg of a straddle be marked to market immediately prior to settlement. Although this may help rationalize and enforce the straddle rules, it may not be viewed as a simplification. Such a rule could, however, fit within the scope of a broader modernization of the straddle rules that overall produces a simpler, more administrable regime.

[591] In eliminating the stock exception, consideration should be given to (1) whether further guidance is needed as to when risk is substantially diminished such that stock and other positions constitute legs of a straddle, (2) the interaction and continued relevance of section 1233, and (3) whether other "clean up" could be accomplished, such as eliminating the qualified covered call exception.

Identification and capitalization approach

The complexity of the present law straddle rules arises most starkly in situations in which a taxpayer has an unbalanced straddle. The unbalanced straddle problem exists whenever one or more positions offset only a portion of one or more other positions. For example, assume the taxpayer holds two shares of stock (i.e., is long) in XYZ stock corporation: share A with a $30 basis and share B with a $40 basis. When the value of the XYZ stock is $45, the taxpayer pays a $5 premium to purchase a put option on one share of the WYZ stock with an exercise price of $40. The issue arises as to whether the purchase of the put option creates a straddle with respect to share A, share B, or both. Assume that, when the value of the XYZ stock is $100, the put option expires unexercised. Taxpayer incurs a loss of $5 on the expiration of the put option, and sells share B for a $60 gain. On a literal reading of section 1092(a), the $5 loss would be deferred because the loss ($5) does not exceed the unrecognized gain ($70) in share A, which is also an offsetting position to the put option -- notwithstanding that the taxpayer recognized more gain than the loss through the sale of share B. This complexity is exacerbated when the taxpayer has a large portfolio of actively traded personal property that may be offsetting to the loss leg of the straddle.

Aware of this problem, Congress directed the Treasury Secretary to promulgate regulations that prescribe the method for determining the portion of such other positions (i.e., the larger leg) that should be taken into account for purposes of the straddle rules. The legislative history to the Economic Recovery Tax Act of 1981 provides:

> If there is more than one position with unrealized gain which was acquired prior to the loss disposition, which offsets the loss position and which does not belong to an identified straddle, the bill authorizes the Secretary of the Treasury to prescribe regulations for allocating the loss among the unrealized gain in such positions and for allocating unrealized gain among loss positions. The committee intends that allocation of unrealized gain positions to unrealized losses be done in a consistent manner that does not distort income. Regulations issued under this bill should provide that one dollar of unrealized appreciation at the end of any year defer at most only one dollar of realized loss.[592]

Although 20 years have passed since the enactment of section 1092, no such regulations have been issued. The IRS issued a private letter ruling in February 1999, however, which addressed the unbalanced straddle situation.[593] Under the facts of the ruling, a taxpayer entered into a costless collar with respect to a portion of the shares of a particular stock held by the taxpayer.[594] Other shares were held in an account as collateral for a loan and still other shares

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[592] S. Rep. 97-144 (July 6, 1981).

[593] PLR 199925044 (Feb. 3, 1999).

[594] A costless collar generally is the purchase of a put option and the sale of a call option with the same trade dates and maturity dates and set such that the premium paid and the premium received are substantially equal. The collar can be considered as economically similar to a short position in the stock.

were held in excess of the shares used as collateral and the number of shares specified in the collar. The ruling concluded that the collar offset only a portion of the stock consisting of the number of shares specified in the costless collar because the payoff under each option comprising the collar was determined by that number of shares. The ruling further concluded that:

> In the absence of regulations under section 1092(c)(2)(B), we conclude that it is permissible for Taxpayer to identify which shares of Corporation stock are part of the straddles and which shares are used as collateral for the loans using appropriately modified versions of the methods of section 1.1012-1(c)(2) [providing rules for adequate identification of shares of stock sold or transferred by a taxpayer] and or section 1.1092(b)-3T(d)(4) [providing requirements and methods for identification of positions that are part of a section 1092(b)(2) identified mixed straddle].[595]

Although the staff recommendation would require "up front" identification, the recommendation is generally consistent with the approach taken in the private letter ruling. To continue with the above example, assume that at the time the taxpayer purchased the put option, the taxpayer identified it as a straddle of share A. Subsequently, when the value of the XYZ stock is $100, the put option expires unexercised and taxpayer incurs a $5 loss. Under the staff recommendation, the $5 loss would be capitalized into the basis of share A. The basis in share A would become $35. If the taxpayer sells share A for $100, it will have a $65 gain (which can be viewed as representing the net of the $70 straddle period gain on share A and the $5 straddle period loss on the expiration of the unexercised put option). If, instead, share B were sold, then the taxpayer would have $60 gain and the $5 straddle loss would be deferred because it was capitalized into the basis of the identified share. The policy of the straddle rules would seem to be achieved, and the result is consistent with the economics of the straddle – that is, the option contract only hedges one share of stock. Consideration, however, would have to be given to certain safeguards such as (1) additional rules that would apply when a taxpayer fails to properly identify the positions of the straddle on a timely basis, (2) Treasury authority to reclassify improperly or inappropriately identified positions, and (3) a rule that coordinates the staff recommendation with the wash sale rules. In addition, an ordering rule may be necessary that would apply to dispositions of less than an entire lot that has been partially offset in a properly identified straddle.

Elimination of the stock exception

The stock exception from the straddle rules has been severely curtailed by legislative amendment and regulatory interpretation, and may no longer comport with the overall policy objectives of the straddle rules. Under proposed Treasury regulations, the application of the stock exception would be essentially limited to offsetting positions involving direct ownership of stock and short sales of stock.[596] As a result, the stock exception injects significant complexity

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[595] PLR 199925044 (Feb. 3, 1999).

[596] Prop. Treas. Reg. sec. 1.1092(d)-2(c).

into the straddle rules in order to exempt a narrow class of transactions that arguably should be subject to the straddle rules.[597] Although eliminating what remains of the stock exception would result in simplification, consideration would have to be given to providing additional guidance that would clarify when positions are offsetting (i.e., when there is a substantial diminution of risk of loss).

In addition to eliminating the stock exception, consideration could be given to eliminating the qualified covered call exception, which has become significantly more complex in light of recently published Treasury regulations. Also, once stock is clearly covered by section 1092, section 1233 (the short sale rules) would seem to apply only to the very narrow circumstances of short sales involving non-actively traded property. Consideration should be given to the continued necessity of section 1233 if the stock exception to section 1092 is eliminated.

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[597] Keyes, *Federal Taxation of Financial Instruments and Transactions* para. 17.02[3] (2000) ("It is important to note that the application of the straddle rules where stock is involved is one of the most confusing and controversial areas in financial products taxation.").

C. Provide More Uniform Treatment of Interest Charges

Present Law

In general

A number of provisions in the tax law allow tax deferral in the form of income deferral or accelerated deductions. Even though Congress is aware of the deferral opportunities these provisions create, it has retained them for a variety of reasons. For example, Congress enacted the installment sale rules in 1926 to alleviate the liquidity problems that an installment seller may encounter as well as avoid the difficulty of valuing the installment obligation. In the 1980s, Congress became aware of the time value of money benefit of tax deferral but did not repeal the installment sale rules. Instead, Congress enacted an interest charge on sellers of property with a sales price of $5 million or more using the installment method. The interest charge was designed to allow sellers to continue using the installment method but at the same time to eliminate the time value of money benefit of tax deferral.

In other cases, Congress has enacted a specific provision to eliminate the time value of money benefit of a particular transaction. For example, in 1986, Congress enacted the passive foreign investment company rules because it concluded that "eliminating the economic benefit of deferral is necessary to eliminate the tax advantages that U.S. shareholders in foreign investment funds have heretofore had over U.S. persons investing in domestic investment funds."[598] A major component of these rules is an interest charge. In fact, Congress has enacted an interest charge in a number of different areas of the tax laws, including installment sales over $5 million, installment sales of timeshares and residential lots, long-term contracts, income forecast method of depreciation, foreign trusts, constructive ownership transactions, domestic international sales corporations and passive foreign investment companies.[599]

Special rules

Installment sales over $5 million

Generally, if a seller sells property on the installment method and the face amount of all installment obligations that arose and are outstanding at the end of the year exceeds $5 million, then the seller owes interest to the government on the deferred tax liability. The following example illustrates the operation of the interest charge rule for installment sales over $5 million. Assume an individual seller owns land with a basis of $1 million. After owning the land for more than one year, the seller sells it on December 31, 1999, for $10 million with the entire purchase price to be paid in one year's time on December 31, 2000, plus one year's worth of interest. The seller has made an installment sale over $5 million so that the interest charge rule is implicated. At the time of sale in 1999, the seller has $9 million of gain that is not recognized because of the installment sale rules. The seller must pay interest to the government equal to: the

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[598] H. Rep. 99-841 (September 18, 1986), at II-641.

[599] The Treasury Department has also implemented an interest charge regime under section 367. *See* Treas. Reg. secs. 1.367(a)-8 and 1.367(e)-2.

applicable percentage times the deferred tax liability times the underpayment rate. The applicable percentage is 50 percent ($10 million minus $5 million divided by $10 million). The deferred tax liability is $1.8 million ($9 million of unrecognized gain times 20 percent net capital gain rate). The underpayment rate is assumed, for this example, to be 10 percent (assumed underpayment rate in effect on December 1999). The interest owed the government is $90,000 (50 percent times $1.8 million times 10 percent).

Installment sales of timeshares and residential lots

Generally, dealers of timeshares and residential lots are permitted to use the installment method but must pay interest to the government on the taxes deferred through use of this method. The following example illustrates the operation of the interest charge rule for installment sales of timeshares and residential lots. Assume X is an individual who is a dealer in undeveloped residential lots. X sells a lot with a basis of $1,000 and a sales price of $10,000. The face amount of the installment obligation is $10,000. The obligation provides for adequate interest and monthly principal payments of $1,000 for a period of ten months. The date of the sale is June 1, 1999. The first monthly payment is due on July 1, 1999 and on the first day of every month thereafter until satisfied.

No interest is imposed on payments received in year 1999, the year of sale. The first payments on which interest is imposed occur on January 1, 2000. The first payment on which interest is due is received seven whole monthly compounding periods from the date of the sale (June 1, 1999 to January 1, 2000). The gross profit ratio for the sale is 90 percent. Assume in year 2000, X has taxable income of $10,000 unrelated to the installment sale.

X receives a $1,000 payment on January 1, 2000, of which $900 is gain and $100 is recovery of basis. X's total gain on the other three payments received in year 2000 is $2,700. Therefore, X recognizes $3,600 of gain in year 2000 from the June 1, 1999 installment sale. X's tax liability for year 2000 is $2,040 (15 percent rate multiplied by $13,600). X's tax liability determined without regard to the gain on the installment obligation is $1,500. The excess of X's tax liability with regard to the installment payments over its tax liability without regard to such payments is $540. Of this excess, $135 is allocated to and treated as the tax liability attributable to the January 1, 2000 payment on the installment obligation. Therefore, seven months of interest is owed the government on $135 (June 1, 1999 to January 1, 2000). Eight months of interest is owed on the $135 that is allocated to the February 1, 2000 payment, nine months of interest is owed on the $135 that is allocated to the March 1, 2000 payment and ten months of interest is owed on the $135 that is allocated to the April 1, 2000 payment.

Long-term contracts

Generally, on completion of a long-term contract that is reported under the percentage of completion method, the taxpayer will either owe interest to the government or receive interest from the government based on the timing of the income inclusion under the contract. During the life of the contract, the taxpayer reported income based on estimates. At the completion of the contract, the actual figures are known and it is the difference between the estimates and actual figures that leads to the timing discrepancy. This is referred to as the look back rule. For example, assume taxpayer enters into a long-term contract with a contract price of $1,000. The

estimated contract costs are $800. The actual costs in year one are $200 and the actual costs in year two are $500. The contract is completed in year two. Under the percentage of completion method, the taxpayer will report $250 of gross income in year one (25 percent times $1,000) because, at that time, it was estimated that the contract was 25 percent completed ($200 actual costs in year one divided by $800 estimated total costs). The net income in year one is $50 ($250 minus $200).

In year two, gross income is $750 ($1,000 minus $250 reported for year one). The look back rule will apply in year two, the year the contract is completed. The actual costs totaled $700 while the estimated costs were $800. The taxpayer should have reported more income in year one and, as result, will owe interest to the government. The results of year one are recomputed using the actual results. In year one, 28.57 percent of the contract was completed ($200 actual costs in year one divided by $700 total actual costs). Therefore, $285.71 should have been included in gross income in year one rather than $250. The net income in year one would then be $85.71 ($285.71 minus $200). The hypothetical tax on the increase in net income in year one of $35.71 ($85.71 minus $50) will attract one year of interest owed the government. The taxpayer does not pay the hypothetical tax to the government. Rather it is used to determine the interest owed the government. The interest is computed using the overpayment rate.

Income forecast method of depreciation[600]

Generally, taxpayers who use the income forecast method of depreciation will either overstate or understate their depreciation deductions from year to year because the depreciation deductions are based on estimates of future income. At the end of the property's depreciable life, however, the actual figures are known and it is the difference between the estimates and actual figures that leads to the timing discrepancy of the depreciation deductions each year. Under a look-back rule that is applied in the third and tenth taxable years after the taxable year the property is placed in service, the taxpayer must recompute the depreciation deductions each year using actual figures and more accurate estimates.[601] Comparing the recomputed depreciation deductions with the original depreciation deductions will result in hypothetical overpayments or underpayments of tax. The taxpayer does not pay or receive the hypothetical underpayment or overpayment. Rather it is used to determine the interest owed to or by the government. The interest is computed using the overpayment rate.

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[600] The computation of the interest charge under the income forecast method is almost identical to that under the provision for long-term contracts. The major difference is that the look-back rule under the income forecast method occurs during the third and tenth taxable years after the taxable year the property was placed in service. Sec. 167(g)(4). The look-back rule for long-term contracts occurs in the year the contract is completed.

[601] The depreciation deduction in the tenth taxable year after the taxable year the property was placed in service is the adjusted basis of the property as the beginning of that year. Sec. 167(g)(1)(C).

Accumulation distributions from foreign trusts

Generally, a U.S. beneficiary of a foreign non-grantor trust must include an accumulation distribution in income upon receipt. The tax is computed using a special five-year averaging provision and interest owed to the government is computed under a special weighted average rule. The following example illustrates the operation of the interest charge rule for accumulation distributions from foreign trusts. Assume a U.S. beneficiary receives a $150 accumulation distribution from a foreign non-grantor trust in year 2000. The foreign trust has undistributed net income of $100 in 1997, $100 in 1998 and $100 in 1999. The U.S. beneficiary is taxed on the accumulation distribution under a special averaging provision, which generally equals the beneficiary's average marginal tax rate for the previous five years. Once the tax is computed on the $150 accumulation distribution, the interest must also be computed on the tax. In determining the number of years of interest that is owed the government, the U.S. beneficiary calculates a dollar-weighted number of years. It is determined as follows: ($100 undistributed net income from 1997 times three years) plus ($100 undistributed net income from 1998 times two years) plus ($100 undistributed net income from 1999 times one year) divided by $300 (total undistributed net income). This equals two and therefore two years of interest on the tax is owed the government using the underpayment rate.

Constructive ownership transactions

Generally, a taxpayer who enters into a constructive ownership transaction must report part or all of the gain in the transaction as ordinary income. The ordinary income component is allocated to prior years in computing the interest owed to the government. Assume on January 1, 2000, T enters into a three-year notional principal contract in which the securities dealer agrees to pay T, on the settlement date, the amount of any increase in the notional value of an interest in a pass-through entity.[602] This is a constructive ownership transaction. On December 31, 2002, the value of the notional principal contract increased by $200,000, $50,000 of which is net underlying long-term capital gains and $150,000 of which is recharacterized as ordinary income. The recharacterized ordinary income is allocated to year 2000, year 2001 and year 2002 using the applicable Federal rate for purposes of the interest charge. Using an applicable Federal rate of six percent, $47,116.47 will be allocated to year 2000, $49,943.46 is allocated to year 2001 and $52,940.07 is allocated to year 2002. T must determine the tax that would have been paid on $47,116.47 if it were included in income in year 2000. This hypothetical tax will attract two years of interest. T must also determine the tax that would have been paid on $49,943.46 if it were included in income in year 2001. This hypothetical tax will attract one year of interest.

Passive foreign investment companies

Generally, a U.S taxpayer who invests in a foreign investment fund is taxed on the earnings of the fund when a distribution is made or the U.S. taxpayer sells the fund. When an excess distribution is made to the U.S. shareholder, the shareholder must allocate all or a portion of the distribution to prior years in computing the interest owed to the government. The

[602] This example is based on an example in the legislative history. *See*, H. Rep. 106-478 (November 17, 1999), at 161.

following example illustrates the operation of the interest charge rule for passive foreign investment companies. Assume X is a calendar year, domestic corporation. On December 31, 1995, X acquires a share of stock of FC, a foreign corporation, for $500. FC has been a section 1291 fund since FC's taxable year that began January 1, 1996. Generally, a section 1291 fund is a passive foreign investment company in which the shareholder has not elected pass-through treatment under section 1295. On December 31, 1999, X sold the FC stock for $1,000 incurring no foreign tax on the disposition. X's gain on the sale of $500 is taxed as an excess distribution and is allocated pro rata over X's four year holding period. Therefore, $125 is allocated to each year. The $125 allocated to year 1999, the current shareholder year, is included in ordinary income for that year. The allocations to years 1996, 1997, and 1998, the prior passive foreign investment company years, are subject to the interest charge. For example, the $125 allocated to year 1996 is multiplied by the highest corporate tax rate for that year of 35 percent equaling $43.75. This amount attracts interest from March 15, 1997 (due date of the 1996 corporate tax return) to March 15, 2000 (due date of the 1999 tax return). The $125 allocated to year 1997 results in additional tax of $43.75 that will attract two years of interest, and the additional tax of $43.75 in year 1998 will attract one year of interest. The interest charge is computed using the underpayment rate.

Domestic International Sales Corporations

Generally, each shareholder of a domestic international sales corporation must pay interest on an annual basis on the shareholder's domestic international sales corporation related deferred tax liability at the base period T-bill rate. For example,[603] assume P corporation owns all of the stock of D corporation (a domestic international sales corporation). Both corporations are calendar-year taxpayers. At the end of 1998, D has accumulated domestic international sales corporation income of $85,000 and no previously taxed income. During 1999, D has taxable income and earnings of profits of $40,000, deemed distribution of $15,000, domestic international sales corporation income of $25,000 and actual distributions of $60,000. On December 31, 1999, P's domestic international sales corporation related deferred tax liability is equal to P's tax liability if the deferred domestic international sales corporation income were included in P's income for the year less P's actual tax liability for the year. The deferred domestic international sales corporation income is equal to the accumulated domestic international sales corporation income as of December 31, 1998 (the previous year) over the distributions in excess of income for 1999. The accumulated domestic international sales corporation income as of December 31, 1998 is $85,000. The distribution in excess of income for 1999 is $20,000 ($60,000 of actual distributions in 1999 minus zero of previously taxed income as of December 31, 1998 minus $15,000 of deemed distribution in 1999 minus $25,000 of domestic international sales corporation income in 1999). Therefore, deferred domestic international sales corporation income is $65,000 ($85,000 minus $20,000). P must compute its tax liability for 1999 first with and then without the $65,000 amount. The difference in tax liability is the domestic international sales corporation related deferred tax liability. P must pay one year's interest to the government on the domestic international sales corporation related deferred tax liability. This is done annually.

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[603] This example is based on an example in the proposed regulations. *See,* Prop. Reg. sec. 1.995(f)-1(f)(4), Example.

Sources of Complexity

Present law is complicated for several reasons. First, the interest charge is designed to eliminate the time value of money benefit of tax deferral. It is not necessarily designed to penalize the taxpayer for using a particular provision or engaging in a particular transaction. Notwithstanding that there is generally a uniform policy for imposing an interest charge on the deferral of tax, there is no uniform rate imposed under the Code. The disparity of rates used to accomplish basically the same task is itself a source of complexity.

A second problem with the interest charge method is the number of different mechanical computations used by the government. Under the interest charge method, the government views tax deferral as a non-interest bearing loan to the taxpayer. To eliminate the time value of money benefit, the government requires the taxpayer to pay interest on this otherwise non-interest bearing loan. While this principle is quite simple, the government uses a number of different methods in calculating the interest adding needless complexity to the tax laws. Table 19, below, demonstrates the different methods the government uses in charging a taxpayer interest:

Table 19.--Present-Law Interest Charge Methods

Code Section	Description	Interest Rate	Period of Interest	Tax Base for Charge	Collection
453A(c)	Installment Obligations Aggregating $5 Million or More	Underpayment rate for each year	Year of sale to year of payment	Maximum tax rate each year (including capital gain rate) times deferred tax liability[604]	Annually (in advance)
453(l)(3)	Installment Sales of Timeshares and Residential Lots	Applicable Federal rate at time of Sale	Date of sale to the date of payment(s)	Actual (marginal) tax in year of payment(s)	At time of payment(s)

[604] TAM 9853002 (Sept. 11, 1998) (interest charge is computed using the fair market value of a contingent payment installment note; if the amount ultimately collected on the note is determined to be lower, no refund of the interest paid will be made).

Table 19.--Present-Law Interest Charge Methods

167(g)	Income Forecast Method of Depreciation	Overpayment Rate	The year to which the depreciation is recomputed to the recom-putation year (3rd and 10th years after the year the property is placed in service)	Marginal tax in each year to which the depreciation is recomputed	In recomputation year (3rd and 10th year after the property is placed in service)
460(b)	Long-Term Contracts	Overpayment rate for each year	Due date of the year to which the income is recomputed to due date of completion year	Marginal tax in each year to which the income is recomputed	At time of contract completion
668	Distributions from foreign Trusts	Underpayment rate for each year	Year of accumulation to date of distribution	Actual tax under special 5-yr averaging	At time of distribution
1260(b)	Constructive Ownership Transactions	Underpayment rate for each year	The year to which income is allocated to due date for year the transaction closed	Marginal tax in each year to which income is allocated	At time of closing the transaction
1291	Passive Foreign Investment Companies	Underpayment rate for each year	Due date of year to which the income is allocated to due date for year of excess distribution	Maximum tax rate in each year to which income is allocated	At time of excess distribution
995(f)	Domestic International Sales Corporations	Base period T-bill rate	Year of accumulation (based on year prior to dis-tribution) to year of distribution	Marginal tax that would have been paid if currently distributed	Annually

Another source of complexity is the use of different approaches in computing the base for the interest charge. For example, under the passive foreign investment company rules, the excess distribution is ratably allocated over the current and previous years. In 1999, Congress adopted a constant yield to maturity approach (an economically more accurate approach) with respect to constructive ownership transactions in section 1260.

Recommendation for Simplification

The Joint Committee staff recommends that the eight different interest computation schemes should be consolidated into three separate regimes: (1) an annual interest charge rule; (2) a look back rule in which estimates are used; and (3) a look back rule in which the tax is allocated to prior years based on the applicable Federal rate. The interest rate that would be applied in connection with the three separate regimes would be a uniform rate.[605]

The following examples demonstrate the application of each of the rules.

The annual interest charge rule

Assume an individual seller owns land with a basis of $1 million. After owning the land for more than one year, the seller sells it in year 1999, for $10 million with the entire purchase price to be paid in three years' time in year 2002 (with adequate stated interest). The seller has made an installment sale over $5 million so that interest charge rule is implicated. At the time of sale in year 1999, the seller has $9 million of gain that is not recognized because of the installment sale rules. The seller must pay interest to the government equal to: the applicable percentage times the deferred tax liability times the underpayment rate. The applicable percentage is 50 percent ($10 million minus $5 million divided by $10 million). The interest charge attributable to each year (2000, 2001, and 2002) would accrue from the due date of the prior year's tax return to the due date of the current year's tax return. In the above example, the amount of interest charge for each year remains constant because the deferred tax liability amount ($1.8 million) remains unchanged throughout the period.[606]

The look back rule with estimates

Assume taxpayer enters into a long-term contract with a contract price of $1,000. The estimated contract costs are $800. The actual costs in 1999 are $200 and the actual costs in 2000 are $500. The contract is completed in 2000. Under the percentage of completion method, the taxpayer will report $250 of gross income in year 1999 (25 percent times $1,000) because, at that time, it was estimated that the contract was 25 percent completed ($200 actual costs in year one divided by $800 estimated total costs). The net income in 1999 is $50 ($250 minus $200).

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[605] The recommendation does not address the appropriate interest rate or the deductibility of the interest.

[606] The amount of interest charge for each year is $92,250 (assuming an interest rate of ten percent compounded semi-annually).

In 2000, gross income is $750 ($1,000 minus $250 reported for year one). The look back rule will apply in year 2000. The actual costs totaled $700 while the estimated costs were $800. The taxpayer should have reported more income in year 1999 and, as result, will owe interest to the government. The results of year 1999 are recomputed using the actual results. In year 1999, 28.57 percent of the contract was completed ($200 actual costs in year one divided by $700 total actual costs). Therefore, $285.71 should have been included in gross income in year 1999 rather than $250. The net income in year 1999 would then be $85.71 ($285.71 minus $200). The hypothetical tax on the increase in net income in year 1999 of $35.71 ($85.71 minus $50) will attract one year of interest owed the government. The taxpayer does not pay the hypothetical tax to the government. Rather it is used to determine the interest owed the government.

Look-back rule in which tax is allocated to prior years

Assume X, a calendar-year U.S. corporation, acquires a share of stock of FC, a foreign corporation, for $500 on December 31, 1995. FC has been a section 1291 fund since FC's taxable year that began January 1, 1996. On December 31, 1999, X sold the FC stock for $1,000 incurring no foreign tax on the disposition. X's gain on the sale of $500 is taxed as an excess distribution. Assume the tax on the $500 of gain is $175. The tax is allocated over X's four year holding period. Under a constant yield to maturity approach, the $175 tax on the excess distribution will be allocated (using an assumed rate of 10 percent) as follows: $37.70 is allocated to 1996; $41.50 is allocated to 1997; $45.60 is allocated to 1998; and $50.20 is allocated to 1999. The allocations to 1996, 1997, and 1998, the prior passive foreign investment company years, are subject to the interest charge. The interest charge attributable to 1996 (assuming an interest rate of ten percent, compounded semi-annually) would accrue during the period beginning with the due date of the 1996 return (March 15, 1997) and ending with the due date of the 1999 return (March 15, 2000).[607] Similarly, the interest charge attributable to 1997 and 1998 would accrue during the period beginning with the due dates of the returns and ending with the due date of the 1999 return.[608]

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[607] The interest charge attributable to 1996 is $12.82.

[608] The interest charge attributable to 1997 is $8.94, and the interest charge attributable to 1998 is $4.67.

Table 20, below, demonstrates the interest computation scheme under the Joint Committee staff recommendation:

Table 20.--Proposed Interest Charge Methods

Code Section	Description	Interest Rate	Period of Interest	Tax Base for Charge	Collection
453A(c)	Installment Obligations Aggregating $5 Million or More	Uniform rate	Due date of year of deferral to due date of next year's return	Marginal tax in each year gain is not recognized	Annual
453(l)(3)	Installment Sales of Timeshares and Resi-dential Lots	Uniform rate	Due date of year of deferral to due date of next year's return	Marginal tax in each year gain is not recognized	Annual
167(g)	Income Forecast Method of Depreciation	Uniform rate	Due date of year to which the depre-ciation is recomputed to due date of recomputation year (3rd and 10th year after the year the property is placed in service)	Marginal tax in each year to which the depreciation is recomputed	In recomputation year (3rd and 10th year after the property is placed in service)
460(b)	Long-Term Contracts	Uniform rate	Due date of year to which the income is recomputed to due date of completion year	Marginal tax in each year to which the income is recomputed	At time of contract completion
668	Distributions from Foreign Trusts	Uniform rate	Due date of year of accumulation to due date of year of distribution	Marginal tax in year of distribution allocated to prior years using AFR	At time of distribution
1260(b)	Constructive Ownership	Uniform rate	Due date of year to which	Marginal tax in year of	At time of closing the

Table 20.--Proposed Interest Charge Methods

Code Section	Description	Interest Rate	Period of Interest	Tax Base for Charge	Collection
			tax is allocated to due date for year the transaction closed	closing the transaction allocated to prior years using AFR	transaction
1291	Passive Foreign Investment Companies	Uniform rate	Due date of year to which the tax is allocated to due date for year of excess distribution	Marginal tax in year of excess distribution allocated to prior years using AFR	At time of "excess distribution"
995(f)	Domestic International Sales Corporations	Uniform rate	Due date of year of accumulation to due date of year of next year's return	Marginal tax that would have been paid if currently distributed	Annual

Generally, the different types of interest charge rules can be broken down into two categories: a pay-as-you-go rule versus a look-back rule. For example, the interest charge for installment sales over $5 million and domestic international sales corporations would fall in the pay-as-you-go category while distributions from foreign trusts, passive foreign investment companies, long-term contracts, income forecast method of depreciation, installment sales of timeshares and residential lots and constructive ownership transactions would fall in the look-back rule category. It does not appear possible to apply the pay-as-you-go system to the category of transactions that fall in the look-back rule unless estimates or deemed rates of return are utilized. The look-back rule can be broken down into two sub-categories: a look-back rule in which estimates are used (long-term contracts and income forecast method) and a look-back rule in which income is allocated to prior years upon the occurrence of an event (passive foreign investment companies, constructive ownership and distributions from foreign trusts).

Each method has problems that are corrected by the proposed regime. The present law interest charge on installment sales over $5 million is an advance charge, which appears to be inaccurate. On the due date of the return for the year of sale, no tax deferral has taken place yet. The interest charge on installment sales of timeshares and residential lots is needlessly complex and delays the collection of interest until payment(s) is received, when it could can easily be calculated and collected on an annual basis. The interest charge on domestic international sales corporations appears to accept a one-year deferral. The recommended annual interest charge regime would resolve all of these problems.

The present law interest charge on long-term contracts and income forecast method of depreciation is almost identical to the second proposed rule (look-back rule with estimates). The only difference may be the interest rate that is applied.

The present law interest charge on accumulation distributions from foreign trusts, passive foreign investment companies and constructive ownership transactions is quite different than the third proposed rule (look-back rule with tax allocated to prior years using the applicable Federal rate). The tax on the income is calculated in the year the income is recognized. The tax (but not the income) is allocated to prior years based on the applicable Federal rate. By allocating the tax and not the income to prior years, one step in the interest calculation has been eliminated. There is no need to calculate the hypothetical tax on the reallocated income, which can be difficult if a number of years are involved or the years involved are quite distant. Also, it is difficult to determine what tax attributes should be taken into account in prior years in computing the hypothetical tax. By reallocating the tax but not the income, much of the complexity has been removed.

There may be some possibility of manipulation in the timing of the recognition of the income. If the income is recognized in a year in which the taxpayer owes little or no taxes, then the interest on the tax allocated to prior years will be minimal. But this concern should go more to the tax rather than the interest. The interest will generally be small when compared to the tax. Present law is a realization based income tax system. Taxpayers are generally free to determine when to realize (and recognize) income. So if, for example, a taxpayer closes out a constructive ownership transaction in a year in which the taxpayer is in an extremely low tax bracket, then the tax owed will be low and correspondingly the interest on the tax allocated to prior years may be quite low. Taxpayers are permitted this flexibility in a realization based income tax system.

D. Redraft Rules for Taxation of Annuities

Present Law

Distributions from annuity, endowment, and life insurance contracts

Section 72 of the Code provides rules for the taxation of distributions under an annuity, endowment, or life insurance contract. In general, it provides rules with respect to amounts received as an annuity, and amounts not received as an annuity.[609]

For amounts received as an annuity, an "exclusion ratio" is provided for determining the taxable portion of each payment. The portion that represents recovery of the taxpayer's investment in the contract is not taxed. The exclusion ratio is the ratio of the taxpayer's investment in the contract to the expected return under the contract, that is, the total of the payments expected to be received under the contract. The ratio is determined as of the taxpayer's annuity starting date. Each annuity payment is multiplied by the exclusion ratio, and the resulting portion of each payment is treated as nontaxable recovery of the investment in the contract. Once the taxpayer has recovered his or her investment in the contract, all further payments are included in income. If the taxpayer dies before the full investment in the contract is recovered, a deduction is allowed on the final return for the remaining investment in the contract.

Section 72 uses the term "investment in the contract" in lieu of the general tax notion of basis. Investment in the contract is defined (as of the annuity starting date) as the aggregate amount of premiums or other consideration paid for the contract, minus the aggregate amount already received under the contract (to the extent it was excludable from income).

Amounts not received as annuity generally are included in income if received on or after the annuity starting date. Amounts not received as an annuity generally are included in income to the extent allocable to income on the contract if received before the annuity starting date (i.e., as income first).[610]

Amounts not received as an annuity under a life insurance or endowment contract generally are includible in income to the extent that the amounts received exceed the taxpayer's investment in the contract. Such distributions generally are treated first as a tax-free recovery of the investment in the contract, and then as income. In the case of a modified endowment contract, however, in general, distributions are treated as income first, loans are treated as distributions (i.e., income rather than basis recovery first), and an additional 10-percent tax is

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[609] Note that an exclusion from income is provided for amounts received under a life insurance contract paid by reason of the death of the insured (sec. 101(a)).

[610] Sec. 72(e)(2).

imposed on the income portion of distributions made before age 59-1/2 and in certain other circumstances.[611]

Distributions from tax-favored retirement arrangements

In addition to governing distributions from annuity, endowment, or life insurance contracts, section 72 also applies to distributions from various types of tax-favored retirement arrangements, including qualified retirement plans under section 401(a), qualified annuity plans under section 403(a), tax-sheltered annuities under section 403(b), and individual retirement arrangements ("IRAs").[612] In some cases, these tax-favored retirement arrangements include after-tax amounts, such as employee contributions or nondeductible IRA contributions, so that a portion of the distributions represents a recovery of basis. Accordingly, other Code provisions dealing with the tax treatment of distributions from these arrangements refer to section 72,[613] which provides basis recovery rules as described above.[614]

For many years the exclusion ratio applied to payments from tax-favored retirement arrangements as well as from annuity contracts. However, under present law, special basis recovery rules generally apply to distributions from tax-favored retirement arrangements.[615] In addition, over the years, other provisions have been added to section 72 that relate only to tax-

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[611] Secs. 72(e) and (v). A modified endowment contract is a life insurance contract that does not meet a statutory "seven-pay" test, i.e., generally is funded more rapidly than seven annual level premiums (sec. 7702A).

[612] Only some of the special rules under section 72 that apply generally to tax-favored retirement arrangements apply to individual retirement plans; others do not. Similarly, a pension plan contract described in section 818(a)(3) receives the same treatment as tax-favored retirement arrangements for some, but not all, purposes under section 72. This inconsistency of treatment even among types of tax-favored retirement plans adds to the complexity of the rules under section 72.

[613] Secs. 402(a) (distributions from a qualified trust), 403(a)(1) (distributions from a qualified annuity contract), 403(b)(1) (distributions from a tax-sheltered annuity contract), and 408(d)(1) (distributions from an individual retirement account or individual retirement annuity. The following provisions relating to nonqualified deferred compensation arrangements also refer to section 72: secs. 402(b)(2) (distributions from a nonqualified trusts), 403(c) (distributions from a nonqualified annuity contract), and 457(f)(1)(B) (distributions from an ineligible deferred compensation plan). Generally, the provisions applicable to nonqualified and ineligible deferred compensation arrangements do not apply to tax-favored retirement arrangements.

[614] In fact, however, many tax-favored retirement arrangements consist solely of before-tax contributions, so the individual has no basis. Distributions from those arrangements are fully taxable under section 61 of the Code without the need to apply section 72.

[615] For an explanation of the basis recovery rules applicable to tax-favored retirement plans, see Section III. D. of this Part, above.

favored retirement arrangements or that except these arrangements from the general rules that apply to other annuities.

The following table (Table 21) shows the various provisions of section 72 and shows whether each applies to tax-favored retirement arrangements[616] or to other arrangements.[617] The table is intended to help in evaluating the usefulness of breaking section 72 into separate sections.

Over half of the provisions of section 72 apply only to tax-favored retirement arrangements, more than 25 percent of the provisions do not apply to tax-favored retirement arrangements, and the remaining provisions apply both to tax-favored retirement arrangements and other arrangements. In addition, although the exclusion ratio provisions of section 72(b) (also known as the "general rule"), are applicable to tax-favored retirement arrangements, the provisions actually do not apply to many taxpayers because of the simplified method of basis recovery. See the discussion in Section III. D. of this Part, above.

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[616] As indicated in the table and footnotes, there is some variation in the particular types of tax-favored retirement arrangements to which particular provisions of section 72 apply.

[617] "Other arrangements" means any arrangement or contract other than a tax-favored retirement arrangement.

Table 21.–Application of Provisions of Section 72 to Tax-Favored Arrangements and Other Arrangements

Provision	Other Arrangements	Tax-Favored Retirement Arrangements
72(a) - general rule	Yes	Yes[1]
72(b) - exclusion ratio	Yes	Yes, but only in limited cases; simplified method under 72(d) generally applies after 1996
72(c) - definitions		
(1) investment in the contract	Yes	Yes, but modified by 72(f)
(2) adjustment for refund feature	Yes	Generally no[2]
(3) expected return	Yes	Only if 72(b) applies
(4) annuity starting date	Yes	Yes
72(d) - simplified method and ability to treat employee contributions to a defined contribution plan as separate contract	No	Yes[3]
72(e) - nonannuity amounts		
(1) application	Yes	Yes, but modified by (e)(5)(A)&(D)[4] and (e)(8)
(2) general rule	Yes	Yes, after taken out by (e)(5) and brought back in by (e)(8)
(3) allocation to income and investment	Yes	No, allocation under special rule of (e)(8)(B)
(4) special rules for applying (e)(2)(B) - loans treated as distributions, policyholder dividends, transfers without adequate consideration	Yes	Generally no[5]
(5) exemption from (e)(2)(B) & (4)(A) for existing contracts, life insurance and endowment contracts, qualified plans, and full redemptions	Yes, to contracts specified therein	Yes, but modified by (e)(8)
(6) investment in the contract for purposes of (e)	Yes	Yes, to extent (e)(2)(B) applies
(7) repealed		
(8) qualified plans	No	Yes
(9) State tuition programs and Education IRAs	Yes, to arrangements specified therein	No

Table 21.–Application of Provisions of Section 72 to Tax-Favored Arrangements and Other Arrangements

Provision	Other Arrangements	Tax-Favored Retirement Arrangements
(10) modified endowment contracts	Yes, to arrangements specified therein	Generally no
(11) anti-abuse rules	Yes	No[6]
(f) - employee contributions	No	Yes
(g) - transfers for value	Yes	No[7]
(h) - option to receive annuity in lieu of lump sum	Yes	No[8]
(i) NONE		
(j) - interest	Yes	Generally no
(k) REPEALED		
(l) - face-amount certificates	Yes	Generally no
(m) - special rules for employee plans	No	Yes[9]
(n) - special military retirement rules	No	Yes, but only military retirement pay
(o)[10] - deductible employee contributions	No	Yes[11]
(p) - loans treated as distributions	No	Yes[12]
(q) - penalty for premature withdrawals	Yes	No[13]
(r) - railroad retirement benefits	No	Yes, but only railroad retirement
(s) - required distributions after death	Yes	No[14]
(t) - early distributions from qualified retirement plans	No	Yes[15]
(u) - annuity contracts not held by natural persons	Yes	No[16]
(v) - distributions from modified endowment contracts	Yes	Generally no
(w) - cross reference for basis of annuity contracts sold	Yes	No[17]

Table 21.–Application of Provisions of Section 72 to Tax-Favored Arrangements and Other Arrangements

Footnotes

[1] Many, perhaps most, tax-favored retirement arrangements consist of only before-tax amounts, so distributions are fully taxable under section 61(a)(9) or (11) (subject to special rules, such as for rollovers) and section 72 does not have any effect.

[2] The provision of section 72 does not specifically exclude tax-favored retirement arrangements, but the subject addressed in the particular provision does not seem likely or possible to arise in a tax-favored retirement arrangements context.

[3] Applies to a "qualified employer retirement plan," defined in section 72(d)(1)(G) by reference to section 4974(c)(1), (2), or (3), that is, a plan described in section 401(a), 403(a) or 403(b).

[4] Amounts received from a "qualified plan," that is, a section 401(a), 403(a), 403(b) or 818(a)(3) plan, an IRA or an individual retirement annuity.

[5] Section 72(e)(5)(A) & (D) exempts qualified plans from (e)(2)(B) and (e)(4)(A) (loans treated as distributions). Section 72(e)(8)(A) reapplies (e)(2)(B) to qualified plans, but does not mention (e)(4)(A), though the loan rules of section 72(p) would apply. The policyholder dividends and transfer without adequate consideration provisions are not likely to apply to a qualified plan, particularly the latter since interests in tax-favored retirement arrangements are not assignable.

[6] Exception for qualified plans under section 72(e)(5)(D) (a section 401(a), 403(a), 403(b) or 818(a)(3) plan, an IRA or an individual retirement annuity).

[7] Interests in tax-favored retirement arrangements are not assignable.

[8] This provision prevents constructive receipt treatment of a lump sum when a person elects an annuity instead. However, constructive receipt does not apply to qualified plans; only amounts "actually distributed" are taxable. Therefore, section 72(h) would never apply to qualified plan amounts.

[9] Particular provisions apply to section 401(c) employees, section 401(a) or 403(a) plans, or QDROs.

[10] The cross-references in section 72(o)(5)(C) and section 72(o)(5)(D) to subsection (p)(3)(A)(i) and subsection (p)(3)(B), they should refer to subsection (p)(4)(A)(i) and subsection (p)(4)(B), respectively.

[11] Applies to same plans as section 72(p); see footnote 14.

[12] Section 401(a), 403(a) and 403(b) plans and Federal, State and local government plans regardless of whether qualified.

[13] Exception for distributions from a qualified plan under section 72(e)(5)(D) (a section 401(a), 403(a), 403(b) or 818(a)(3) plan, an IRA or an individual retirement annuity which is purchased by an employer on termination of a section 401(a) or 403(a) plan and held by the employer until the employee separates from service.

[14] Exception for a section 401(a), 403(a), 403(b) or plan, an IRA or an individual retirement annuity.

[15] Applies to a "qualified retirement plan" as defined in section 4974(c), that is, a plan described in section 401(a), 403(a) or 403(b), an IRA or an individual retirement annuity.

[16] Exception for contracts held by a section 401(a), 403(a) or 403(b) plan or an individual retirement plan or contracts purchased by an employer on termination of a section 401(a) or 403(a) plan and held by the employer until all amounts are distributed to the employee or beneficiary.

[17] Interests in tax-favored retirement arrangements are not assignable.

Sources of Complexity

The basic provisions of section 72 contain language that is complex and difficult to follow. Over the years, special provisions and counterbalancing rules have been added. These additions have increased the complexity of the language to the point that it is inordinately difficult to understand the rules it provides. While there may be other provisions of the Code that also are drafted using complex language, section 72 is a noteworthy example. Redrafting and reordering the provisions now in section 72 would constitute a meaningful reduction in the complexity of the language of the Code.

As a result of legislative changes, few of the provisions of section 72 apply both to tax-favored retirement arrangements and to annuity, endowment, or life insurance contracts; most apply only to one or the other. The provisions of section 72 that apply only to tax-favored retirement arrangements are interspersed with those that do not, so that it is necessary to study all of section 72 just to identify which provisions apply. Moreover, section 72 does not include all the rules governing distributions from tax-favored retirement arrangements. For example, the rules for tax-free rollovers are provided elsewhere.[618] It is therefore necessary also to consider provisions other than section 72 to determine how distributions from tax-favored retirement arrangements are taxed.

The rules for taxation of distributions from tax-favored retirement arrangements are highly technical and complex, as are the rules that apply to the annuity, endowment or life insurance contracts to which section 72 also applies. The current structure of section 72 makes it difficult to identify the rules applicable to these different types of arrangements, causing unnecessary additional complexity.

Recommendation for Simplification

The Joint Committee staff recommends that section 72 should be redrafted to eliminate overly convoluted language and improve the readability of the statutory language.

The Joint Committee staff recommends that the provisions of section 72 that apply to tax-favored retirement arrangements should be separated from the other provisions of section 72 and combined with the other rules governing the taxation of distributions from tax-favored retirement arrangements.

Readability of statutory language

The Joint Committee staff believes that complexity in the statutory provisions of the Code generally should be addressed. Section 72 is recognized as a statutory provision that is unnecessarily complex. This complexity is due in part to the piecemeal manner in which changes have been made to section 72. The Joint Committee staff worked with the House of Representatives Legislative Counsel's office to redraft a portion of section 72. This proposed redraft follows this discussion.

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[618] *See* secs. 402(c), 403(a)(4), 403(b)(8), and 408(d)(3).

Separating unrelated provisions[619]

Section 72 governs distributions from disparate types of instruments or vehicles. These disparate instruments fall into two general categories, tax-favored retirement arrangements and other arrangements (including life insurance, endowment and annuity contracts).[620] Separately stating the rules for these two categories could eliminate some of the intertwined rules and numerous cross-references that make the current language difficult for practitioners and taxpayers to read and understand. In addition, separate statement of the rules for each category would facilitate clear, readable drafting of any future modifications to the rules. Although there could be concern that a restatement of established rules could raise questions about whether substantive changes were intended or actually effected by the restatement, the simplification benefit of the restatement (especially if the intent not to make substantive changes were clear) would likely outweigh this concern.

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[619] The Joint Committee staff is also recommending that the rules relating to taxation of distributions from tax-favored retirement arrangements be simplified. See Section III.D. of this Part, above.

[620] As noted above, provisions relating to nonqualified deferred compensation arrangments also refer to section 72.

[DISCUSSION DRAFT]

FEBRUARY 9, 2001

1 **SEC. ___. SIMPLIFICATION OF RULES REGARDING INCOME**
2 **INCLUSION OF CERTAIN DISTRIBUTIONS**
3 **UNDER ANNUITY CONTRACTS.**

4 Subsection (e) of section 72 of the Internal Revenue
5 Code of 1986 (relating to amounts not received as annu-
6 ities) is amended to read as follows:

7 "(e) TAX TREATMENT OF NONANNUITY DISTRIBU-
8 TIONS AND CERTAIN OTHER DISTRIBUTIONS.—

9 "(1) IN GENERAL.—

10 "(A) APPLICATION OF SUBSECTION.—This
11 subsection shall apply to nonannuity distribu-
12 tions if no provision of this subtitle (other than
13 this subsection) applies with respect to such
14 distributions.

15 "(B) NONANNUITY DISTRIBUTION DE-
16 FINED.—For purposes of this subsection, the
17 term 'nonannuity distribution' means—

18 "(i) any amount received under an an-
19 nuity, endowment, or life insurance con-
20 tract but which is not received as an annu-
21 ity, and

1 "(ii) any amount received which is in
2 the nature of a dividend or similar dis-
3 tribution.
4 "(C) INCOME-FIRST TREATMENT.—For in-
5 come-first treatment, see paragraph (2).
6 "(D) BASIS-FIRST TREATMENT.—For
7 basis-first treatment, see paragraph (5).
8 "(2) INCOME-FIRST TREATMENT.—A non-
9 annuity distribution—
10 "(A) if received on or after the annuity
11 starting date, shall be included in gross income,
12 or
13 "(B) if received before the annuity starting
14 date—
15 "(i) shall be included in gross income
16 to the extent allocable to income on the
17 contract, and
18 "(ii) shall not be included in gross in-
19 come to the extent allocable to the invest-
20 ment in the contract.
21 "(3) ALLOCATION OF AMOUNTS TO INCOME
22 AND INVESTMENT.—For purposes of paragraph
23 (2)(B)—
24 "(A) ALLOCATION TO INCOME.—Any
25 amount of a nonannuity distribution shall be

1 treated as allocable to income on the contract to
2 the extent that such amount does not exceed
3 the excess (if any) of—
4 "(i) the cash value of the contract
5 (determined without regard to any sur-
6 render charge) immediately before the
7 amount is received, over
8 "(ii) the investment in the contract at
9 such time.
10 "(B) ALLOCATION TO INVESTMENT.—Any
11 amount of a nonannuity distribution shall be
12 treated as allocable to investment in the con-
13 tract to the extent that such amount is not allo-
14 cated to income under subparagraph (A).
15 "(4) SPECIAL RULES FOR APPLICATION OF IN-
16 COME-FIRST TREATMENT.—
17 "(A) LOANS TREATED AS NONANNUITY
18 DISTRIBUTIONS.—For purposes of paragraph
19 (2)(B), if, during any taxable year, an
20 individual—
21 "(i) receives (directly or indirectly)
22 any amount as a loan under any annuity,
23 endowment, or life insurance contract, or

"(ii) assigns or pledges (or agrees to assign or pledge) any portion of the value of any such contract,

such amount or portion shall be treated as received under the contract as a nonannuity distribution. The preceding sentence shall not apply for purposes of determining investment in the contract, except the investment in the contract shall be increased by any amount included in gross income by reason of the amount being treated as a nonannuity distribution under the preceding sentence.

"(B) POLICYHOLDER DIVIDENDS NOT SUBJECT TO INCOME-FIRST TREATMENT.—Any amount received which is in the nature of a dividend or similar distribution shall not be included in gross income under paragraph (2)(B)(i) to the extent such amount is retained by the insurer as a premium or other consideration paid for the contract.

"(C) TRANSFERS WITHOUT ADEQUATE CONSIDERATION SUBJECT TO INCOME-FIRST TREATMENT.—For purposes of paragraph (2)(B)—

"(i) IN GENERAL.—If an individual who holds an annuity contract transfers it without full and adequate consideration, such individual shall be treated as receiving under the contract as a nonannuity distribution an amount equal to the excess of—

"(I) the cash surrender value of such contract at the time of transfer, over

"(II) the investment in such contract at such time.

"(ii) EXCEPTION FOR CERTAIN TRANSFERS BETWEEN SPOUSES OR FORMER SPOUSES.—Clause (i) shall not apply to any transfer to which section 1041(a) (relating to transfers of property between spouses or incident to divorce) applies.

"(iii) ADJUSTMENT TO INVESTMENT IN CONTRACT OF TRANSFEREE.—If under clause (i) an amount is included in the gross income of the transferor of an annuity contract, the investment in the contract

of the transferee in such contract shall be increased by the amount so included.

"(D) MODIFIED ENDOWMENT CONTRACTS SUBJECT TO INCOME-FIRST TREATMENT.—[former paragraph (10)]

"(i) IN GENERAL.—Notwithstanding paragraph (5)(C) (relating to certain life insurance and endowment contracts subject to basis-first treatment), in the case of any modified endowment contract (as defined in section 7702A)—

"(I) paragraph (2)(B) (relating to income-first treatment) and subparagraph (A) (relating to loans treated as nonannuity distributions) shall apply, and

"(II) in applying subparagraph (A), 'any person' shall be substituted for 'an individual'.

"(ii) TREATMENT OF CERTAIN BURIAL CONTRACTS.—Notwithstanding clause (i), subparagraph (A) shall not apply to any assignment (or pledge) of a modified endowment contract if such assignment (or pledge) is solely to cover the payment of

1 expenses referred to in section
2 7702(e)(2)(C)(iii) and if the maximum
3 death benefit under such contract does not
4 exceed $25,000.
5 "(E) QUALIFIED PLANS SUBJECT TO IN-
6 COME-FIRST TREATMENT.—[former paragraph
7 (8)]
8 "(i) IN GENERAL.—Notwithstanding
9 any other provision of this subsection, in
10 the case of any amount received before the
11 annuity starting date from a trust or con-
12 tract described in paragraph (5)(D) (relat-
13 ing to contracts under qualified plans sub-
14 ject to basis-first treatment), paragraph
15 (2)(B) (relating to income-first treatment)
16 shall apply to such amounts.
17 "(ii) ALLOCATION OF AMOUNT RE-
18 CEIVED.—For purposes of paragraph
19 (2)(B) (relating to income-first treatment),
20 the amount allocated to the investment in
21 the contract shall be the portion of the
22 amount described in clause (i) which bears
23 the same ratio to such amount as the in-
24 vestment in the contract bears to the ac-
25 count balance. The determination under

1 the preceding sentence shall be made as of
2 the time of the distribution or at such
3 other time as the Secretary may prescribe.
4 "(iii) TREATMENT OF FORFEITABLE
5 RIGHTS.—If an employee does not have a
6 nonforfeitable right to any amount under
7 any trust or contract to which clause (i)
8 applies, such amount shall not be treated
9 as part of the account balance.
10 "(iv) INVESTMENT IN THE CONTRACT
11 BEFORE 1987.—In the case of a plan which
12 on May 5, 1986, permitted withdrawal of
13 any employee contributions before separa-
14 tion from service, clause (i) shall apply
15 only to the extent that amounts received
16 before the annuity starting date (when in-
17 creased by amounts previously received
18 under the contract after December 31,
19 1986) exceed the investment in the con-
20 tract as of December 31, 1986.
21 "(F) QUALIFIED STATE TUITION PRO-
22 GRAMS AND EDUCATIONAL INDIVIDUAL RETIRE-
23 MENT ACCOUNTS SUBJECT TO INCOME-FIRST
24 TREATMENT.—[former paragraph (9)] Not-
25 withstanding any other provision of this sub-

1 section, paragraph (2)(B) (relating to income-
2 first treatment) shall apply to amounts received
3 under a qualified State tuition program (as de-
4 fined in section 529(b)) or under an education
5 individual retirement account (as defined in sec-
6 tion 530(b)). The rule of subparagraph (E)(ii)
7 (relating to allocation of amount received) shall
8 apply for purposes of this subparagraph.
9 "(5) BASIS-FIRST TREATMENT.—
10 "(A) IN GENERAL.—In the case of any
11 nonannuity distribution to which this paragraph
12 applies which is received before the annuity
13 starting date—
14 "(i) paragraph (2)(B) (relating to in-
15 come-first treatment) and paragraph
16 (4)(A) (relating to loans treated as non-
17 annuity distributions) shall not apply, and
18 "(ii) the amount shall be included in
19 gross income, but only to the extent it ex-
20 ceeds the investment in the contract.
21 "(B) CONTRACTS ENTERED INTO BEFORE
22 AUGUST 14, 1982, SUBJECT TO BASIS-FIRST
23 TREATMENT.—This paragraph shall apply to
24 contracts entered into before August 14, 1982.
25 Any amount allocable to investment in the con-

1 tract after August 13, 1982, shall be treated as
2 from a contract entered into after such date.
3 "(C) CERTAIN LIFE INSURANCE AND EN-
4 DOWMENT CONTRACTS SUBJECT TO BASIS-
5 FIRST TREATMENT.—Except as provided in
6 paragraph (4)(D) (relating to modified endow-
7 ment contracts subject to income-first treat-
8 ment) and except to the extent prescribed by
9 the Secretary by regulations, this paragraph
10 shall apply to any nonannuity distribution
11 which is received under a life insurance or en-
12 dowment contract.
13 "(D) CONTRACTS UNDER QUALIFIED
14 PLANS SUBJECT TO BASIS-FIRST TREAT-
15 MENT.—Except as provided in paragraph
16 (4)(E) (relating to qualified plans subject to in-
17 come-first treatment), this paragraph shall
18 apply to any amount received—
19 "(i) from a trust described in section
20 401(a) which is exempt from tax under
21 section 501(a),
22 "(ii) from a contract—
23 "(I) purchased by a trust de-
24 scribed in clause (i),

"(II) purchased as part of a plan described in section 403(a),

"(III) described in section 403(b), or

"(IV) provided for employees of a life insurance company under a plan described in section 818(a)(3), or

"(iii) from an individual retirement account or an individual retirement annuity.

Any dividend described in section 404(k) which is received by a participant or beneficiary shall, for purposes of this subparagraph, be treated as paid under a separate contract to which clause (ii)(I) applies.

"(E) FULL REFUNDS, SURRENDERS, REDEMPTIONS, AND MATURITIES SUBJECT TO BASIS-FIRST TREATMENT.—This paragraph shall apply to—

"(i) any amount received, whether in a single sum or otherwise, under a contract in full discharge of the obligation under the contract which is in the nature of a refund of the consideration paid for the contract, and

"(ii) any amount received under a contract on its complete surrender, redemption, or maturity.

In the case of any amount to which the preceding sentence applies, the rule of paragraph (2)(A) shall not apply.

"(6) SPECIAL RULES.—

"(A) INVESTMENT IN THE CONTRACT.—For purposes of this subsection, the investment in the contract as of any date is—

"(i) the aggregate amount of premiums or other consideration paid for the contract before such date, minus

"(ii) the aggregate amount received under the contract before such date, to the extent that such amount was excludable from gross income under this subtitle or prior income tax laws.

"(B) ANTI-ABUSE RULES.—

"(i) IN GENERAL.—For purposes of determining the amount includible in gross income under this subsection—

"(I) all modified endowment contracts issued by the same company to the same policyholder during any cal-

1 endar year shall be treated as 1 modi-
2 fied endowment contract, and
3 "(II) all annuity contracts issued
4 by the same company to the same pol-
5 icyholder during any calendar year
6 shall be treated as 1 annuity contract.
7 The preceding sentence shall not apply to
8 any contract described in paragraph (5)(D)
9 (relating to qualified plans).
10 "(ii) REGULATORY AUTHORITY.—The
11 Secretary may by regulations prescribe
12 such additional rules as may be necessary
13 or appropriate to prevent avoidance of the
14 purposes of this subsection through serial
15 purchases of contracts or otherwise.

E. Special Rules for Mortgage Guaranty Insurance, Lease Guaranty Insurance, and Insurance of State and Local Obligations

Present Law

A property and casualty insurance company is subject to tax on its taxable income, generally defined as its gross income less allowable deductions. For this purpose, gross income includes underwriting income and investment income, as well as other items. Underwriting income is the premiums earned on insurance contracts during the year, less losses incurred and expenses incurred. The amount of losses incurred is determined by taking into account the discounted unpaid losses. Specific rules are provided for determining the amount of discounted unpaid losses for each line of business for each year. Under Treasury regulations, the unpaid losses taken into account include only actual unpaid losses, not, for example, catastrophe reserves or other types of reserves that do not represent actual unpaid losses. Such reserves may represent estimates of possible future losses. These types of reserves may be required, or permitted, for purposes of accounting under State insurance regulations whose purpose is to maintain insurance company solvency.

In the case of mortgage guaranty insurance, lease guaranty insurance, and insurance of State and local obligations, special tax rules have been provided for certain types of reserves. These reserves are those for losses resulting from adverse economic cycles, and, in the case of insurance of State and local obligations, losses from declining revenues related to such obligations.

Under the special rules for these reserves, a deduction is allowed for the amount that is required by State law or regulation to be set aside in the reserve for the taxable year, and for preceding taxable years (to the extent such amounts were not previously deducted). The amount of the deduction may not exceed the taxable income for the year, computed without regard to the deduction, and may not exceed 50 percent of the amount of premiums earned with respect to that type of insurance contract for the year.

The deduction is allowed only if the taxpayer purchases "tax and loss" bonds in an amount equal to the tax benefit equal to the deduction for the year. The tax and loss bonds are non-interest bearing bonds issued by the Federal government.

Under the provision, an account is established to keep track of the amount of the deduction for each year, so that it can be reversed after a 10-year (or 20-year) period. Each year, the amount of the deduction for the tenth preceding taxable year is subtracted from the account and is thereby included in income. For insurance of State and local obligations, the amount of the deduction for the twentieth (rather than the tenth) preceding year is subtracted from the account and included in income.

This set of rules permits a deduction for reserve amounts that would not be allowed as a deduction for losses incurred, so long as the tax benefit of the deduction is actually paid over to the Federal government in the form of a non-interest-bearing tax and loss bond. Upon maturity of the bond, the deduction is reversed and the taxpayer includes the amount of it in income. The net effect is that the taxpayer never actually gets an economic benefit from the tax benefit of the

deduction. It is understood that the principal utility of this set of tax rules arises under financial accounting rules that may deem an asset and offsetting liability to be created under these requirements.

Sources of Complexity

The system of providing a deduction, then negating it by requiring the purchase of a Federally-issued bond in the amount of the benefit of the deduction, can be criticized as tax complexity that is unnecessary. The sole utility of the deduction may arise under financial accounting rules that are unrelated to accurate measurement of the taxpayer's income for Federal income tax purposes. The fictional deduction system may be interpreted under financial accounting rules as having significance that it does not have under the Federal income tax rules. Significant simplification could be achieved by repealing these rules.

Recommendation for Simplification

The Joint Committee staff recommends that the special rules permitting a deduction for certain reserves for mortgage guaranty insurance, lease guaranty insurance, and insurance of State and local obligations, provided the taxpayer purchases tax and loss bonds, should be eliminated.

The present-law rules can be criticized as giving rise to complexity that achieves no Federal income tax goal, but rather, only a particular financial accounting result. The financial accounting result may be based on an assumption about the net effect of the fictional deduction and purchase of tax and loss bonds. Simplification of the tax rules, without any change in the measurement of income under the tax law, could be achieved by eliminating the provisions.

F. Special Deduction, and Exception to Reduction in Unearned Premium Reserves, for Blue Cross and Blue Shield Organizations

Present Law

A property and casualty insurance company is subject to tax on its taxable income, generally defined as its gross income less allowable deductions. For this purpose, gross income includes underwriting income and investment income, as well as other items. Underwriting income is the premiums earned on insurance contracts during the year, less losses incurred and expenses incurred. The amount of losses incurred is determined by taking into account the discounted unpaid losses. Premiums earned during the year is determined taking into account a 20-percent reduction in the otherwise allowable deduction, intended to represent the allocable portion of expenses incurred in generating the unearned premiums.[621]

Present law provides that an organization described in sections 501(c)(3) and (4) of the Code is exempt from tax only if no substantial part of its activities consists of providing commercial-type insurance. When this rule was enacted in 1986, certain treatment (described below) applied to Blue Cross and Blue Shield organizations providing health insurance that (1) were in existence on August 16, 1986; (2) were determined at any time to be tax-exempt under a determination that had not been revoked; and (3) were tax-exempt for the last taxable year beginning before January 1, 1987 (when the present-law rule became effective), provided that no material change occurred in the structure or operations of the organizations after August 16, 1986, and before the close of 1986 or any subsequent taxable year.

The treatment applicable to such Blue Cross and Blue Shield organizations, which became taxable organizations under the provision, is as follows.

A special deduction applies with respect to health business of such organizations, equal to 25 percent of the claims and expenses incurred during the taxable year less the adjusted surplus at the beginning of the taxable year. For purposes of the special deduction, liabilities incurred during the taxable year under cost-plus contracts are added to claims incurred, and expenses incurred in connection with the administration of cost-plus contracts are added to expenses incurred.

In addition, an exception is provided for such organizations from the application of the 20-percent reduction in the deduction for increases in unearned premiums that applies generally to property and casualty companies.

Sources of Complexity

The special deduction for 25 percent of claims and expenses from health business, and the exception to the 20-percent reduction with respect to unearned premiums, contribute to complexity in the tax system by creating a separate set of rules for a subset of taxpayers. Multiple sets of rules for similar taxpayers give rise to inefficiency both for taxpayers and for tax

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[621] See Joint Committee on Taxation, *General Explanation of the Tax Reform Act of 1986* (JCS-10-87), May 4, 1987, at 595.

administrators. In addition, parallel, but different, rules may be a trap for the unwary. Simplification could be achieved by eliminating the duplicative, but different, set of rules.

Recommendation for Simplification

The Joint Committee staff recommends that the special tax rules provided to Blue Cross and Blue Shield organizations in existence on August 16, 1986, should be eliminated. Appropriate rules should be provided for taking into account items arising from the resulting change in accounting method for tax purposes.

The special deduction for 25 percent of claims and expenses from health business, and the exception to the 20-percent reduction with respect to unearned premiums, apply only to Blue Cross and Blue Shield organizations that have not materially changed structure or organization since August 16, 1986. These special benefits were designed for organizations that have continued to be structured and operated similarly to the way they were when they were tax-exempt.[622] The continuing retention of a separate set of tax benefits for some organizations is based on historical facts that may no longer be directly relevant to the tax treatment of health insurers. To the extent that these special tax benefits were provided to formerly tax-exempt health insurers to ease their transition to taxable status, it can be argued that the transition is likely to be complete. The remaining benefit of having a different set of tax rules for certain health insurers arguably can no longer be justified as continuing transition relief. Significant simplification could be achieved by eliminating the extra set of rules, so that all taxable health insurers are subject to one set of tax rules.

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[622] *See* H. Rep. 99-426 (Dec. 7, 1985) at 664. The Committee stated, "[T]he availability of tax-exempt status under [then-]present law has allowed some large insurance entities to compete directly with commercial insurance companies. For example, the Blue Cross/Blue Shield organizations historically have been treated as tax-exempt organizations described in sections 501(c)(3) or (4). This group of organizations is now among the largest health care insurers in the United States."

G. Treatment of Life Insurance Companies

Present Law

Consolidated returns

Under present law, life insurance companies generally may not be included in a consolidated return of an affiliated group including nonlife-insurance companies, unless the common parent of the group elects to treat the life insurance companies as includible corporations.[623] Under this election, two special five-year limitation rules apply. The first five-year rule provides that a life insurance company may not be treated as an includible corporation until it has been a member of the group for the five taxable years immediately preceding the taxable year for which the consolidated return is filed.[624] The second five-year rule provides that any net operating loss of a nonlife-insurance member of the group may not offset the taxable income of a life insurance member for any of the first five years the life and nonlife-insurance corporations have been members of the same affiliated group.[625]

Treatment of mutual companies

In general, a corporation may not deduct amounts distributed to shareholders with respect to the corporation's stock. The Deficit Reduction Act of 1984 added a provision to the rules governing insurance companies that was intended to remedy the failure of prior law to distinguish between amounts returned by mutual life insurance companies to policyholders as customers, and amounts distributed to them as owners of the mutual company.

Under the provision, section 809 of the Code, a mutual life insurance company is required to reduce its deduction for policyholder dividends by the company's differential earnings amount. If the company's differential earnings amount exceeds the amount of its deductible policyholder dividends, the company is required to reduce its deduction for changes in its reserves by the excess of its differential earnings amount over the amount of its deductible policyholder dividends. The differential earnings amount is the product of the differential earnings rate and the average equity base of a mutual life insurance company.

The differential earnings rate is based on the difference between the average earnings rate of the 50 largest stock life insurance companies and the earnings rate of all mutual life insurance companies. The mutual earnings rate applied under the provision is the rate for the second calendar year preceding the calendar year in which the taxable year begins.[626]

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[623] Sec. 1504(c)(2).

[624] Sec. 1504(c)(2).

[625] Sec. 1503(c)(2).

[626] The differential earnings rate cannot be a negative number. A company's equity base equals the sum of: (1) its surplus and capital increased by 50 percent of the amount of any

A recomputation or "true-up" in a subsequent year is required if the differential earnings amount for the taxable year either exceeds, or is less than, the recomputed differential earnings amount. The recomputed differential earnings amount is calculated taking into account the average mutual earnings rate for the calendar year (rather than the second preceding calendar year, as above). The amount of the true-up for any taxable year is added to, or deducted from, the mutual company's income for the succeeding taxable year.

Sources of Complexity

The treatment of affiliated groups of corporations that include both life insurance companies and other types of companies is more complicated than other types of affiliated groups that wish to file consolidated returns. The two five-year rules require substantial additional record-keeping and calculations by taxpayers, as well as creating complexity in structuring business transactions. The rules generally have the effect of deferring or slowing the allowance of losses in consolidation, but not permanently disallowing the losses.

The rules for mutual companies add complexity to the tax law in several respects. The rules impose an additional set of calculations in two separate taxable years of the affected insurance companies. Part of the complexity of these rules arises from the fact that a portion of the calculation of the mutual companies' disallowed deduction is based on earnings rates of other companies, the 50 largest stock companies. Some mutual companies may be able to manipulate these rules by planning capital gains realizations. Changes in the composition of the life insurance industry, including demutualizations and other transactions designed to minimize the impact of these rules, have had the effect of disrupting the functioning of the rules (which were based on the assumption of a particular balance between the stock segment and the mutual segment of the life insurance industry).

Recommendation for Simplification

The Joint Committee staff recommends that the two five-year rules relating to consolidated returns of affiliated groups including life insurance companies and nonlife insurance companies should be eliminated. Appropriate conforming rules should be provided.

Consolidated returns

The recommendation would reduce the complexity associated with filing consolidated returns, for affiliated groups that include both life insurance companies and nonlife insurance companies. The complexity both to the acquired corporations and the existing members of the affiliated group in corporate acquisitions involving life insurance and nonlife insurance

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provision for policyholder dividends payable in the following taxable year; (2) the amount of its nonadmitted financial assets; (3) the excess of its statutory reserves over its tax reserves; and (4) the amount of any mandatory security valuation reserves, deficiency reserves, and voluntary reserves. A company's average equity base is the average of the company's equity base at the end of the taxable year and its equity base at the end of the preceding taxable year.

companies would be reduced, with respect to record-keeping and with respect to calculation of tax liability.

It could be argued that the principal effect of eliminating these five-year rules would be to allow affiliated groups to deduct corporate losses earlier than under present law. Some might argue that, because life insurance companies measure income differently than most other types of businesses, in some instances using some concepts that are derived from State regulatory accounting conventions, losses of other companies should not be allowed to offset their income as rapidly as other businesses' income. Nevertheless, it could be said that the simplification benefit of eliminating the five-year rules outweighs the relatively small change in policy associated with eliminating them. Further, the policy goal of limiting the use of nonlife insurance company losses against life insurance company income would be protected by the retention of the present-law rule that limits the use of nonlife insurance company losses in any taxable year by 35 percent of the loss, or 35 percent of the insurance company members' taxable income, whichever is less.[627]

Treatment of mutual companies

The Joint Committee staff considered eliminating the rules for mutual companies that reduce their deductions for policyholder dividends by the company's differential earnings amount, but the Joint Committee staff concluded that significant policy issues would be involved. While simplification could be achieved by eliminating a complex set of rules whose operation has been affected by alteration of the factual assumptions on which the provisions are based, the policy issue of treatment of mutual policyholder dividends as, in part, a return on equity, would have to be resolved. Further, because of the reduction in the number of mutual companies affected by the provision, the total number of taxpayers affected by the provision is declining, not increasing. As a result of these concerns, no recommendation is made with respect to these provisions.

[627] Sec. 1503(c)(1).

IX. INTERNATIONAL TAX

A. Structural Issues Relating to International Tax

Overview

The United States taxes U.S. citizens, residents, and corporations (collectively, U.S. persons) on all income, whether derived within the United States or elsewhere. By contrast, the United States taxes nonresident alien individuals and foreign corporations (collectively, foreign persons) only on income with a sufficient nexus to the United States.

The United States generally cedes the primary right to tax income derived from sources outside the United States to the foreign country where such income is derived. Thus, a credit against the U.S. income tax imposed on foreign-source taxable income is provided for foreign taxes paid on that income. In order to implement the rules for computing the foreign tax credit, the Code and the regulations thereunder set forth an extensive set of rules governing the determination of the source, either U.S. or foreign, of items of income and the allocation and apportionment of items of expense against such categories of income.

The tax rules of foreign countries that apply to foreign income of U.S. persons vary widely. For example, some foreign countries impose income tax at higher effective rates than those of the United States. In such cases, the foreign tax credit allowed by the United States is likely to eliminate any U.S. tax on income from a U.S. person's operations in the foreign country. On the other hand, operations in countries that have low statutory tax rates or generous deduction allowances or that offer tax incentives (e.g., tax holidays) to foreign investors are apt to be taxed at effective tax rates that are lower than the U.S. rates. In such cases, after application of the foreign tax credit, a residual U.S. tax generally is imposed on income from a U.S. person's operations in the foreign country.

The tax rules applicable to U.S. persons that control business operations in foreign countries depend on whether the business operations are conducted directly (through a foreign branch, for example) or indirectly (through a separate foreign corporation). A U.S. person that conducts foreign operations directly includes the income and losses from such operations on such person's U.S. tax return for the year the income is earned or the loss is incurred. Thus, the income from the U.S. person's foreign operations is subject to current U.S. tax. However, a foreign tax credit may reduce or eliminate the U.S. tax on such income.

Income earned by a foreign corporation from its foreign operations generally is subject to U.S. tax only when such income is distributed to U.S. persons that hold stock in such corporation. Accordingly, a U.S. person that conducts foreign operations through a foreign corporation generally is subject to U.S. tax on the income from those operations when the income is repatriated to the United States through a dividend distribution to the U.S. person. The income is reported on the U.S. person's tax return for the year the distribution is received, and the United States imposes tax on such income at that time. A foreign tax credit may reduce the U.S. tax imposed on such income.

A variety of complex anti-deferral regimes impose current U.S. tax on income earned by a U.S. person through a foreign corporation. The main anti-deferral regimes set forth in the Code are the controlled foreign corporation rules of subpart F (secs. 951-964) and the passive foreign investment company rules (secs. 1291-1298). Additional anti-deferral regimes set forth in the Code include the foreign personal holding company rules (secs. 551-558), the personal holding company rules (secs. 541-547), the accumulated earnings tax (secs. 531-537), and the foreign investment company and electing foreign investment company rules (secs. 1246 and 1247).

The tax that otherwise would be imposed under applicable foreign law on certain foreign-source income earned by U.S. persons may be reduced or eliminated under tax treaties between the United States and foreign countries. Moreover, U.S. tax on foreign-source income may be reduced or eliminated by treaty provisions that treat certain foreign taxes as creditable for purposes of computing U.S. tax liability.

Because two or more different tax jurisdictions will be involved, the income of a U.S. person that arises from cross-border investments is likely to face a more complex tax environment than would income from investments located solely in the United States. In this regard, the taxpayer must know the rules by which income is taxed in both countries and, in the case of a country with which the United States has a tax treaty in force, also must know the rules that pertain under the treaty.

In addition, the Code imposes rules that are applicable to cross-border transactions beyond those that apply to similar transactions in a solely domestic context. For example, the issue of dividing income earned on an investment into that on which U.S. tax may be deferred and that which is currently includible (e.g., under the subpart F rules for investments in foreign corporations) does not generally arise with respect to investments in the domestic context. In addition, the detailed rules for sourcing income and expenses generally are relevant for U.S. persons only for purposes of the foreign tax credit limitation – these rules are not relevant for U.S. persons engaged in purely domestic transactions.[628] Moreover, detailed and complicated rules apply under section 367 and the regulations thereunder for certain property transferred abroad in transactions that would otherwise be tax-free in the domestic context under certain nonrecognition Code provisions.[629] Finally, the transfer pricing rules under section 482 and the regulations thereunder, which apply in the domestic context, raise unique issues in the

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[628] The detailed sourcing rules also are relevant for foreign persons for purposes of determining their domestic activities that are subject to U.S. tax.

[629] The sec. 367 rules are designed to prevent avoidance of U.S. tax, for example, for gain inherent in property transferred by a U.S. person to a foreign corporation. Under sec. 367(a), gain generally is recognized on outbound transfers of appreciated property by a U.S. person to a foreign corporation (notwithstanding general nonrecognition provisions of the Code such as sec. 351). In addition, a separate and complicated set of rules apply under sec. 367(b) and the regulations thereunder with respect to certain types of inbound transactions, such as inbound reorganizations into U.S. corporations and liquidations of foreign subsidiaries into U.S. corporations. Certain exceptions from the sec. 367 rules may apply.

international context. The rules generally seek to apply arm's-length standards for transactions between commonly controlled persons.[630] In the absence of these rules, a U.S. person, for example, could seek to shift income under non-arm's-length terms to a foreign person who is not subject to tax (or is subject to a low rate of tax). However, to the extent that adjustments under these rules to the terms of a related party international transaction are not recognized by a foreign jurisdiction, double taxation issues could arise.[631]

Multiple policy goals and complexity in international taxation

In general

There is a general consensus among practitioners and academics that the Code provisions applicable to the U.S. taxation of income from international transactions are complex. Taxpayers voice concerns that the international provisions are difficult to interpret and costly to apply. Tax administrators voice similar concerns that the international provisions are difficult to administer and enforce. As is true with complexity elsewhere in the Code, the complexity in the international tax area arises from multiple policy objectives that are trying to be achieved by the rules pertaining to income from cross-border transactions. Among the primary policy objectives are:

(1) Promotion of economic efficiency;

(2) Fostering the competitiveness of U.S. enterprises in foreign markets;

(3) Relief from "double" or excessive taxation;

(4) Preservation of the U.S. income tax base;

(5) Maintaining consistency with international norms;

(6) Promoting the overall fairness of the U.S. tax system; and

(7) Providing simplicity in compliance and administration.

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[630] The regulations under sec. 482 contain extremely complex rules governing the determination of an arm's-length charge for various types of transactions. In addition, certain detailed and costly contemporaneous documentation requirements apply in order for taxpayers to avoid certain penalties under sec. 6662 for transfer pricing adjustments by the IRS.

[631] These double taxation issues potentially can be resolved through a competent authority process under the mutual agreement procedures of a U.S. tax treaty. However, resolution of the issues is not assured and the process can be lengthy. Some of the complexities associated with this area have been relieved to some degree by the use of advance pricing agreements entered into among taxpayers, the IRS, a foreign tax authority (or, alternatively, between just taxpayers and the IRS), although significant complexity in this area remains.

Complexity can arise when these objectives conflict with one another. The sections below briefly illustrate how the Code balances some of the conflicting policy objectives and the complexity that such balancing may create.

Promoting economic efficiency and fostering the competitiveness of U.S. enterprises

Capital movements across national borders in response to tax policy, rather than investment in response to pure economic fundamentals, reduce worldwide economic welfare. The nature of these economic distortions depends on the method of taxing income from international investment. If investment income is taxed only at the source, substantial amounts of capital could be diverted to jurisdictions with the lowest tax rates instead of flowing to investment projects with the highest pre-tax rate of return.

There is no consensus on what method of taxing international investment income minimizes distortions in the allocation of capital when nations tax income at different effective rates, but the alternatives of capital export neutrality and capital import neutrality are the most cited guiding principles. These two standards are each desirable goals of international tax policy. The problem is that, with unequal tax rates among countries, these two goals are not mutually attainable. Satisfying both principles at the same time is possible only if effective tax rates on capital income are the same in all countries.

Capital export neutrality.--Capital export neutrality refers to a system in which an investor residing in a particular locality can locate investment anywhere in the world (including at home) and pay the same tax.

Capital import neutrality.--Capital import neutrality refers to a system of international taxation in which income from investment located in each country is taxed at the same rate regardless of the residence of the investor.

Some commentators refer to the principle of capital import neutrality as promoting "competitiveness." This notion of competitiveness refers to the ability of U.S. multinationals (firms headquartered in the United States that operate abroad) that locate production facilities overseas to compete in foreign markets. Overseas production facilities owned by U.S. interests may compete with firms owned by residents of the host country or with multinational firms based in other countries.[632] The notion of capital import neutrality promoting the

[632] The term "competitiveness" encompasses different concepts. In the present context it might be better labeled "multinational competitiveness." Multinational competitiveness refers to the competitiveness of certain types of firms or industries relative to other types of firms or industries. The term "competitiveness" also is used in the context of measuring the ability of firms located in the United States to sell their output in foreign markets and to compete in domestic markets with output produced in foreign countries. In that context, competitiveness might be better labeled "trade competitiveness." Trade competitiveness often is measured by the U.S. trade deficit. Competitiveness also is used to describe comparisons of the current U.S. living standard and the prospects for future U.S. living standards with those of other countries. This notion of competitiveness focuses on the productivity growth of U.S. labor and the saving rate of the United States, because both of these factors affect future living standards.

competitiveness of such businesses focuses on the after-tax returns to investments in production facilities abroad.

Table 22, below, compares capital import neutrality with capital export neutrality. The table provides a taxonomy of the tax that would apply to income from an investment by location of the investment and by residence of the investor under the principle of capital export neutrality (panel a) and under capital import neutrality (panel b). Tax rates are always equal for investors residing in the same country under capital export neutrality. Tax rates are always equal for investments located in the same country under capital import neutrality.

Table 22.–The Principles of Capital Export Neutrality and Capital Import Neutrality

a. Capital Export Neutrality

Domestic investor faces domestic tax rate no matter where investment is located. Foreign investor faces foreign tax rate no matter where investment is located.

		Location of Investment	
		Domestic	Foreign
Residence of Investor	Domestic	Tax income at domestic rate	Tax income at domestic rate
	Foreign	Tax income at foreign rate	Tax income at foreign rate

b. Capital Import Neutrality

Domestic investment income subject to the domestic tax rate regardless of the residence of the taxpayer. Foreign investment income subject to foreign tax rate regardless of the residence of the taxpayer.

		Location of Investment	
		Domestic	Foreign
Residence of Investor	Domestic	Tax income at domestic rate	Tax income at foreign rate
	Foreign	Tax income at domestic rate	Tax income at foreign rate

Table 22 shows that satisfying both principles at the same time is possible only if effective tax rates on capital income are the same in all countries. A government can implement capital export neutrality by taxing worldwide income of its residents but also allowing full and immediate credits for income taxes paid to foreign governments. Such a policy would conflict with the goal of protecting the U.S. income tax base, as it would have the effect of forgiving U.S. tax on domestic income to offset high foreign taxes. This has the effect of using U.S. tax collected from domestic income to subsidize the revenue requirement of a foreign jurisdiction. It also may be thought to decrease the fairness of the U.S. tax system by reducing the tax burdens imposed on income from domestic investments that is necessary to fund the operation of the

government for some taxpayers but not all taxpayers. Limitations on foreign tax credits protect the U.S. tax base, but they also reduce efficiency and can be a source of complexity.

Capital import neutrality may be achieved by the residence country exempting income earned from foreign jurisdictions entirely from tax and allowing the source country's taxation to be the only taxation on the income of international investors. This is commonly referred to as a "territorial" or an "exemption" system of international taxation (as compared with the United States credit-based system). This policy also would conflict with the goal of protecting the U.S. income tax base by, for example, making it possible for U.S. taxpayers to manage passive investment portfolios offshore and claim exemption from the U.S. income tax. Some have suggested that simplification could be achieved by providing for a territorial system (*i.e.*, an exemption from U.S. tax) for foreign-source active income. There are significant policy issues with such an approach that are beyond the scope of this study. In addition, it should be noted that limitations on an exemption system to limit the loss of tax base from passive investments would require rules similar to those of present-law subpart F. Most observers view these rules as complex.

As a whole, the U.S. system of taxation is a hybrid containing elements consistent with both capital import neutrality and capital export neutrality. With regard to the relative treatment of domestic and outbound investment, many provisions work at cross purposes.[633] Some

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[633] Some analysts observe that promoting national economic interest may not coincide with promoting worldwide economic income. Because countries typically tax income arising within their borders, a nation can increase its income through policies that reduce outbound investment by its residents and encourage inbound investment by foreigners. This is the case even if net outbound investment is driven below the level that would prevail in a free and efficient international capital market.

In a world of source taxation, the national interest and the interests of outbound investors do not coincide. Outbound investment is only in the national interest if the return after foreign tax (but before domestic tax) equals or exceeds the before-tax return on domestic investment. To further its national interest, a government can reduce outbound investment by reducing the after-tax rate of return on outbound investment and driving its before-tax return above that on domestic investment. A government can penalize outbound investment by imposing a layer of taxation in addition to foreign taxation at source. This result can be achieved when a capital exporting nation, in response to foreign-source taxation, does not cede taxing jurisdiction over foreign-source income (for example, through a foreign tax credit) and allows only a deduction for foreign taxes. Several authors provide a description of how deductions for foreign taxes maximize domestic welfare of a capital-exporting country. *See* Caves, *Multinational Enterprises and Economic Analysis*, (Cambridge, England: Cambridge University Press), at 229-231 (1982); and Musgrave, *United States Taxation of Foreign Investment Income: Issues and Arguments*, (Cambridge, Massachusetts: International Tax Program, Harvard Law School), at 134 (1969).

The policy of allowing only deductions for foreign taxes is sometimes known as "national neutrality." The change from a system allowing a credit for foreign taxes to a system allowing a deduction for foreign taxes would be a fundamental change in U.S. income tax policy. For this

provisions of current law favor outbound investment, while others discourage it. For example, as described above, the foreign-source income earned directly by a U.S. corporation through a foreign branch is taxed on a current basis, a rule consistent with capital export neutrality, promoting the efficient allocation of capital. In contrast, taxation of foreign-source income earned through a U.S.-controlled foreign corporation generally is deferred until the income is repatriated, a rule consistent with capital import neutrality, promoting competitiveness.

The efforts to balance the conflicting objectives of competitiveness (*e.g.*, the general rule of deferral for income earned by foreign corporations) and economic efficiency (*e.g.*, exceptions to deferral such as the controlled foreign corporation rules under subpart F) have led to considerable complexity in the Code. For example, complexity abounds amidst the rules for identifying and computing income earned through a foreign corporation for which deferral applies, the rules for identifying and computing income earned through a foreign corporation that is subject to current inclusion to the corporation's U.S. shareholders, and the rules for determining the occasions for termination of deferral. In many cases, the exceptions from the general rule of deferral are subject to even further exceptions, leading to additional complexity in determining whether such income benefits from deferral or is subject to current inclusion. As described above, these tensions cannot be adequately addressed merely by implementing a simplified rule without considering the other important policy objectives relevant to rules for cross-border transactions.

The Joint Committee staff recognizes that certain simplification steps recently have been taken in this area. For example, the Taxpayer Relief Act of 1997 (the "1997 Act") generally eliminated the overlap between the subpart F rules and the passive foreign investment company rules. The Joint Committee staff considered several suggestions to further simplify rules relating to subpart F and other anti-deferral regimes. In this study, the Joint Committee staff has made recommendations to provide some relief from this complexity. Some suggestions to simplify the subpart F rules were not included because the suggestions involved significant policy changes to the structure of the rules. For example, some have suggested that active income, including certain mobile income such as foreign base company sales income,[634] be exempted from the subpart F rules (with the result that such income would benefit from the general rule of deferral). As noted above, others have suggested switching to a territorial tax system, at least for foreign active income.[635] The Joint Committee staff determined that such types of proposals involved broad policy considerations that went beyond the goal of simplification.

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reason, the Joint Committee staff does not consider the ramifications for the complexity, or simplification, of international taxation that may result from such a policy change.

[634] The subpart F rules currently tax certain active income earned by U.S.-controlled foreign corporations, including foreign base company sales, services, shipping, and oil-related income.

[635] Certain exclusions from gross income for extraterritorial income apply under present law.

Relief from double taxation and preservation of the U.S. income tax base

U.S. persons are taxed on their worldwide income. To avoid international double taxation[636] of foreign-source income, U.S. persons are allowed to claim a credit against their U.S. tax liability for foreign income taxes paid. The foreign tax credit is limited to U.S. tax liability on foreign-source income. Without this limitation, foreign taxes paid at rates higher than the U.S. rate would reduce U.S. tax liability with respect to U.S.-source income, as discussed above.

Similarly, the Code provides separate limitations for certain types of foreign-source income to reduce the extent to which excess foreign taxes can be "cross-credited" against residual U.S. tax on low-taxed foreign-source income. The foreign tax credit limitation categories relate to the following items of income: (1) passive income, (2) high withholding tax interest, (3) financial services income, (4) shipping income, (5) certain dividends received from a noncontrolled section 902 foreign corporation (a "10/50 company"),[637] (6) certain dividends from a domestic international sales corporation or former domestic international sales corporation, (8) taxable income attributable to certain foreign trade income, (7) certain distributions from a foreign sales corporation or former foreign sales corporation, and (9) any other income not described in items (1) through (8) (so-called general basket limitation income). Such limitations to protect the U.S. tax base on U.S.-source income create complexity.

In order to protect the U.S. tax base, it is necessary to define precisely what the U.S. tax base comprises. The rules for sourcing of gross income generally seek to ensure that items of income that are subject to foreign taxation are treated as foreign source. Accompanying the sourcing rules are rules governing the allocation and apportionment of expenses between U.S.- and foreign-source gross income. In the absence of rules providing for the accurate measurement of U.S. and foreign income and expense, the foreign tax credit limitation may be too low to permit crediting of the foreign taxes paid. Similarly, these rules generally seek to ensure that items of income not subject to foreign tax cannot be used to circumvent the sourcing, allocation, and apportionment rules play a critical role in the relief of international double taxation and in the preservation of the U.S. tax base.[638]

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[636] While the principle is called "double taxation," the issue is one of the total effective rate of tax applied to income earned on an overseas investment, not the number of times the income is subject to tax.

[637] Dividends paid by a 10/50 company in taxable years beginning before January 1, 2003, are subject to a separate foreign tax credit limitation for each 10/50 company. Subject to certain exceptions, dividends paid by a 10/50 company in taxable years beginning after December 31, 2002, are subject to either a look-through approach in which the dividend is attributed to a particular limitation category based on the underlying earnings which gave rise to the dividend (for post-2002 earnings and profits), or a single-basket limitation approach for dividends from all 10/50 companies (for pre-2003 earnings and profits).

[638] The growth of e-commerce will put increased pressure on the application of these admittedly complex sourcing rules. *See, e.g.*, Prop. Reg. sec. 1.863-9 (providing certain sourcing rules for income from communications activities). The scope of the issues that may arise in the

Present law generally treats income as having a U.S. source when a reasonable economic nexus exists with the United States. For example, in the case of active business or service income, the location of the relevant economic activity generally determines nexus. Present law generally requires that expenses be allocated and apportioned to U.S.- or foreign-source gross income based on their factual relationship to gross income. An item of expense that relates to the production of all gross income is apportioned on a *pro rata* basis between U.S.- and foreign-source gross income. Most of the United States' trading partners apply broadly similar principles of nexus and factual determination of expense. Detailed and special allocation rules apply to certain types of expenses such as interest expense. To the extent these detailed rules do not comport with the rules of our trading partners, there is a deviation from the policy goal of maintaining consistency with international norms, but such rules may serve to protect the U.S. tax base. On the other hand, to the extent these detailed rules do not comport with the rules of our trading partners, they could result in the potential for double taxation.

Factual determinations improve the accuracy of measurement, but generally increase the taxpayer's compliance burden. Simplified rules could reduce compliance burdens, but might be less accurate. As a result, some taxpayers may not perceive simplified rules as promoting fairness in the U.S. tax system. Simplified rules for source and allocation may, depending on the rules, lead to erosion of the U.S. tax base or increase the potential for double taxation.

As discussed above, the Joint Committee staff recognizes that there are significant complexities associated with the international tax rules, particularly with respect to the determination of the foreign tax credit (including identifying foreign-source gross income under the various limitation categories and allocating various expenses against such foreign-source gross income in a particular limitation category). The Joint Committee staff also recognizes that the 1997 Act contained several international tax simplification provisions relating to the foreign tax credit, including: (1) an elective exemption from the foreign tax credit limitation rules for individuals with up to $300 ($600 in the case of married individuals filing a joint return) of creditable foreign taxes relating to foreign-source passive income, (2) the elimination of the separate baskets for dividends from each 10/50 company, (3) a simplified election to compute the alternative minimum tax foreign tax credit limitation fractions by using the ratio of foreign-source regular taxable income to entire alternative minimum taxable income,[639] and (4) a clarification that high-taxed income is not excluded from the separate limitation basket for financial services income.[640]

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future is difficult to assess and beyond the scope of the present study. Thus, the Joint Committee staff makes no specific recommendations with respect to e-commerce.

[639] This simplified limitation fraction relieved taxpayers of some of the complexities associated with sourcing income and expenses relating to tax preference and other alternative minimum tax adjustments for purposes of determining the alternative minimum tax foreign tax credit limitation. The election to use the simplified limitation fraction may be made only for the taxpayer's first taxable year beginning after December 31, 1997.

[640] In addition, the 1997 Act included other international tax simplification provisions, including (1) simplifying the treatment of personal transactions in foreign currency by applying

The Joint Committee staff considered several suggestions to further reduce complexity in the foreign tax credit area. In this study, the Joint Committee staff makes specific recommendations to provide relief from some of the complexity. The Joint Committee staff believes that further simplification could be achieved but would require policy decisions that are beyond the scope of this study. For example, some have suggested that the foreign tax credit limitation categories could be reduced to two categories: a category for active income and a category for passive income. Alternatively, there could be two limitation categories based on whether foreign-source income is high-taxed or low-taxed. Other suggestions included treating active income that is currently in a separate limitation category (e.g., shipping or financial services income) as income in the general limitation basket. Others have suggested that certain limitation categories could be eliminated, such as the separate limitation category for high withholding tax interest. Another suggestion was to eliminate the "high-tax kick out" rules from the passive income limitation category.[641] These and other ideas could provide simplification, but also raise significant policy issues relating to the purpose for the foreign tax credit limitation that were determined to be beyond the scope of this study.

Taxation of foreign persons

The discussion above focused generally on complexity for U.S. persons engaged in international transactions. Complexity also exists for foreign persons engaged in transactions within the United States in that such persons generally are taxed by the United States only on their U.S.-source income (with certain exceptions). Thus, as discussed above, the rules for determining the source of income and the allocation of expenses can create significant

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nonrecognition treatment to any resulting foreign exchange gain that does not exceed $200; (2) generally providing for the translation of accrued foreign taxes at the average exchange rate for the year; (3) various rules simplifying the formation and operation of international joint ventures, including the elimination of the excise tax under prior law sec. 1491 for transfers of appreciated property by a U.S. person to a foreign corporation as paid-in surplus or as a contribution to capital or to a foreign partnership, estate, or trust; (4) increasing the threshold for stock ownership of a foreign corporation that results in information reporting obligations under sec. 6046 from 5 percent (based on value) to 10 percent (based on vote or value); and (5) simplifying the stock and securities trading safe harbor under sec. 864(b)(2) by eliminating the requirement for both partnerships and foreign corporations that trade in stocks and securities for their own account that the entity's principal office not be within the United States. Some commentators have suggested that reductions in complexity were not achieved in certain cases. For example, some have suggested that the use of the average exchange rate method (as opposed to the prior-law date of payment method) for translating accrued foreign taxes may generate additional administrative burdens in certain circumstances involving foreign taxes paid in a nonfunctional currency.

[641] In this regard, certain detailed and complex rules provide that certain passive income that is high-taxed income is not included in the separate limitation category for passive income (i.e., is "kicked out" of the passive income basket), and is included in the general limitation basket.

complexity for foreign persons in determining their activities and income that are subject to U.S. tax.

Additional complexities can arise for foreign persons in determining the manner in which they are subject to U.S. tax. In this regard, foreign persons are subject to U.S. tax under a bifurcated approach. Under the first approach, foreign persons who are engaged in a U.S. trade or business are taxed on a net income basis on their U.S.-source business income, meaning that costs incurred in generating such U.S.-source income are deductible.[642] Thus, foreign persons are taxed on such income in a similar manner to U.S. persons, promoting fairness in the tax system.[643]

Under the second approach, foreign persons who are not engaged in a U.S. trade or business are subject to a 30-percent U.S. withholding tax on the gross amount of certain types of U.S.-source investment income (*e.g.*, dividends and interest).[644] Many reasons have been advanced for taxing such U.S.-source income on a gross basis, including the lack of business activities in the United States, the need to collect tax on foreign persons located outside the United States by means of withholding, the difficulty of verifying the amount of any deductions, and the minimal amount of costs usually associated with certain types of investment income (as

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[642] *See* American Law Institute, *Federal Income Tax Project, International Aspects of United States Income Taxation, Proposals of the American Law Institute on United States Taxation of Foreign Persons and of the Foreign Income of United States Persons*, at 9-10 (1987) (the "ALI Report").

[643] For similar reasons, a complicated regime applies under the Foreign Investment in Real Property Tax Act rules, in which a foreign person who recognizes a capital gain on the disposition of a U.S. real property interest is subject to U.S. net basis taxation on such gain. The tax is enforced through a corresponding withholding tax regime. The rules were enacted to establish equity of tax treatment in U.S. real property between foreign and domestic investors. In addition, a foreign person investing in U.S. real property is subject to gross basis taxation on rental income, but is permitted to elect net basis taxation. In many cases, net basis taxation (even though the applicable rates may be higher than the gross withholding tax rate), can result in a lower effective tax rate because of the ability to apply deductions in arriving at net taxable income.

[644] As a result, gross basis taxation, at a flat rate generally lower than the net basis taxation rates, can be viewed as a rough surrogate for the application of net basis taxation. *See* the ALI Report at 11. The 30-percent gross basis tax may be reduced under a bilateral tax treaty. In addition, a complex set of rules applies to impose certain branch level taxes (*e.g.*, the branch profits tax and the branch interest tax) with respect to a foreign corporation's branch operations in the United States. Although complex, the branch profits tax was enacted to more fairly subject a foreign corporation's U.S. business profits to approximately the same level of taxes whether the business was conducted through a U.S. subsidiary or through a U.S. branch. The branch profits tax also is viewed as being more administrable than the so-called secondary withholding tax, which imposes a withholding tax on dividends paid by foreign corporations with a certain level of U.S.-source income.

opposed to business income). Thus, complexity can arise for foreign persons in determining whether they are subject to net basis taxation or gross basis taxation on their U.S.-source income.[645]

In addition, foreign persons are exempt from U.S. tax on certain items of U.S-source income, including portfolio interest, bank interest, and most capital gains.[646] Thus, although there may be other policy objectives involved in providing for such types of exemptions, complexity can arise for foreign persons in determining whether their U.S.-source income either is exempt from or is subject to U.S. tax. In addition, as discussed above, complexity for foreign persons is further increased by the various U.S. tax treaties that may modify the U.S. tax rules and, thus, the extent to which such foreign persons may be taxed by the United States.

Complexity in international taxation and individual taxpayers

While the preceding discussion of complexity in international taxation has been general, concerns of complexity with regard to individual taxpayers arise, for example, in the context of passive investments. With the worldwide reductions in barriers to cross-border investing, increasing numbers of U.S. individual taxpayers make portfolio investments overseas. While a number of countries tax only current residents on their worldwide income, the United States taxes both U.S. citizens and residents on their worldwide income. In particular, individuals passively investing abroad must be aware of the special Code rules and regulations applicable to, for example, controlled foreign corporations, passive foreign investment companies, and foreign personal holding companies. These rules substantially increase the filing and compliance burdens of taxpayers with passive investments abroad compared to taxpayers with similar domestic investments. However, as in some of the cases discussed above, altering the underlying premise of worldwide taxation and modifying the application of certain of these rules applicable to individuals would involve significant changes in policy that are beyond the scope of this study. For example, worldwide taxation promotes, perhaps imperfectly, economic efficiency of investment (by not encouraging offshore portfolio investments solely for the purpose of gaining a lower tax rate); fairness (by not providing otherwise similarly financially situated taxpayers with different effective tax rates); and preservation of the U.S. income tax base.

Similarly, with the worldwide reductions in barriers to cross-border investing, increasing numbers of foreign individuals make portfolio investments in the United States. These individuals may become subject to U.S. income taxation in addition to whatever income tax liability may be imposed by their country of residence. In particular, a foreign person passively investing in the United States must be aware of the extent of his or her U.S. activities, and if

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[645] For example, the issue of whether a foreign person is engaged in a trade or business (and, thus, potentially subject to net basis taxation) is a factual determination that may be difficult to make.

[646] *But see* sec. 871(a)(2) (providing for a 30-percent net basis tax on certain U.S.-source capital gains of nonresident alien individuals present in the United States for at least 183 days during a taxable year).

significant enough, must determine whether his or her investment gives rise to sufficient economic nexus that would subject such person to income tax as if he or she were a resident of the United States. Commentators and practitioners generally view the rules establishing nexus as complex. As is the case for U.S. persons, changing certain of the rules applicable to foreign persons investing in the United States would involve significant changes in policy that are beyond the scope of this study. For example, exemptions from and reductions in rates of withholding taxes applicable to foreign persons established under law and negotiated under treaty encourage foreign investment in the United States, while the nexus rules effectively may increase rates of tax applicable to foreign persons, but promote preservation of the U.S. income tax base and promote fairness by not providing otherwise similarly financially situated foreign persons with different effective tax rates on investments in U.S. assets.

Modification to the existing regime for individuals would involve tradeoffs between these policy goals. For that reason, the Joint Committee staff offers recommendations that may provide only modest reductions in the burden of complexity on individuals making cross-border portfolio investments.

B. Anti-Deferral Regimes Applicable to Income Earned Through Foreign Corporations

Present Law

In general

Income earned by a foreign corporation from its foreign operations generally is subject to U.S. tax only when such income is distributed to any U.S. persons that hold stock in such corporation. Accordingly, a U.S. person that conducts foreign operations through a foreign corporation generally is subject to U.S. tax on the income from those operations when the income is repatriated to the United States through a dividend distribution to the U.S. person. The income is reported on the U.S. person's tax return for the year the distribution is received, and the United States imposes tax on such income at that time. The foreign tax credit may reduce the U.S. tax imposed on such income.

A variety of complex anti-deferral regimes impose current U.S. tax on income earned by a U.S. person through a foreign corporation. Detailed rules for coordination among the anti-deferral regimes are provided to prevent the U.S. person from being subject to U.S. tax on the same item of income under multiple regimes.

The Code sets forth the following anti-deferral regimes: the controlled foreign corporation rules of subpart F (secs. 951-964); the passive foreign investment company rules (secs. 1291-1298); the foreign personal holding company rules (secs. 551-558); the personal holding company rules (secs. 541-547); the accumulated earnings tax rules (secs. 531-537); and the foreign investment company rules (secs. 1246-1247). The operation and application of these regimes are described in the following sections.

Controlled foreign corporations

In general

The subpart F rules are applicable to controlled foreign corporations. In general, under the subpart F rules, U.S. 10-percent shareholders of a controlled foreign corporation are required to include in income for U.S. tax purposes currently certain income of the controlled foreign corporation (referred to as "subpart F income"), without regard to whether the income is distributed to the shareholders (sec. 951(a)(1)(A)). In effect, the Code treats the U.S. 10-percent shareholders of a controlled foreign corporation as having received a current distribution of their pro rata shares of the controlled foreign corporation's subpart F income. In addition, the U.S. 10-percent shareholders of a controlled foreign corporation are required to include in income for U.S. tax purposes their pro rata shares of the controlled foreign corporation's earnings to the extent invested by the controlled foreign corporation in U.S. property (sec. 951(a)(1)(B)). The amounts included in income by the controlled foreign corporation's U.S. 10-percent shareholders under these rules are subject to U.S. tax currently. The U.S. tax on such amounts may be reduced through foreign tax credits.

A foreign corporation is a controlled foreign corporation if U.S. 10-percent shareholders own more than 50 percent of such corporation's stock (measured by vote or by value) (sec. 957).

[647] For this purpose, a U.S. 10-percent shareholder is a U.S. person that owns 10 percent or more of the corporation's stock (measured by vote) (sec. 951(b)).

In determining stock ownership for purposes of the subpart F rules, a U.S. person generally is considered to own a proportionate share of stock owned, directly or indirectly, by or for a foreign corporation, foreign partnership, or foreign trust or estate of which the U.S. person is a shareholder, partner, or beneficiary (sec. 958(a)). In addition, constructive ownership rules apply for purposes of determining whether a U.S. person is a U.S. 10-percent shareholder, whether a foreign corporation is a controlled foreign corporation, and whether two persons are related, but not for purposes of requiring the inclusion of amounts with respect to the controlled foreign corporation in a U.S. shareholder's gross income (secs. 958(b) and 318(a)).

Earnings and profits of a controlled foreign corporation that have been included in income by the U.S. 10-percent shareholders are not taxed again when such earnings are actually distributed to such shareholders (sec. 959(a)(1)). Similarly, previously taxed earnings are not included in income by the U.S. 10-percent shareholders in the event that such earnings are invested by the controlled foreign corporation in U.S. property (sec. 959(a)(2)). In the event that stock in the controlled foreign corporation is transferred subsequent to an income inclusion by a U.S. 10-percent shareholder but prior to the actual distribution of previously taxed income, the transferee shareholder generally is similarly exempt from U.S. tax on the distribution.

The inclusion of an amount of a controlled foreign corporation's subpart F income by the U.S. 10-percent shareholders generally results in a corresponding increase in the shareholder's basis in the controlled foreign corporation stock (sec. 961(a)). In addition, the distribution of previously taxed income to the U.S. shareholder of a controlled foreign corporation generally results in a corresponding decrease in the shareholder's basis in the stock (sec. 961(b)).

Subpart F income

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

The subpart F income of a controlled foreign corporation is limited to its current earnings and profits (sec. 952(c)). Under this rule, current deficits in earnings and profits in any income category reduce the controlled foreign corporation's subpart F income. In addition, accumulated deficits in a controlled foreign corporation's earnings and profits generated by certain activities in prior years may be used to reduce the controlled foreign corporation's subpart F income generated by similar activities in the current year.

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[647] A broader definition of a controlled foreign corporation applies in the case of a foreign corporation engaged in certain insurance activities (see secs. 953(c) and 957(b)).

Pursuant to a de minimis rule, generally none of a controlled foreign corporation's income for a taxable year is treated as foreign base company income or subpart F insurance income if the controlled foreign corporation's gross foreign base company income and gross subpart F insurance income total less than the lesser of 5 percent of the controlled foreign corporation's gross income or $1 million (sec. 954(b)(3)(A)). Pursuant to a full inclusion rule, if more than 70 percent of a controlled foreign corporation's gross income is foreign base company income and/or subpart F insurance income, generally all of the controlled foreign corporation's income is treated as foreign base company income or subpart F insurance income (whichever is appropriate) (sec. 954(b)(3)(B)). Under an elective exception for income that is subject to high foreign taxes, foreign base company income and subpart F insurance income generally do not include items of income received by the controlled foreign corporation that the taxpayer establishes were subject to an effective foreign tax rate greater than 90 percent of the maximum U.S. corporate tax rate (sec. 954(b)(4)).

Foreign base company income

Foreign base company income includes five categories of income: foreign personal holding company income, foreign base company sales income, foreign base company services income, foreign base company shipping income, and foreign base company oil related income (sec. 954(a)). In computing foreign base company income, income in these five categories is reduced by allowable deductions properly allocable to such income (sec. 954(b)(5)).

Foreign personal holding company income.--One major category of foreign base company income is foreign personal holding company income (sec. 954(c)). For subpart F purposes, 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;[648] (3) net gains from commodities transactions;[649] (4) net gains from foreign currency transactions;[650] (5) income that is equivalent to interest; (6) income from notional principal contracts; and (7) payments in lieu of dividends.

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[648] An exclusion is provided for gains and losses from the sale or exchange of property that is inventory property in the hands of the controlled foreign corporation. Also excluded are gains and losses from the sale or exchange of property (including gains or losses arising out of bona fide hedging transactions) by a controlled foreign corporation that is a regular dealer in such property. A temporary exclusion also applies to gains and losses from the sale or exchange of property that gives rise to dividends, interest, rents, royalties, or annuities if such property gives rise to certain active financing income (secs. 954(c)(1)(B) and 954(h) and (i)).

[649] Exceptions are provided for gains and losses from certain bona fide hedging transactions and certain active business transactions.

[650] An exception is provided for hedging and other transactions directly related to the business needs of the controlled foreign corporation.

Subpart F foreign personal holding company income does not include rents and royalties received by the controlled foreign corporation in the active conduct of a trade or business from unrelated persons (sec. 954(c)(2)(A)). Also generally excluded are dividends and interest received by the controlled foreign corporation from a related corporation organized and operating in the same foreign country in which the controlled foreign corporation was organized, and rents and royalties received by the controlled foreign corporation from a related corporation for the use of property within the country in which the controlled foreign corporation was organized (sec. 954(c)(3)). However, interest, rent, and royalty payments do not qualify for this exclusion to the extent that such payments reduce subpart F income of the payor.

Temporary exceptions from foreign personal holding company income as well as foreign base company services 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") (sec. 954(h) and (i)). [651]

Foreign base company sales and services income.--Foreign base company income also includes foreign base company sales and services income. Foreign base company sales income generally consists of sales income of a controlled foreign corporation located in a country that is neither the origin nor the destination of the goods with respect to sales of property purchased from or sold to a related person (sec. 954(d)).[652] Foreign base company services income consists of income from services performed outside the controlled foreign corporation's country of incorporation for or on behalf of a related party (sec. 954(e)). [653]

Foreign base company shipping income.--Foreign base company income includes foreign base company shipping income. Foreign base company shipping income consists of income derived from (1) the use (or hiring or leasing for use) of any aircraft or vessel in foreign commerce, (2) the performance of services directly related to the use of any such aircraft or vessel, or (3) the sale, exchange or other disposition of any such aircraft or vessel (sec. 954(f)). Foreign base company shipping income also includes any income derived from certain space or ocean activities.

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[651] These exceptions for active financing income are applicable for taxable years beginning before January 1, 2002.

[652] A special branch rule applies only for purposes of determining a controlled foreign corporation's foreign base company sales income. Under this rule, a branch of a controlled foreign corporation is treated as a separate corporation where the activities of the controlled foreign corporation through the branch outside the controlled foreign corporation's country of incorporation have substantially the same effect as if such branch were a subsidiary (sec. 954(d)(2)).

[653] For purposes of the subpart F rules, a related person is defined as any individual, corporation, trust, or estate that controls or is controlled by the controlled foreign corporation, or any individual, corporation, trust, or estate that is controlled by the same person or persons that control the controlled foreign corporation (sec. 954(d)(3)).

Foreign base company oil related income.--Foreign base company income includes foreign base company oil related income (i.e., income other than extraction income). Foreign base company oil related income generally includes all oil related income, other than income derived from a source within a foreign country in connection with either (1) oil or gas that was extracted from a well located in that foreign country, or (2) oil, gas, or a primary product of oil or gas that is sold by the controlled foreign corporation or a related person for use or consumption within that foreign country, or is loaded in that country on a vessel or aircraft as fuel for such vessel or aircraft (sec. 954(g)). An exception is available for any controlled foreign corporation that, together with related persons, does not constitute a large oil producer.

Passive foreign investment companies

In general

The Tax Reform Act of 1986 established an anti-deferral regime applicable to U.S. persons that hold stock in a passive foreign investment company. The passive foreign investment company rules are aimed at U.S. persons who invest in foreign corporations generating primarily passive income. The Congress believed that the tax rules should not operate to provide U.S. investors with tax incentives to make passive investments through a foreign corporation by granting deferral on such income, when U.S. investors in domestic investment companies were subject to tax currently on similar types of income.[654] In addition, the Congress believed that the regime should apply even in cases where U.S. persons did not control the foreign corporation; thus, the regime does not contain a stock ownership requirement.[655]

A U.S. shareholder of a passive foreign investment company generally is subject to U.S. tax, plus an interest charge, that reflects the value of the deferral of tax, upon receipt of a distribution from the passive foreign investment company or upon a disposition of passive foreign investment company stock. However, if a "qualified electing fund" election is made, the U.S. shareholder is subject to U.S. tax currently on the shareholder's pro rata share of the passive foreign investment company's total earnings; a separate election may be made to defer payment of such tax, subject to an interest charge, on income not currently received by the shareholder. In addition, with respect to passive foreign investment company stock that is marketable, electing shareholders currently take into account as income (or loss) the difference between the fair market value of their passive foreign investment company stock as of the close of the taxable year and their adjusted basis in such stock (subject to certain restrictions).

A foreign corporation is a passive foreign investment company if (1) 75 percent or more of its gross income for the taxable year consists of passive income, or (2) 50 percent or more of the average assets of the corporation consist of assets that produce, or are held for the production

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[654] *See* Joint Committee on Taxation, *General Explanation of the Tax Reform Act of 1986* (JCS-10-87), May 4, 1987, at 1023.

[655] *Id.*

of, passive income (sec. 1297(a)).[656] For this purpose, passive income generally means income that satisfies the definition of foreign personal holding company income under the subpart F provisions (sec. 1297(b)). However, except as provided in regulations, passive income does not include certain active-business banking or insurance income. Also excluded from the definition of passive income is certain active-business securities income. In addition, interest, dividends, rents, and royalties received from related persons are excepted from treatment as passive income to the extent that such amounts are allocable to income of the payor that is not passive income (sec. 1297(b)(2)(C)).

In determining whether a foreign corporation that owns a subsidiary is a passive foreign investment company, look-through treatment is provided in certain cases. A foreign corporation that owns, directly or indirectly, at least 25 percent of the value of the stock of another corporation is treated as owning a proportionate part of the other corporation's assets and income.[657]

Constructive ownership rules apply in determining whether a U.S. person owns stock in a passive foreign investment company (sec. 1298(a)). Under these rules, a U.S. person generally is treated as owning such person's proportionate share of passive foreign investment company stock (1) owned by a partnership, trust or estate of which the person is a partner or beneficiary, (2) owned by a corporation of which the person is a 50-percent or greater shareholder (measured by value), or (3) owned by another passive foreign investment company of which the person is a shareholder.

Treatment of nonqualified funds

In the absence of a qualified electing fund election, a U.S. shareholder of a passive foreign investment company is subject to U.S. tax and an interest charge at the time the

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[656] The 50-percent passive foreign investment company asset test generally is applied using fair market value for purposes of measuring the passive foreign investment company's assets (sec. 1297(f)). For this purpose, fair market value is used for a foreign corporation that is publicly traded. A foreign corporation is treated as publicly traded if stock in such corporation is regularly traded on a national securities exchange that is registered with the Securities Exchange Commission, the national market system established pursuant to applicable securities laws, or any other exchange or market that the Treasury Secretary determines has rules that adequately ensure a sound fair market value for the market price of the stock. However, in the case of a foreign corporation that is a controlled foreign corporation that is not publicly traded (or any other foreign corporation that so elects), the asset test for passive foreign investment company status is applied using the adjusted bases of the corporation's assets rather than their fair market value (sec. 1297(f)(2)).

[657] Thus, amounts such as interest and dividends received from foreign or domestic subsidiaries are eliminated from the parent's income in applying the income test, and the stock or debt investment is eliminated from the parent's assets in applying the asset test. A special rule treats as active assets certain U.S. stock investments of a 25-percent owned U.S. corporation (sec. 1298(b)(8)).

shareholder receives an "excess" distribution from the passive foreign investment company or disposes of stock in the passive foreign investment company (sec. 1291). Under this rule, gain recognized on receipt of an "excess" distribution or on disposition of passive foreign investment company stock generally is treated as ordinary income earned pro rata over the shareholder's holding period with respect to the passive foreign investment company stock, and is taxed at the highest applicable tax rate in effect for each respective year. Interest is imposed at the underpayment rate on the tax liability with respect to amounts allocated to prior taxable years. Special rules apply for purposes of computing foreign tax credits with respect to such distributions (sec. 1291(g)).

An "excess" distribution is any distribution during the current taxable year that exceeds 125 percent of the average amount of distributions received during the three preceding years (or, if shorter, the taxpayer's holding period prior to the current taxable year) (sec. 1291(b)). The determination of an excess distribution excludes from the three-year average distribution base that part of a prior-year excess distribution that is considered attributable to deferred earnings. There are no excess distributions for the first year in the U.S. shareholder's holding period.

Treatment of qualified electing funds

A U.S. person that owns stock in a passive foreign investment company may elect that the passive foreign investment company be treated as a "qualified electing fund" with respect to that shareholder (sec. 1295). Under such election, the U.S. shareholder must include currently in gross income the shareholder's pro rata share of the passive foreign investment company's total earnings and profits (sec. 1293). This inclusion rule generally requires current payment of tax, absent a separate election to defer payment of the tax (sec. 1294).

The amount currently included in the income of an electing shareholder is divided between the shareholder's pro rata share of the ordinary earnings of the passive foreign investment company and the shareholder's pro rata share of the net capital gain of the passive foreign investment company (sec. 1293(a)(1)). The characterization of income, and the determination of earnings and profits, generally is made pursuant to general Code rules (sec. 1293(e)).

A U.S. shareholder's pro rata share of income generally is determined by attributing the passive foreign investment company's income for the taxable year ratably over the days in such year (sec. 1293(b)). Electing shareholders include in income for the period in which they held stock in the passive foreign investment company an amount equal to the sum of their daily ownership interest in the passive foreign investment company multiplied by the income attributed to such day. If it is established that a passive foreign investment company maintains records determining its shareholders' pro rata shares of income more accurately than by allocating a year's income ratably on a daily basis, the shareholders' pro rata shares of income may be determined on that basis.

The distribution of earnings and profits that were previously included in the income of an electing U.S. shareholder under these rules is not taxed as a dividend to the shareholder (sec. 1293(c)). The basis of an electing U.S. shareholder's stock in a passive foreign investment company is increased by amounts currently included in income under these rules, and is

decreased by any amount that is actually distributed but treated as previously taxed (sec. 1293(d)).

U.S. shareholders generally may elect to defer the payment of U.S. tax on amounts that are included currently in income but for which no current distribution has been received (sec. 1294). An election to defer tax is treated as an extension of time to pay tax for which a U.S. shareholder is liable for interest. The disposition of stock in a passive foreign investment company terminates all previous extensions of time to pay tax with respect to the earnings attributable to that stock. Any transfer of ownership generally is treated as a disposition for this purpose, regardless of whether the transfer constitutes a realization or recognition event under general Code rules.

Mark-to-market election

A shareholder of a passive foreign investment company may make a mark-to-market election with respect to the stock of a passive foreign investment company, provided that such stock is marketable (sec. 1296). Under such an election, the shareholder includes in income each year an amount equal to the excess, if any, of the fair market value of the passive foreign investment company stock as of the close of the taxable year over the shareholder's adjusted basis in such stock. The shareholder is allowed a deduction for the excess, if any, of the adjusted basis of the passive foreign investment company stock over its fair market value as of the close of the taxable year. However, deductions generally are allowable under this rule to the extent of any net mark-to-market gains with respect to the stock included by the shareholder for prior taxable years.

For purposes of this election, passive foreign investment company stock generally is considered marketable if it is regularly traded on a national securities exchange that is registered with the Securities Exchange Commission, or on the national market system established pursuant to applicable securities laws, or any other exchange or market that the Treasury Secretary determines has rules which adequately ensure a sound fair market value for the market price of the stock (sec. 1296(e)).

The shareholder's adjusted basis in marketable passive foreign investment company stock is adjusted to reflect the amounts included or deducted under this election (sec. 1296(b)). Amounts included in income pursuant to the election, as well as gain on the actual sale or other disposition of the passive foreign investment company stock, are treated as ordinary income (sec. 1296(c)). Ordinary loss treatment also applies to the deductible portion of any mark-to-market loss on the passive foreign investment company stock, as well as to any loss realized on the actual sale or other disposition of passive foreign investment company stock to the extent that the amount of such loss does not exceed the net mark-to-market gains previously included with respect to such stock. The source of amounts with respect to a mark-to-market election generally is determined in the same manner as if such amounts were gain or loss from the sale of stock in the passive foreign investment company (sec. 1296(c)).

A mark-to-market election applies to the taxable year for which made and all subsequent taxable years, unless the passive foreign investment company stock ceases to be marketable or the Treasury Secretary consents to the revocation of such election.

The passive foreign investment company rules for nonqualified funds generally do not apply to a shareholder of a passive foreign investment company if a mark-to-market election is in effect for the shareholder's taxable year. However, certain coordination rules apply to ensure that the taxpayer does not avoid the interest charge with respect to amounts attributable to periods before the election (sec. 1296(j)).

Foreign personal holding companies

In general

The foreign personal holding company rules are aimed at preventing U.S. persons from accumulating income tax-free in foreign "incorporated pocketbooks." If a foreign corporation qualifies as a foreign personal holding company, all the U.S. shareholders of the corporation are subject to U.S. tax currently on their pro rata share of the corporation's undistributed foreign personal holding company income.

A foreign corporation is a foreign personal holding company if it satisfies both a stock ownership requirement and a gross income requirement (sec. 552(a)). The stock ownership requirement is satisfied if, at any time during the taxable year, more than 50 percent (measured by vote or by value) of the stock of the corporation is owned by or for five or fewer individual citizens or residents of the United States. Indirect and constructive ownership rules apply for purposes of the stock ownership requirement (sec. 554). The gross income requirement is satisfied initially if at least 60 percent of the corporation's gross income is foreign personal holding company income. Once the corporation qualifies as a foreign personal holding company, however, the gross income threshold for each subsequent year is only 50 percent, until the expiration of either one full taxable year during which the stock ownership requirement is not satisfied or three consecutive taxable years for which the gross income requirement is not satisfied at the 50-percent threshold (sec. 552(a)(1)).

If a foreign corporation is a foreign personal holding company, its undistributed foreign personal holding company income is treated as distributed as a dividend on a pro-rata basis to all of its U.S. shareholders (sec. 551(b)). The undistributed foreign personal holding company income that is deemed distributed is treated as recontributed by the shareholders to the foreign personal holding company as a contribution to capital. Accordingly, the earnings and profits of the corporation are reduced by the amount of the deemed distribution (sec. 551(d)), and each shareholder's basis in his or her stock in the foreign personal holding company is increased by the shareholder's pro rata portion of the deemed distribution (sec. 551(e)).

Foreign personal holding company income

Foreign personal holding company income generally includes passive income such as (1) dividends, interest, certain royalties, and annuities; (2) gains from stock and securities transactions (other than gains of dealers); (3) gains from commodities transactions (other than gains from bona fide hedging transactions); (4) income with respect to interests in estates and trusts and gains from the sale of such interests; (5) certain amounts received with respect to certain personal services contracts; (6) certain amounts received as compensation for the use of the corporation's property by certain shareholders; and (7) rents, unless such income constitutes

at least 50 percent of the corporation's gross income (sec. 553(a)). Look-through rules apply for purposes of characterizing certain dividends and interest received from related persons (sec. 552(c)).

Personal holding companies

In addition to the corporate income tax, a tax is imposed at the rate of 39.6 percent on the undistributed personal holding company income of a personal holding company (sec. 541). This tax substitutes for the tax that would have been incurred by the shareholders on dividends actually distributed by the personal holding company.

A corporation generally is a personal holding company if (1) at least 60 percent of its adjusted gross income for the taxable year is personal holding company income, and (2) at any time during the last half of the taxable year more than 50 percent (by value) of its outstanding stock is owned, directly or indirectly, by or for not more than five individuals (sec. 542(a)). The definition of a personal holding company is very similar to that of a foreign personal holding company, discussed above, but does not depend on the U.S. citizenship or residence status of the shareholders. However, specified exceptions to the definition of a personal holding company preclude the application of the personal holding company tax to, among others, any foreign personal holding company, most foreign corporations owned solely by nonresident alien individuals, and any passive foreign investment company (sec. 542(c)(5), (7), and (10)). Notwithstanding these exceptions, the personal holding company tax is potentially applicable to a small class of closely-held foreign corporations.

Accumulated earnings tax

In addition to the corporate income tax, a tax is imposed at the rate of 39.6 percent on the accumulated taxable income of a corporation formed or availed of for the purpose of avoiding income tax with respect to its shareholders (or the shareholders of any other corporation), by permitting its earnings and profits to accumulate instead of being distributed (secs. 531, 532(a)). The fact that the earnings and profits of the corporation are allowed to accumulate beyond the reasonable needs of the business generally is determinative of the required tax-avoidance motive (sec. 533).

The accumulated earnings tax applies to a foreign corporation with respect to income derived from U.S. sources if any of its shareholders are subject to income tax on distributions by the foreign corporation by reason of being (1) U.S. citizens or residents, (2) nonresident individuals who are not citizens and to whom section 871 is applicable, or (3) foreign corporations with beneficial owners (direct or indirect) described in (1) or (2).[658]

Like the personal holding company tax, the accumulated earnings tax acts as a substitute for the tax that would have been incurred by the shareholders on dividends actually distributed by the corporation. The accumulated earnings tax does not apply to any personal holding company, foreign personal holding company, or passive foreign investment company (sec. 532(b)). These exceptions, along with the current inclusion of subpart F income in the gross

[658] Treas. Reg. sec. 1.532-1(c).

incomes of the U.S. 10-percent shareholders of a controlled foreign corporation, result in only a very limited application of the accumulated earnings tax to foreign corporations.

Foreign investment companies

Gain on a sale or exchange (or a distribution that is treated as an exchange) of stock in a foreign investment company generally is treated as ordinary income to the extent of the taxpayer's ratable share of the undistributed earnings and profits of the foreign investment company (sec. 1246(a)). This rule operates not to prevent deferral of U.S. tax, as do the foregoing sets of rules, but rather to prevent the use of a foreign corporation to convert ordinary income into capital gain.

Foreign investment companies that were registered under the Investment Company Act of 1940 could elect before January 1, 1963, to be subject to tax rules similar to that for U.S. mutual funds (sec. 1247). A foreign investment company that made the election under section 1247 must annually distribute to its shareholders at least 90 percent of its taxable income. In addition, the corporation must notify the shareholders within 45 days after the close of the taxable year their pro rata amounts of the corporation's net capital gain for the year (determined as if the corporation were a domestic corporation) and the portion of such gain which is being distributed. U.S. shareholders of the foreign investment company that made the election under section 1247 are not subject to the ordinary income rules of section 1246 unless the shareholder did not report for a year his or her pro rata share of the undistributed net capital gain.

A foreign corporation generally is a foreign investment company if (1) the corporation is registered as a management company or as a unit investment trust, or is engaged primarily in the business of investing, reinvesting, or trading in securities or commodities or any interest in securities or commodities and (2) 50 percent or more (measured by vote or by value) of the stock of the corporation is held (directly or indirectly) by U.S. persons (sec. 1246(b)).

Coordination among the anti-deferral regimes

U.S. shareholders that are subject to current inclusion under the subpart F rules with respect to stock of a passive foreign investment company that is also a controlled foreign corporation generally are not also subject to the passive foreign investment company provisions with respect to the same stock (sec. 1297(e)).[659] As a result, there generally is not an overlap between the controlled foreign corporation and passive foreign investment company rules. Special rules apply to options to acquire stock for these purposes. If a shareholder is not subject to the passive foreign investment company provisions because the shareholder is subject to subpart F and the shareholder subsequently ceases to be subject to subpart F with respect to the

[659] In this regard, a corporation is not treated as a passive foreign investment company with respect to a shareholder during the qualified portion of the shareholder's holding period for the stock of such corporation. The qualified portion of the shareholder's holding period generally is the portion of such period that is after December 31, 1997, and during which the shareholder is a U.S. shareholder (within the meaning of sec. 951(b)) and the corporation is a controlled foreign corporation (within the meaning of sec. 957).

corporation, the shareholder's holding period for such stock is treated as beginning immediately after such cessation for purposes of applying the passive foreign investment company rules.

If an item of income of a foreign corporation would be includable in the gross income of a U.S. shareholder both under the controlled foreign corporation rules and under the foreign personal holding company rules, that item of income is included only under the controlled foreign corporation rules (sec. 951(d)). This rule of precedence operates only to the extent that the controlled foreign corporation rules and the foreign personal holding company rules overlap on an item-by-item basis. Income includible under only one set of rules (foreign personal holding company rules or subpart F rules) is includible under that set of rules. A taxpayer taxable under subpart F on amounts other than subpart F income (on such items as withdrawals from foreign base company shipping income and investments in U.S. property) is taxable under subpart F whether or not the taxpayer is also taxable on the undistributed foreign personal holding company income of the foreign corporation under the foreign personal holding company rules.

If an item of income of a foreign corporation would be includable in the gross income of a U.S. shareholder both under the controlled foreign corporation rules and under the rules relating to the current taxation of income from certain passive foreign investment companies, that item of income is included only under the controlled foreign corporation rules (sec. 951(f)). In addition, if an item of income of a foreign corporation would be includable in the gross income of a U.S. shareholder both under the controlled foreign corporation rules and under the rules relating to the current taxation of income from electing foreign investment companies, that item of income is included only under the foreign investment company rules (sec. 951(c)). Any amount that is taxable under only one set of rules is included in gross income pursuant to that set of rules.

In the case of a foreign corporation that is both a foreign personal holding company and a passive foreign investment company, to the extent that the income of the foreign corporation would be taxable to a U.S. person both under the foreign personal holding company rules and under section 1293 (relating to current taxation of income of certain passive foreign investment companies), that income is treated as taxable to the U.S. person only under the foreign personal holding company rules (sec. 551(g)).

In the case of a passive foreign investment company that is a qualified electing fund, the amount of income treated as a dividend on a sale or exchange of stock in a controlled foreign corporation (under sec. 1248) does not include any amount of income included previously under the qualified electing fund rules to the extent that that amount of income has not been distributed from the passive foreign investment company prior to the sale or exchange of the stock.

As noted above, the personal holding company tax does not apply to any foreign personal holding company or passive foreign investment company, and the accumulated earnings tax does not apply to any personal holding company, foreign personal holding company, or passive foreign investment company.

Section 1246 does not apply to the earnings and profits of any foreign investment company for any year after 1986 if the company is a passive foreign investment company for that

year (sec. 1298(b)(7)). In addition, an electing foreign investment company under section 1247 is excluded from the definition of a passive foreign investment company (sec. 1297(d)).

Sources of Complexity

The various anti-deferral regimes applicable to income earned through foreign corporations were enacted or modified at different times. A consistent theme of the various anti-deferral regimes is to provide current taxation for certain types of interest, dividend, rental, royalty, and other similar income. However, the enactment over time of the various anti-deferral regimes has resulted in different thresholds for applying the regimes, for example, based on income or asset tests at the foreign corporation level, or of U.S. stock ownership tests at the shareholder level. The various regimes also apply different mechanisms by which the benefits of deferral are denied to U.S. shareholders of foreign corporations. For example, some regimes target specific types of income (*e.g.*, foreign personal holding company income and base company income) while others cause the U.S. shareholder to include their pro rata share of the foreign corporation's income once the thresholds are met. Some regimes preserve the character of the income earned in the hands of a foreign corporation while others do not. Some provide for movement of losses between years of a single foreign corporation or between multiple corporations while others do not. Different regimes have different ordering rules for determining which dividends from foreign corporations subject to the regimes are subject to tax on repatriation and which are untaxed distributions of previously taxed income.

Because of the differences among the various anti-deferral regimes, U.S. persons frequently are faced with the need to consult multiple sets of anti-deferral rules when they hold stock in a foreign corporation. In addition, the interaction of the rules causes additional complexity. Although significant simplification was achieved in 1997 through the general elimination of the overlap between the subpart F and passive foreign investment company rules, there remains overlap among the various regimes. These overlaps require the Code to provide specific rules of priority for income inclusions among the regimes, as well as additional coordination provisions pertaining to other operational differences among the various regimes. The multiple application of anti-deferral regimes to a corporation can result in significant complexity with little or no ultimate tax consequences.[660]

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[660] Some have cited the subpart F rules as an area of significant complexity. The Joint Committee staff considered several ideas and proposals to simplify the subpart F rules. For example, some suggested that passive but not active income be taxed under subpart F. *See, e.g.*, Department of the Treasury, *International Tax Reform, An Interim Report* (January 1993). The Joint Committee staff determined that many of these ideas or proposals raised significant policy issues that were beyond the scope of this study.

Recommendation for Simplification

The Joint Committee staff recommends that (1) the rules applicable to foreign personal holding companies and foreign investment companies should be eliminated, (2) foreign corporations should be excluded from the application of the personal holding company rules, and (3) subpart F foreign personal holding company income should include certain personal services contract income targeted under the present-law foreign personal holding company rules.[661]

During the past century various anti-deferral rules have been enacted at different points in time with respect to income earned through a foreign corporation. In general, the following six different sets of rules (in order of enactment) are applicable or potentially applicable to U.S. persons who earn income through a foreign corporation: (1) the accumulated earnings tax (1913),[662] (2) the personal holding company rules (1934), (3) the foreign personal holding

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[661] In this regard, the recommendation would treat as foreign personal holding company income for subpart F purposes amounts received under a contract to furnish personal services if a person other than the corporation has the right to designate (by name or by description) the individual who is to perform the services, or if the individual who is to perform the services is designated (by name or by description) in the contract. The recommendation similarly would treat as foreign personal holding company income for subpart F purposes any amount received from the sale or other disposition of such a contract. These rules would apply only if at some time during the taxable year 25 percent or more of the value of the corporation's stock is owned (directly or indirectly) by or for the individual who may be designated to perform the services.

[662] Some suggested that foreign corporations be excluded from the accumulated earnings tax rules. Although the recommendation is intended to address complexity for U.S. persons who potentially account for income earned through foreign corporations under multiple anti-deferral regimes, it may be appropriate to retain the accumulated earnings tax rules for U.S. shareholders of foreign corporations to the extent that such rules continue to apply generally. Otherwise, U.S. persons may have an incentive to have a foreign corporation engage in a U.S. trade or business activity in order to avoid accumulated earnings taxes that may otherwise apply. The accumulated earnings tax rules, however, may have less significance for foreign shareholders of foreign corporations. In this regard, the branch profits tax generally will be imposed on income that a foreign corporation accumulates beyond its reasonable needs under the accumulated earnings tax. Consideration could be given to eliminating the accumulated earnings tax rules for a foreign corporation with foreign shareholders, or with a mix of foreign shareholders as well as U.S. shareholders with no more than an insignificant (e.g., less than 10 percent) ownership interest in the foreign corporation. *See* American Law Institute, *Federal Income Tax Project, International Aspects of United States Income Taxation, Proposals of the American Law Institute on United States Taxation of Foreign Persons and of the Foreign Income of United States Persons*, at 157-167 (1987) (hereinafter referred to as the "ALI Report") (proposing that a foreign corporation be subject to the accumulated earnings tax only if at least one U.S. person directly or indirectly owns 10 percent or more in value of its stock, and only with respect to income effectively connected with a U.S. trade or business or otherwise subject to U.S. tax on a net income basis).

company rules (1937), (4) the controlled foreign corporation rules (1962), (5) the foreign investment company rules (1962), and (6) the passive foreign investment company rules (1986). In 1993, an additional anti-deferral regime was enacted under section 956A that required U.S. shareholders to include currently in income their pro rata shares of the accumulated earnings of a controlled foreign corporation invested in excess passive assets.[663] That seventh regime was eliminated in 1996.[664] In addition, in 1997, the overlap between the subpart F and passive foreign investment company rules generally was eliminated.

Over the years, the layering of anti-deferral regimes over other anti-deferral regimes has led to a proliferation of complexity in this area. While each regime was enacted to address particular issues that existed at the time of enactment, a consistent theme for all the regimes is to currently tax certain types of passive income.

Prior proposals have been considered to consolidate the various anti-deferral regimes. For example, prior proposals would have consolidated the various anti-deferral regimes into a single regime applicable to passive foreign corporations.[665] A passive foreign corporation was defined for these purposes as any foreign corporation if (1) 60 percent or more of its gross income is passive income, (2) 50 percent or more of its assets (on average during the year, measured by value) produce passive income or are held for the production of income, or (3) it is registered under the Investment Company Act of 1940 (as amended) either as a management company or as a unit investment trust. This definition represents a consolidation of the threshold tests for foreign personal holding companies, passive foreign investment companies, and foreign investment companies. These proposals generally would have eliminated deferral with respect to all U.S. shareholders of a passive foreign corporation that is also a controlled foreign corporation,[666] as well as with respect to U.S. shareholders owning 25 percent or more of the

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[663] *See* the Omnibus Budget Reconciliation Act of 1993, Pub. Law No. 103-66, sec. 13231, 107 Stat. 312 (1993).

[664] *See* the Small Business Job Protection Act of 1996, Pub. Law No. 104-188, sec. 1501, 110 Stat. 1755 (1966).

[665] *See, e.g.,* Joint Committee on Taxation, *Technical Explanation of the Tax Simplification Act of 1993* (H.R. 13) (JCS-1-93), January 8, 1993, at 85-122; Joint Committee on Taxation, *Explanation of H.R. 5270 (Foreign Income Tax Rationalization and Simplification Act of 1992)* (JCS-11-92), May 29, 1992, at 68-81.

[666] The elimination of deferral with respect to all income earned through certain controlled foreign corporations, as provided under these proposals, raises significant policy issues that generally are beyond the scope of this study. For recent discussions of policy issues raised by the subpart F rules, see Department of the Treasury, *The Deferral of Income Earned Through U.S. Controlled Foreign Corporations, A Policy Study* (December 2000); National Foreign Trade Council, *The NFTC Foreign Income Project: International Tax Policy for the 21st Century, Part One: A Reconsideration of Subpart F* (1999).

stock of a passive foreign corporation that is not a controlled foreign corporation.[667] The proposals also would have eliminated the foreign personal holding company rules and the foreign investment company rules, and would have excluded foreign corporations from the application of the personal holding company rules and the accumulated earnings tax.

The Joint Committee staff believes that simplification in this area could be achieved by eliminating some of the anti-deferral regimes outright.[668] By reducing the number of anti-deferral regimes, U.S. shareholders of foreign corporations can be spared the burden of understanding and complying with a multiplicity of separate anti-deferral regimes with separate definitions and requirements. Simplification would be achieved through the elimination of the foreign personal holding company rules and the foreign investment company rules, as well as the exclusion of foreign corporations from the personal holding company rules. In this manner, income earned through foreign corporations would potentially be subject to the controlled foreign corporation rules or the passive foreign investment company rules.[669] These two regimes are not only the main anti-deferral regimes in the Code, but are the main types of anti-deferral regimes that have been employed over the years by most developed countries.[670]

The elimination of some of the anti-deferral regimes, while intended to provide simplification for both taxpayers and the government, may have consequences in terms of potential gaps that may exist to the extent that the subpart F or passive foreign investment company rules do not cover circumstances that are presently covered by these other regimes. Described below are some areas where gaps may exist. In general, the Joint Committee staff believes that these areas are not significant enough to justify retaining a particular regime. Consideration could be given to certain modifications to the subpart F and/or passive foreign

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[667] Taxpayers owning less than 25 percent of the stock of a passive foreign corporation that is not a controlled foreign corporation could also elect the elimination of deferral with respect to income earned by the foreign corporation. In addition, less than 25-percent shareholders of a passive foreign corporation that is not a controlled foreign corporation and who do not elect current inclusion would be subject to either a mark-to-market method or an interest charge method (similar to the present-law passive foreign investment company rules).

[668] *See* Tillinghast, *International Tax Simplification*, 8 American J. of Tax Policy 187, 199-204 (1990) (proposing to eliminate the foreign personal holding company, foreign investment company, and (as applicable to foreign corporations) the personal holding company rules) (hereinafter referred to as "Tillinghast").

[669] With the general elimination of the overlap between the controlled foreign corporation and passive foreign investment company rules in 1997, U.S. persons generally would be subject under the recommendation to only one of these regimes. In addition, as described above, the recommendation does not modify the accumulated earnings tax rules for foreign corporations.

[670] *See* Organization for Economic Cooperation and Development, *Studies in Taxation of Foreign Source Income, Controlled Foreign Company Legislation* (1996).

investment company rules to address issues that might be raised by the elimination of certain anti-deferral regimes.

Foreign personal holding company rules

The foreign personal holding company rules have been described as an "anachronistic vestige."[671] In general, subject to limited exceptions described below, U.S. persons who are potentially taxable under the foreign personal holding company rules will be taxable under either the subpart F or passive foreign investment company rules. The foreign personal holding company and passive foreign investment company regimes are designed to currently tax U.S. shareholders of foreign corporations that principally derive passive income. Thus, even though certain differences may exist, these differences should not justify retaining the foreign personal holding company rules.

Since the threshold tests for foreign personal holding companies are different than those for controlled foreign corporations and passive foreign investment companies, there are potentially circumstances in which the elimination of the foreign personal holding company rules would result in U.S. shareholders who are currently taxable under the foreign personal holding company rules from not being taxed under any remaining anti-deferral regimes. In this regard, under present law, a foreign corporation could be treated as a foreign personal holding company but not as a controlled foreign corporation or a passive foreign investment company. Under the stock ownership test, a foreign corporation is a foreign personal holding company if, among other things, more than 50 percent (measured by vote or by value) of the stock of the corporation is owned by or for five or fewer individual citizens or residents of the United States. A foreign corporation is a controlled foreign corporation if U.S. 10-percent shareholders own more than 50 percent of such corporation's stock (measured by vote or by value). Thus, for example, if one U.S. shareholder owns 49 percent of the stock of a foreign corporation, and a second U.S. shareholder owns 2 percent of such stock (with the remaining stock owned by unrelated foreign shareholders), the foreign corporation would satisfy the stock ownership test for a foreign personal holding company (because less than five U.S. shareholders own more than 50 percent of the stock), but it would not be treated as a controlled foreign corporation (because there is not one or more 10-percent or greater U.S. shareholders who own more than 50 percent of the stock).

In addition, under present law, a foreign corporation could be treated as a foreign personal holding company but not as a passive foreign investment company. Under the income test, a foreign personal holding company must have at least 50 percent (60 percent in the first year) of the corporation's gross income as passive income. In contrast, under the passive foreign investment company income test, at least 75 percent of the foreign corporation's gross income must be passive income. This gap in income thresholds could lead to potential gaps in the

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[671] Tillinghast at 201. *See also* the ALI Report at 441 ("The significance of the foreign personal holding company provisions has been greatly reduced by the 1986 enactment of the [passive foreign investment company] provisions . . . since virtually any corporation qualifying as a foreign personal holding company will also be a [passive foreign investment company] whose U.S. shareholders may be subject to current taxation (or a deferred tax with an interest charge)".

taxation of U.S. shareholders of a foreign corporation if the foreign personal holding company rules were eliminated.[672] However, this gap may not be significant given that a foreign corporation can alternatively be treated as a passive foreign investment company if 50 percent or more of its assets are passive assets. In addition, since the income and assets of a foreign corporation may fluctuate year by year, a foreign corporation that is a foreign personal holding company but that currently does not meet the passive foreign investment company income or asset thresholds may meet one or both of such thresholds in a subsequent year.[673]

In addition, there are potential gaps in the types of passive income that are targeted under the different regimes.[674] For example, the definition of foreign personal holding company income under the foreign personal holding company rules includes amounts received under a contract to furnish personal services if a person other than the corporation has the right to designate (by name or by description) the individual who is to perform the services, or if the individual who is to perform the services is designated (by name or by description) in the contract. The foreign personal holding company rules also treat as foreign personal holding company income any amount received from the sale or other disposition of such a contract. These rules apply only if at some time during the taxable year 25 percent or more of the value of the corporation's stock is owned (directly or indirectly) by or for the individual who may be designated to perform the services. Similar rules are not included in the definition of foreign personal holding company income under the subpart F rules, or in the definition of passive income under the passive foreign investment company rules.[675] To address some of these

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[672] This gap in income thresholds could be addressed by decreasing the income threshold test under the passive foreign investment company rules to 60 or 50 percent. However, the potential gaps that may exist may not warrant such a change to the passive foreign investment company rules.

[673] Once either threshold is met, the passive foreign investment company would generally be treated as a passive foreign investment company for all future years. Sec. 1298(b)(1). To avoid this result, taxpayers may engage in planning strategies to avoid the passive foreign investment company thresholds on a year-by-year basis.

[674] Compare secs. 553(a), 954(c), and 1297(b).

[675] It should be noted that these items were included in the definition of foreign personal holding company income for subpart F purposes prior to legislative changes made in 1986. There could be other gaps in terms of the types of income that are targeted under the various regimes. For, example, foreign personal holding company income for purposes of the foreign personal holding company rules also includes certain amounts received as compensation by certain shareholders for the use of corporate property. There is not a similar category of income under the subpart F or passive foreign investment company rules. However, rents, which are treated as subpart F foreign personal holding company income and as passive income under the passive foreign investment company rules (but not as foreign personal holding company income under the foreign personal holding company rules if rents constitute 50 percent or more of gross income) should adequately address this category of income. In addition, the foreign personal holding company rules apply to income with respect to interests in estates and trusts, as well as gain from the sale of such interests, whereas the subpart F and passive foreign investment

potential gaps, the recommendation would treat such items as foreign personal holding company income for subpart F purposes.[676]

Foreign investment company rules

The foreign investment company rules generally do not have significant relevance since the enactment of the passive foreign investment company rules in 1986.[677] Gain on a sale or exchange (or a distribution that is treated as an exchange) of stock in a foreign investment company generally is treated as ordinary income to the extent of the taxpayer's ratable share of the undistributed earnings and profits of the foreign investment company. A foreign corporation generally is a foreign investment company if (1) the corporation is registered as a management company or as a unit investment trust, or is engaged primarily in the business of investing, reinvesting, or trading in securities or commodities or any interest in securities or commodities and (2) 50 percent or more (measured by vote or by value) of the stock of the corporation is held (directly or indirectly) by U.S. persons.

Since capital gains currently are taxed at preferential rates for individuals, there is potentially some application that may exist with respect to the foreign investment company rules. However, the rules generally do not apply to any gain to the extent the gain is treated under

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company rules apply only to gain from the sale of trust interests. However, the character pass-through rules of secs. 652(b) and 662(b) for certain income included with respect to interests in trusts and estates should adequately address the treatment of such income for these purposes.

[676] In addition, certain exceptions from treatment as passive income vary under the different regimes. For example, the subpart F and passive foreign investment company rules, which apply to dividends, interest, rents, and royalties, contain certain exceptions for: dividends and interest received by a controlled foreign corporation from a related corporation organized and operating in the same foreign country in which the controlled foreign corporation was organized; rents and royalties received by the controlled foreign corporation from a related corporation for the use of property within the country in which the controlled foreign corporation was organized; rents and royalties received by the controlled foreign corporation in the active conduct of a trade or business from unrelated persons; certain export financing interest; certain dealers; and certain active financing income (under temporary exceptions). The passive foreign investment company rules also except dividends, interest, rents, and royalties received from related persons from treatment as passive income to the extent such amounts are allocable to income of the payor that is not passive income. The foreign personal holding company rules provide exceptions for: certain dividends and interest received from related persons based on look-through rules; certain active business computer software royalties; and rents if the rents constitute 50 percent or more of gross income.

[677] The foreign investment company rules have been described as follows: "Since 1986, § 1246 has been like the cop on the beat after [martial] law has been declared and the army has filled the neighborhood with troops; he is still there, but his authority has been so overwhelmed that it is easily overlooked." Bittker and Lokken, *Fundamentals of International Taxation, U.S. Taxation of Foreign Income and Foreign Taxpayers*, at para. 68.4.1 (1997).

section 1248 as ordinary income from the sale of stock in a controlled foreign corporation.[678] In addition, the rules generally do not apply to the extent that the passive foreign investment company rules apply (which include rules upon the disposition of passive foreign investment company stock).[679] A potential gap may exist with respect to a foreign corporation that is a foreign investment company but that is not a controlled foreign corporation or passive foreign investment company. This would be a foreign corporation that meets the definitional requirements described above for a foreign investment company, but that does not meet the controlled foreign corporation or passive foreign investment company thresholds. However, there are unlikely to be many cases in which, for example, a foreign corporation that is registered as a management company or as a unit investment trust does not also meet one or both of the passive foreign investment company thresholds.[680] Thus, there should not be a significant justification for the retention of this regime.

Personal holding company rules

In addition to the corporate income tax, a tax is imposed at the rate of 39.6 percent on the undistributed personal holding company income of a personal holding company. A corporation generally is a personal holding company if (1) at least 60 percent of its adjusted gross income for the taxable year is personal holding company income, and (2) at any time during the last half of the taxable year more than 50 percent (by value) of its outstanding stock is owned, directly or indirectly, by or for not more than five individuals. The definition of a personal holding company is very similar to that of a foreign personal holding company, discussed above, but does not depend on the U.S. citizenship or residence status of the shareholders.

In the case of a foreign corporation, the personal holding company rules generally apply only to income effectively connected with a U.S. trade or business or other U.S.-source income of the foreign corporation.[681] Specified exceptions to the definition of a personal holding company preclude the application of the personal holding company tax to, among others, any foreign personal holding company, most foreign corporations owned solely by nonresident alien individuals, and any passive foreign investment company. Notwithstanding these exceptions, the

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[678] Sec. 1246(g).

[679] Sec. 1298(b)(7).

[680] One case could involve an active business that invests in securities, for example, but that is owned by a holding company and, therefore, can avoid passive foreign investment company status under special look-through rules under secs. 1296(b)(2) and (c). *See* Tillinghast at 203.

[681] The personal holding company rules impose a tax on undistributed personal holding company income that generally is the taxable income of the corporation (i.e., gross income less deductions). Under section 882(b), gross income of a foreign corporation is limited to gross income effectively connected with the conduct of a U.S. trade or business or other gross U.S.-source income.

personal holding company tax is potentially applicable to a small class of closely-held foreign corporations.

As described above in the context of the foreign personal holding company rules, the passive foreign investment company rules should apply in most cases in which the personal holding company rules could potentially also apply. As described above, there could be gaps based on differences in income threshold tests and definitional differences as to what is considered to be passive income.[682] However, given the limited scope of the personal holding company rules as they apply to foreign corporations, and given that the passive foreign investment company rules should adequately police the routing of passive income (whether U.S.- or foreign-source) through foreign corporations, the personal holding company regime (as applicable to foreign corporations) should no longer be necessary.[683]

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[682] *See* sec. 543(a) for items of income treated as personal holding company income.

[683] *See* the ALI Report at 157-167 (proposing that a foreign corporation not be subject to the personal holding company tax).

C. Expand Subpart F De Minimis Rule

Present Law

Under the rules of subpart F, U.S. 10-percent shareholders of a controlled foreign corporation are required to include in income currently for U.S. tax purposes certain types of income of the controlled foreign corporation, whether or not such income is actually distributed currently to the shareholders (referred to as "subpart F income"). Subpart F income includes foreign base company income and certain insurance income. Foreign base company income includes five categories of income: foreign personal holding company income, foreign base company sales income, foreign base company services income, foreign base company shipping income, and foreign base company oil-related income (sec. 954(a)). Under a de minimis rule, if the gross amount of a controlled foreign corporation's foreign base company income and insurance income for a taxable year is less than the lesser of five percent of the controlled foreign corporation's gross income or $1 million, then no part of the controlled foreign corporation's gross income is treated as foreign base company income or insurance income (sec. 954(b)(3)(A)). Prior to the Tax Reform Act of 1986, a de minimis rule provided that foreign base company income less than 10 percent of gross income would not be subpart F income.

Sources of Complexity

There are complexity and compliance burdens associated with accounting for income both under the general rules for income earned through a foreign corporation, and under special anti-deferral regimes such as subpart F. These include complexity associated with understanding and complying with the subpart F rules, identifying and computing the portion of a controlled foreign corporation's income subject to current inclusion (and the attendant taxpayer filings to report such income), and the portion of a controlled foreign corporation's income for which deferral is permitted. Expanding the present-law subpart F de minimis rule would reduce the complexity and compliance burdens for taxpayers with relatively modest amounts of subpart F income.

Recommendation for Simplification

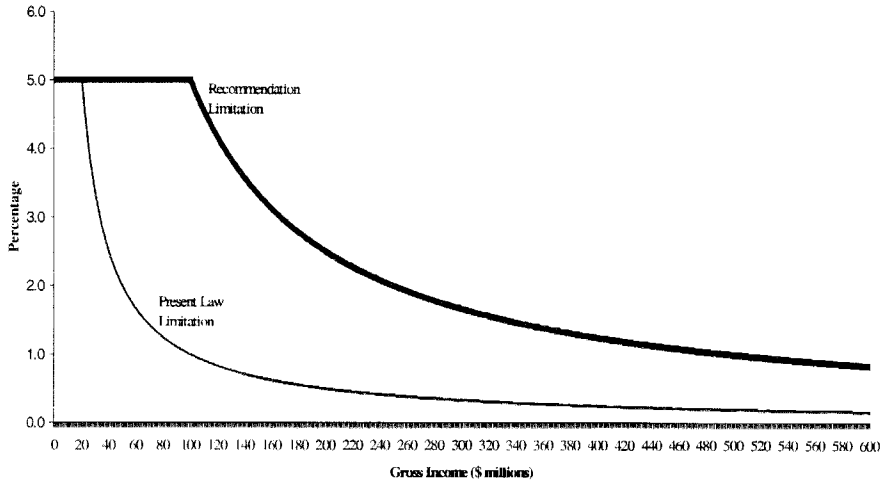
The staff of the Joint Committee on Taxation recommends that the subpart F de minimis rule should be modified to be the lesser of five percent of gross income or $5 million (increased from the present-law dollar threshold of $1 million).

In reducing the percentage of gross income test under the subpart F de minimis rule from 10 percent to 5 percent in 1986, Congress established that an exception was appropriate in situations where a relatively small portion of the controlled foreign corporation's gross income constituted foreign base company income and insurance income. The $1 million dollar limitation of present law has the effect of applying a tighter percentage of gross income test for those controlled foreign corporations with gross income in excess of $20 million ($20 million times 5 percent, or $1 million). Figure 1 below illustrates this point. In the figure the lesser of $1 million or 5 percent of gross income is graphed as a percentage of gross income. The line

"Present Law Limitation" shows how the $1 million prong of the present-law test is the equivalent of imposing an increasingly tighter percentage test as gross income increases.

The recommendation's increase in the dollar limitation to $5 million would have the effect of applying a tighter percentage of gross income test for those controlled foreign corporations with gross income in excess of $100 million ($100 million times 5 percent, or $5 million). See the line "Recommendation Limitation" in Figure 1. By increasing the dollar limitation prong of the de minimis rule, the recommendation would reduce complexity and filing burdens for taxpayers with modest dollar amounts of subpart F income but for whom subpart F income is a relatively insignificant portion of the controlled foreign corporation's gross income.

Figure 1.--Limitation as a Percentage of Gross Income Under Present Law and Recommendation



D. Look-Through Rules for Dividends From Noncontrolled Section 902 Corporations

Present Law

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

Special foreign tax credit limitations apply in the case of dividends received from a foreign corporation in which the taxpayer owns at least 10 percent of the stock by vote and which is not a controlled foreign corporation (a so-called "10/50 company").[684] Dividends paid by a 10/50 company in taxable years beginning before January 1, 2003, are subject to a separate foreign tax credit limitation for each 10/50 company. Dividends paid by a 10/50 company that is not a passive foreign investment company in taxable years beginning after December 31, 2002, out of earnings and profits accumulated in taxable years beginning before January 1, 2003, are subject to a single foreign tax credit limitation for all 10/50 companies (other than passive foreign investment companies). Dividends paid by a 10/50 company that is a passive foreign investment company out of earnings and profits accumulated in taxable years beginning before January 1, 2003, continue to be subject to a separate foreign tax credit limitation for each such 10/50 company. Dividends paid by a 10/50 company in taxable years beginning after December 31, 2002, out of earnings and profits accumulated in taxable years after December 31, 2002, are treated as income in a foreign tax credit limitation category in proportion to the ratio of the earnings and profits attributable to income in such foreign tax credit limitation category to the total earnings and profits (a so-called "look-through" approach). For these purposes, distributions are treated as made from the most recently accumulated earnings and profits. Regulatory authority is granted to provide rules regarding the treatment of distributions out of earnings and profits for periods prior to the taxpayer's acquisition of such stock.

Sources of Complexity

The foreign tax credit generally has been cited as an area of the Code with significant complexity. The Joint Committee staff considered several simplification ideas and suggestions in this area. For example, some suggested that the various limitation categories be reduced to two categories: a limitation category for active income and for passive income, or alternatively, a limitation category for high-taxed income and for low-taxed income. As a general matter, the Joint Committee staff determined that many of these ideas involved significant policy issues that were beyond the scope of this simplification study.

One proposal in the foreign tax credit area that would provide simplification without raising significant policy issues relates to a provision passed by the Congress in the Taxpayer Relief Act of 1997 (the "1997 Act"), which provided for a look-through regime to apply in

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

characterizing dividends from 10/50 companies for foreign tax credit limitation purposes. The look-through regime that was enacted in the 1997 Act did provide simplification in the computation of the foreign tax credit because the regime provided for the eventual elimination of the separate limitation baskets for dividends from each 10/50 company. The present-law rules, however, continue to impose a substantial record-keeping burden on companies and result in additional complexity.[685] For instance, dividends paid by a 10/50 company in taxable years beginning after December 31, 2002, will be subject to the concurrent application of both the single basket approach (for pre-2003 earnings and profits) and the look-through approach (for post-2002 earnings and profits). These rules can be simplified by accelerating the effective date for the look-through approach that was enacted as part of the 1997 Act.

Recommendation for Simplification

The Joint Committee staff recommends that, for foreign tax credit limitation purposes, the look-through approach should be immediately applied to all dividends paid by a 10/50 company, regardless of the year in which the earnings and profits out of which the dividend is paid were accumulated.

The recommendation would eliminate the single-basket limitation approach for dividends from 10/50 companies and would accelerate the application of the look-through approach for dividends from such companies for foreign tax credit limitation purposes. The recommendation is similar to proposals included in the Administration's Fiscal Year 1999, 2000, and 2001 budget proposals.[686]

The current rules for dividends from 10/50 companies are complex and result in compliance burdens for taxpayers. For instance, dividends paid by a 10/50 company in taxable years beginning after December 31, 2002, will be subject to the concurrent application of both

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[685] The rules also have the additional negative effect of discouraging minority-position joint ventures abroad. Joint Committee on Taxation, *General Explanation of Tax Legislation Enacted in 1997* (JCS-23-97), December 17, 1997, at 302.

[686] *See, e.g.,* Joint Committee on Taxation, *Description of Revenue Provisions Contained in the President's Fiscal Year 2001 Budget Proposal* (JCS-2-00), March 6, 2000, at 200-201. The Administration proposals also would have broadened regulatory authority to provide rules regarding the treatment of distributions out of earnings and profits for periods prior to the taxpayer's acquisition of the stock of the 10/50 company, including rules to disregard both pre-acquisition earnings and profits and foreign taxes, in appropriate circumstances. Such an approach may provide administrative simplification in cases in which it would be difficult for a minority shareholder to reconstruct the historical records of an acquired company. Such an approach also may be appropriate in certain cases where a taxpayer enters into transactions effectively to "purchase" foreign tax credits that can be used to reduce the taxpayer's U.S. residual taxes on other foreign-source income. However, this aspect of the Administration's proposals raises policy issues that are beyond the scope of this study (e.g., the concept of disregarding earnings and profits is inconsistent with the general treatment of distributions from acquired corporations for foreign tax credit purposes).

the single-basket approach (for pre-2003 earnings and profits) and the look-through approach (for post-2002 earnings and profits). In light of the delayed effective date for the look-through provision included in the 1997 Act, the 1997 Act's application of the look-through approach only to post-effective date earnings and profits was necessary to avoid affecting the timing of distributions before the effective date. The provision included in the 1997 Act was aimed at reducing the bias against U.S. participation in foreign joint ventures and foreign investment by U.S. companies through affiliates that are not majority-owned. In this regard, the recommendation to accelerate the application of the look-through approach would be consistent with this objective.

Consideration could also be given to providing transition rules regarding the use of pre-effective date foreign tax credits associated with a 10/50 company separate limitation category in post-effective date years. For example, look-through principles similar to those applicable to post-effective date dividends from a 10/50 company could apply to determine the appropriate foreign tax credit limitation category or categories with respect to carrying forward foreign tax credits into future years. A similar transition rule was provided in a tax bill passed by the Congress in 1999.[687] Although such a transition rule would not necessarily provide further simplification, it would address the use of such credits consistent with the look-through approach adopted in 1997.

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[687] *See* H. Rep. 106-289 (August 4, 1999), at 338-339. The bill also provides a default rule in cases in which taxpayers are unable to obtain the necessary information to apply the look-through rules with respect to dividends from a 10/50 company (or in which the income is not treated as falling within one of certain enumerated limitation categories). In such cases, the bill treats the dividend (or a portion thereof) from such 10/50 company as a dividend that is not subject to the look-through rules.

E. Foreign Tax Credits Claimed Indirectly Through Partnerships

Present Law

Under section 902, a domestic corporation that receives a dividend from a foreign corporation in which it owns ten percent or more of the voting stock is deemed to have paid a portion of the foreign taxes paid by such foreign corporation. Thus, such a domestic corporation would be eligible to claim a foreign tax credit with respect to such deemed-paid taxes. The domestic corporation that receives a dividend is deemed to have paid a portion of the foreign corporation's post-1986 foreign income taxes based on the ratio of the amount of such dividend to the foreign corporation's post-1986 undistributed earnings and profits.

Foreign income taxes paid or accrued by lower-tier foreign corporations also are eligible for the deemed-paid credit if the foreign corporation falls within a qualified group (sec. 902(b)). A "qualified group" includes certain foreign corporations within the first six tiers of a chain of foreign corporations if, among other things, the product of the percentage ownership of voting stock at each level of the chain (beginning from the U.S. corporation) equals at least five percent. In addition, in order to claim indirect credits for foreign taxes paid by certain fourth-, fifth-, and sixth-tier corporations, such corporations must be controlled foreign corporations (within the meaning of sec. 957) and the U.S. shareholder claiming the indirect credit must be a U.S. shareholder (as defined in sec. 951(b)) with respect to the controlled foreign corporations. The application of the indirect foreign tax credit below the third tier is limited to taxes paid in taxable years during which the payor is a controlled foreign corporation. Foreign taxes paid below the sixth tier of foreign corporations are ineligible for the indirect foreign tax credit.

Section 960 similarly permits a domestic corporation with subpart F inclusions from a controlled foreign corporation to claim deemed-paid foreign tax credits with respect to foreign taxes paid or accrued by the controlled foreign corporation on its subpart F income.

The foreign tax credit provisions in the Code do not specifically address whether a domestic corporation owning ten percent or more of the voting stock of a foreign corporation through a partnership is entitled to a deemed-paid foreign tax credit.[688] However, Rev. Rul. 71-141 held that two U.S. corporations would be attributed the foreign corporation stock held by their U.S. general partnership for purposes of determining eligibility to claim a deemed-paid

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[688] In addition, the Code does not set forth indirect or constructive attribution rules for purposes of allowing U.S. corporations to claim indirect foreign tax credits. This implies that only direct ownership is considered. *See, e.g., First Chicago Corp. v. Commissioner*, 96 T.C. 421 (1991) (holding that members of a consolidated group in which no single member directly owned at least ten percent of the voting stock of a foreign corporation were not entitled to claim indirect foreign tax credits because sec. 902 and the consolidated return regulations, considered separately or in conjunction with each other, do not permit affiliated corporations to aggregate their share ownership in order to satisfy the ten-percent requirement of sec. 902). *See also* Rev. Ruls. 74-459 and 85-3.

foreign tax credit with respect to the foreign taxes paid by such foreign corporation.[689] The preamble to the final regulations under section 902 states that "[t]he final regulations do not resolve under what circumstances a domestic corporate partner may compute an amount of foreign taxes deemed paid with respect to dividends received from a foreign corporation by a partnership or other pass-through entity."[690] In recognition of the holding in Rev. Rul. 71-141 that a general partner of a domestic general partnership is permitted to claim deemed-paid foreign tax credits with respect to a dividend distribution from the foreign corporation to the partnership, however, the preamble to the final regulations under section 902 states that a "domestic shareholder" for purposes of section 902 is a domestic corporation that "owns" the requisite voting stock in a foreign corporation rather than one that "owns directly" the voting stock. At the same time, the preamble states that the IRS is still considering under what other circumstances Rev. Rul. 71-141 should apply.[691]

Under Section 1113(c)(2) of the Taxpayer Relief Act of 1997 (P.L. 105-34), no liquidation, reorganization, or similar transaction can have the effect of permitting taxes to be taken into account under the indirect foreign tax credit provisions of the Code that could not have otherwise been taken into account because of the denial of indirect taxes below the sixth tier.

Under section 901(b)(5), an individual member of a partnership or a beneficiary of an estate or trust generally may claim a direct foreign tax credit with respect to the amount of his or her proportionate share of the foreign taxes paid or accrued by the partnership, estate, or trust. This rule does not specifically apply to corporations that are either members of a partnership or beneficiaries of an estate or trust. However, section 702(a)(6) provides that each partner (including individuals or corporations) of a partnership must take into account separately its distributive share of the partnership's foreign taxes paid or accrued.

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[689] In Rev. Rul. 71-141, two U.S. corporations formed a domestic general partnership, each taking a fifty percent voting interest. The general partnership owned forty percent of the voting stock of a foreign corporation. The ruling held that each U.S. partner should be treated as owning its share (i.e., twenty percent) of the foreign corporation's voting stock. Thus, each U.S. corporate partner was permitted to claim a sec. 902 deemed-paid foreign tax credit because each partner satisfied the ten-percent minimum ownership requirement under sec. 902.

[690] T.D. 8708, 62 Fed. Reg. 923 (1997).

[691] Prior to the final sec. 902 regulations, the IRS issued proposed regulations under sec. 902 and stated in the preamble that consideration was being given to restricting the circumstances in which the principle of Rev. Rul. 71-141 would be applied. See 60 Fed. Reg. 2049 (1995). In the preamble to the proposed regulations, the IRS requested comments on whether the holding of Rev. Rul. 71-141 should be expanded to allow taxes paid by a foreign corporation to be considered deemed paid by domestic corporations that are partners in domestic limited partnerships or foreign partnerships, shareholders in limited liability companies, beneficiaries of domestic or foreign trusts, or interest holders in other pass-through entities. As described above, the final sec. 902 regulations do not resolve whether indirect foreign tax credits may be claimed in such cases.

The regulations under section 7701 provide elective rules for classifying business organizations for federal tax purposes (the so-called "check-the-box regulations").[692] Under the check-the-box regulations, a business entity with only one owner may be classified as either a corporation or disregarded. If an entity is disregarded under these rules, its activities are treated in the same manner as a sole proprietorship, branch, or division of the owner.

Sources of Complexity

Uncertainty in the law may exist with respect to the application of the indirect foreign tax credit rules when a partner indirectly owns an interest in a foreign corporation through a partnership. Although Rev. Rul. 71-141 appears to address some of these issues in the context of deemed-paid foreign tax credits claimed through U.S. general partnerships, uncertainty with respect to present law may remain, particularly in light of the preamble to the 1997 section 902 final regulations which states that the IRS is still considering under what other circumstances Rev. Rul. 71-141 should apply. This uncertainty in the law creates potential inconsistent positions by taxpayers and the government and can lead to reduced compliance and increased confusion with the law.

Recommendation for Simplification

The Joint Committee staff recommends a clarification that a domestic corporation should be entitled to claim deemed-paid foreign tax credits with respect to a foreign corporation that is held indirectly through a foreign or U.S. partnership, provided that the domestic corporation owns (indirectly through the partnership) ten percent or more of the foreign corporation's voting stock.[693]

There has been some level of uncertainty with respect to the circumstances in which deemed-paid foreign tax credits may be claimed through pass-through entities such as partnerships. The Code does not specifically address this issue. Rather, the issue has been left to unclear administrative guidance. Rev. Rul. 71-141 permits deemed paid foreign tax credits to be claimed through a U.S. general partnership. However, the preamble to the final regulations under section 902 states that "[t]he final regulations do not resolve under what circumstances a domestic corporate partner may compute an amount of foreign taxes deemed paid with respect to dividends received from a foreign corporation by a partnership or other pass-through entity."[694] In addition, the preamble to the final regulations under section 902 states that the IRS is still considering under what other circumstances Rev. Rul. 71-141 should apply.

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[692] Treas. Reg. sec. 301.7701-1, et. seq.

[693] The recommendation would apply to deemed-paid foreign tax credits claimed by domestic corporations that receive dividends from foreign corporations under sec. 902 as well as domestic corporations with subpart F deemed dividend inclusions from a controlled foreign corporation under sec. 960.

[694] T.D. 8708, 62 Fed. Reg. 923 (1997).

The recommendation is similar to a proposal that was included in the Administration's Fiscal Year 2001 Budget Proposal.[695] In this regard, the Administration proposal would have amended section 902(a) (as well as section 960) to clarify that a domestic corporation is eligible to claim a deemed-paid foreign tax credit with respect to a foreign corporation that is held indirectly through a foreign or domestic partnership. For these purposes, partnerships would include limited liability companies and other entities that elect to be treated as partnerships under the check-the-box regulations. In order to claim the indirect foreign tax credit, the domestic corporation must own, indirectly through the partnership, ten percent or more of the voting stock of the foreign corporation. The amount of deemed-paid foreign tax credits that would be available under the proposal is the amount attributable to the domestic corporation's proportionate share of dividend income from the foreign corporation.

There were certain other aspects of the Administration's Fiscal Year 2001 budget proposal. For example, the Administration proposal also would treat a qualified business unit (as defined in section 989(a)) as a separate tier for purposes of the six-tier limitation rule of section 902(b). A qualified business unit, for this purpose, would include a branch, a partnership, and an entity that is disregarded under the check-the-box regulations (e.g., a single-member foreign entity in which the member elects to have the entity disregarded for U.S. tax purposes under the check-the-box regulations). This was included presumably to provide administrative simplification. Arguably, each set of books and records through which the IRS must investigate in the course of an audit creates increased administration burdens. In most cases, branches, disregarded entities, and partnerships maintain a distinct and separate set of books and records. However, this aspect of the Administration proposal does not appear to conflict with the general view as reflected in that proposal and the Joint Committee staff recommendation that taxpayers generally should be entitled to claim deemed-paid foreign tax credits indirectly through partnerships and other pass-through entities.[696] Clarification of this issue should provide taxpayers with more certainty in this area, which may be expected to lead to improved compliance in this area.

Consideration should be given to certain issues with respect to implementing the recommendation. For example, the measure of a U.S. corporation's ownership of a partnership should be specified for purposes of attributing ownership of an underlying foreign corporation under the foreign tax credit rules. In this regard, a U.S. corporation's ownership of a partnership could be based on either a capital or profits interests in the partnership.[697]

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[695] *See* Joint Committee on Taxation, *Description of Revenue Provisions Contained in the President's Fiscal Year 2001 Budget Proposal* (JCS-2-00), March 6, 2000, at 216-221.

[696] The Administration proposal also would expand sec. 901(b)(5) to allow a domestic corporation to claim a direct foreign tax credit for its proportionate share of taxes of a partnership, estate, or trust in which it is a partner or beneficiary, respectively. Thus, the same treatment would apply as applies under present law in the case of individuals.

[697] In addition, consideration should be given as to the manner in which the recommendation might be coordinated with present-law rules under sec. 704(b) dealing with special partnership allocations of credits. *See, e.g.,* Treas. Reg. sec. 1.704-1(b)(4)(ii).

F. Conform Sections 30A and 936

Present Law

In general

Certain domestic corporations with business operations in the U.S. possessions (including, for this purpose, Puerto Rico and the U.S. Virgin Islands) may claim the Puerto Rico and possession tax credit (sec. 936) or the Puerto Rico economic activity credit (sec. 30A), which generally reduce the U.S. tax on certain income, related to their operations in the possessions. Income eligible for the credit under these provisions is possession business income derived from the active conduct of a trade or business within a U.S. possession or from the sale or exchange of substantially all of the assets that were used in such a trade or business. Both credits expire for taxable years beginning after December 31, 2005.

While in a separate section of the Code, the Puerto Rico economic activity credit (sec. 30A) is calculated under rules set forth for the Puerto Rico and possession tax credit (sec. 936). That is, the section 30A credit is a special case of the section 936 credit, applicable only to taxpayers operating in Puerto Rico, while the section 936 credit applies generally to taxpayers operating in any U.S. possession.

The Puerto Rico and possession tax credit applies only to a corporation that qualifies as an existing credit claimant (as defined below). The determination of whether a corporation is an existing credit claimant is made separately for each possession. A corporation that is an existing credit claimant with respect to a possession is entitled to the credit for income from such possession subject to either the economic activity limitation or the income limitation, described below. The credit, subject to such limitations, is computed separately for each possession with respect to which the corporation is an existing credit claimant. In addition, the income upon which the credit is calculated may be subject to an income cap (as defined below). When the taxpayer is subject to the economic activity limitation with respect to income earned in Puerto Rico, the taxpayer claims credit under section 30A rather than under section 936.

In order to qualify for the Puerto Rico and possession tax credit or the Puerto Rico economic activity credit for a taxable year, a domestic corporation must satisfy two conditions. First, the corporation must derive at least 80 percent of its gross income for the three-year period immediately preceding the close of the taxable year from sources within a possession. Second, the corporation must derive at least 75 percent of its gross income for that same period from the active conduct of a possession business.

Economic activity limitation and income limitation

A domestic corporation that has elected the Puerto Rico and possession tax credit and that satisfies these two conditions for a taxable year generally is entitled to a credit based on the U.S. tax attributable to the taxpayer's possession business income. However, the amount of the credit attributable to possession business income is subject to one of two limitations at the election of the taxpayer.

Under the economic activity limit, the amount of the credit with respect to such income cannot exceed an amount equal to the sum of (1) 60 percent of the taxpayer's qualifying wage and fringe benefit expenses, (2) 15 percent of depreciation allowances with respect to short-life qualifying tangible property, plus 40 percent of depreciation allowances with respect to medium-life qualifying tangible property, plus 65 percent of depreciation allowances with respect to long-life tangible property, and (3) in certain cases, the taxpayer's qualifying possession income taxes. The credit calculated under the economic activity limit is referred to as the "economic activity credit." In the case of a qualifying corporation with qualifying income in Puerto Rico, the limitation on the amount of credit that may be claimed under section 936 by reason of the economic activity limit is the basis of the credit that the taxpayer may claim under section 30A.

In the alternative, the taxpayer may elect to apply a limit equal to the applicable percentage of the credit that would otherwise be allowable with respect to possession business income; the applicable percentage is 40 percent. The credit calculated under the percentage limit is referred to as the "income credit."

Income credit

For corporations that are existing credit claimants with respect to a possession and that elected to use the income credit method and not to use the economic activity credit method, the Puerto Rico and possession tax credit attributable to business income from the possession is subject to a cap computed as described below for taxable years beginning before January 1, 2006. For taxable years beginning in 2006 and thereafter, the credit attributable to possession business income (determined under the income credit method) is eliminated.

Economic activity credit

For corporations that are existing credit claimants with respect to a possession and that use the economic activity credit method, the possession tax credit attributable to business income from the possession is not subject to the income cap for taxable years before January 1, 2002. For taxable years beginning after December 31, 2001 and before January 1, 2006, the corporation's possession business income that is eligible for the economic activity credit is subject to a cap computed as described below. For taxable years beginning in 2006 and thereafter, the credit attributable to possession business income (determined under the economic activity credit method) is eliminated.

Computation of income cap

The cap on a corporation's possession business income that is eligible for the Puerto Rico and possession tax credit is computed based on the corporation's possession business income for the base period years ("average adjusted base period possession business income"). Average adjusted base period possession business income is the average of the adjusted possession business income for each of the corporation's base period years. For purposes of this computation, the corporation's possession business income for a base period year is adjusted by an inflation factor that reflects inflation from such year to 1995. In addition, as a proxy for real growth in income throughout the base period, the inflation factor is increased by five percentage

points compounded for each year from such year to the corporation's first taxable year beginning on or after October 14, 1995.

The corporation's base period years generally are three of the corporation's five most recent years ending before October 14, 1995, determined by disregarding the taxable years in which the adjusted possession business incomes were highest and lowest. For purposes of this computation, only years in which the corporation had significant possession business income are taken into account.

If a corporation's possession business income in a year for which the cap is applicable exceeds the cap, then the corporation's possession business income for purposes of computing its Puerto Rico and possession tax credit for the year is an amount equal to the cap. The corporation's credit continues to be subject to either the economic activity limit or the applicable percentage limit, with such limit applied to the corporation's possession business income as reduced to reflect the application of the cap.

Qualification as existing credit claimant

A corporation is an existing credit claimant with respect to a possession if (1) the corporation was engaged in the active conduct of a trade or business within the possession on October 13, 1995, and (2) the corporation elected the benefits of the Puerto Rico and possession tax credit pursuant to an election which is in effect for its taxable year that includes October 13, 1995.[698] A corporation that adds a substantial new line of business (other than in a qualifying acquisition of all the assets of a trade or business of an existing credit claimant) ceases to be an existing credit claimant as of the beginning of the taxable year during which such new line of business is added.

Special rules for certain possessions

A special rule applies to the Puerto Rico and possession tax credit with respect to operations in Guam, American Samoa, and the Commonwealth of the Northern Mariana Islands. For any taxable year beginning before January 1, 2006, a corporation that is an existing credit claimant with respect to one of these possessions for such year continues to determine its credit with respect to operations in such possession without regard to the income cap. For taxable years beginning in 2006 and thereafter, the Puerto Rico and possession tax credit with respect to operations in Guam, American Samoa, and the Commonwealth of the Northern Mariana Islands is eliminated.

Sources of Complexity

The placement of rules for these credits in two non-adjacent Code sections makes it difficult for taxpayers to learn the necessary rules that apply to would-be credit claimants. In

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[698] A corporation will qualify as an existing credit claimant if it acquires all the assets of a trade or business of a corporation that actively conducts such trade or business in a possession on October 13, 1995 and had elected the benefits of the Puerto Rico and possession tax credit pursuant to an election in effect for its taxable year that includes October 13, 1995.

addition, the application of different rules for otherwise similar businesses located in different possessions requires taxpayers contemplating investments in the various possessions to be familiar with multiple rules.

Recommendation for Simplification

The Joint Committee staff recommends that, should the Congress choose to extend the credits under section 30A and section 936 after their expiration after 2005, consideration be given to conforming the application of the credit across all possessions and to combining the rules in one Code section.

The recommendation would reduce complexity by improving the readability of the rules applicable to potential credit claimants. In this regard, combining similar requirements for claiming credits with respect to operations in Puerto Rico and other U.S. possessions (which are currently contained in two separate, non-adjacent Code sections) into one Code section should reduce complexity in terms of understanding the rules for credit claimants in Puerto Rico. In addition, conforming the application of the credit by applying a single set of rules across all U.S. possessions should simplify taxpayer planning and compliance with respect to potentially qualifying investments in the various possessions.

G. Application of Uniform Capitalization Rules for Foreign Persons

Present Law

In general

Taxpayers generally may not deduct currently the costs incurred in producing property or acquiring property for resale. Rather, such costs must be capitalized and recovered through an offset to sales price if the property is produced for sale, or though depreciation or amortization if the property is produced for the taxpayer's own use in a business or investment activity. The purpose of this requirement is to match the costs of producing or acquiring goods with the revenues realized from their sale or use in the business or investment activity.

Section 263A

In general, the uniform capitalization rules require that a portion of the direct and indirect costs of producing property or acquiring property for resale be capitalized or included in the cost of inventory (sec. 263A). The determination of which direct and indirect costs constitute capitalized costs, and the calculation of the amount to capitalize is very detailed and complex. Compared to financial statement reporting requirements, the uniform capitalization rules tend to allow fewer costs to be expensed and require additional costs to be capitalized or included in inventories.

Application to foreign persons

In general

The uniform capitalization rules apply to foreign persons, whether or not engaged in business in the United States.[699] In the case of a foreign corporation carrying on a U.S. trade or business, for example, the uniform capitalization rules apply for purposes of computing the corporation's U.S. effectively connected taxable income, as well as computing its effectively connected earnings and profits for purposes of the branch profits tax.

When a foreign corporation is not engaged in a trade or business in the United States, its taxable income and earnings and profits may nonetheless be relevant under the Code. For example, the subpart F income of a controlled foreign corporation may be currently includible on the return of a U.S. shareholder of the controlled foreign corporation. Regardless of whether or not a foreign corporation is U.S.-controlled, its accumulated earnings and profits must be computed in order to determine the amount of taxable dividend and the indirect foreign tax credit carried by distributions from the foreign corporation to any domestic corporation that owns at least 10 percent of its voting stock.

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[699] Treas. Reg. sec. 1.263A-1(a)(3)(vii) provides that the uniform capitalization rules generally apply to property produced or property acquired for resale by foreign persons.

The earnings and profits surplus or deficit of any foreign corporation for any taxable year generally is determined according to rules substantially similar to those applicable to domestic corporations. However, Prop. Reg. sec. 1.964-1(c)(1)(ii)(B) provides that, for purposes of computing a foreign corporation's earnings and profits, the amount of expenses that must be capitalized into inventory under section 263A may not exceed the amount capitalized in keeping the taxpayer's books and records. For this purpose, the taxpayer's books and records must be prepared in accordance with accounting principles generally accepted in the United States for purposes of reflecting in the financial statements of a domestic corporation the operations of its foreign affiliates. The Preamble to this proposed regulation states that taxpayers have suggested that maintaining separate inventory accounts for U.S. tax and financial accounting purposes is unduly burdensome and that use of a single set of accounts would reduce compliance burdens.[700] This proposed regulation applies only for purposes of determining a foreign corporation's earnings and profits and would not apply for purposes of determining subpart F income or income effectively connected with a U.S. trade or business of a foreign corporation.

U.S. ratio election

Under Notice 88-104,[701] an election may be made to use a simplified method of accounting for the costs (other than interest) required to be capitalized in connection with foreign businesses of foreign or U.S. persons under the uniform capitalization rules. Under the simplified method (also known as the "U.S. ratio method"), an electing foreign person may determine the amount of section 263A costs required to be capitalized for a particular trade or business by reference to data already compiled by a related U.S. person for the same or similar business. In general, the electing foreign person calculates its capitalizable section 263A costs by applying the U.S. ratio of a related taxpayer to the cost (as determined by the foreign person before the application of section 263A) of the property produced or acquired for resale. The U.S. ratio is the ratio of additional section 263A costs to otherwise capitalizable costs incurred by the related taxpayer in a U.S. trade or business.

Sources of Complexity

The uniform capitalization rules are complex and burdensome to apply, particularly with respect to foreign income and activities. In many cases, taxpayers with foreign operations must prepare separate books and records for U.S. financial reporting purposes, for U.S. tax purposes (including the complex adjustments under the uniform capitalization rules), for foreign financial reporting purposes, for foreign tax purposes, as well as for internal reporting purposes. It is difficult and burdensome for taxpayers to compute the annual uniform capitalization adjustments, particularly for foreign earnings and profits that for tax purposes are accounted for on a multi-year pooled basis and that are repatriated to U.S. shareholders in a later year. In addition, enforcement of these rules with respect to foreign income and activities has proven to be difficult. Simplification would be achieved by relieving taxpayers and the IRS from applying these rules with respect to foreign income and earnings and profits of foreign corporations.

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[700] 57 Fed. Reg. 29246 (July 1, 1992).

[701] Sept. 19, 1988.

Recommendation for Simplification

The Joint Committee staff recommends that in lieu of the uniform capitalization rules, costs incurred in producing property or acquiring property for resale should be capitalized using U.S. generally accepted accounting principles for purposes of determining a foreign person's earnings and profits and subpart F income. The uniform capitalization rules would continue to apply to foreign persons for purposes of determining income effectively connected with a U.S. trade or business.

The recommendation would limit the application of the uniform capitalization rules to foreign persons only for purposes of determining income that is effectively connected with a U.S. trade or business. Under the recommendation, the uniform capitalization rules would not apply for purposes of determining the earnings and profits or subpart F income of a foreign corporation (*e.g.*, a foreign subsidiary of a U.S. person). Instead, the amount of expenses to be capitalized for these purposes would be based on generally accepted accounting principles for U.S. financial reporting purposes.[702] This view is consistent with the proposed regulation that effectively would apply generally accepted accounting principles (and not the uniform capitalization rules) to determine earnings and profits of foreign corporations with respect to inventory.[703] The proposal would only apply to property subject to the uniform capitalization rules (without regard to this recommendation) and does not alter other rules regarding capitalization for foreign persons (*e.g.*, section 263).

Limiting the application of the uniform capitalization rules in this manner should provide a significant reduction in compliance burdens for taxpayers, particularly with respect to the computation of a foreign corporation's earnings and profits. In addition, the application of the uniform capitalization rules may have less significance with respect to a foreign corporation's earnings and profits. For example, the application of the uniform capitalization rules for foreign

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[702] The recommendation would apply generally accepted accounting principles only for purposes of capitalizing expenses in determining a foreign corporation's earnings and profits or subpart F income. Some have suggested that, for simplification purposes, U.S. generally accepted accounting principles should apply universally (*e.g.*, recognition of income) for purposes of determining a foreign corporation's earnings and profits. *See, e.g.*, sec. 104 of H.R. 2018 and S. 1164, the International Tax Simplification for American Competitiveness Act of 1999. The Joint Committee staff determined that such an approach raised significant policy issues that were beyond the scope of this study.

[703] The proposed regulation requires expenses to be capitalized into inventory for these purposes in an amount not to exceed the amount that is capitalized under generally accepted accounting principles. This arguably could be interpreted as requiring taxpayers to compute the amount to be capitalized under the uniform capitalization rules and then compare that amount to the amount required to be capitalized under generally accepted accounting principles. The recommendation is intended to provide further simplification from the proposed regulation by simply using the amount of expenses that are capitalized under generally accepted accounting principles, which in most cases would have been the amount used irrespectively.

earnings and profits of foreign corporations owned by U.S. persons may have less significant effects on an annual basis relative to domestic uniform capitalization adjustments because the earnings and profits of a foreign corporation generally are accounted for in one post-1986 pool, thereby diluting the effects of the annual adjustments. Moreover, for foreign tax credit purposes, the effects of the rules are recognized only when the foreign corporation distributes (or is deemed to distribute) a dividend to a U.S. shareholder, further diluting the impact these rules have on an annual basis.

The recommendation also would not apply the uniform capitalization rules for purposes of determining the subpart F income of a foreign corporation. Although this type of income is included by U.S. shareholders of the foreign corporation on a current basis (and, thus, the effects of the uniform capitalization rules may be more relevant for tax purposes), there may be added complexity in continuing to require the use of these rules for purposes of determining subpart F income of a foreign corporation but not for purposes of determining a foreign corporation's earnings and profits.

The recommendation would have the effect of continuing to apply the uniform capitalization rules to the income of foreign branches of U.S. persons. Consideration may be warranted as to whether foreign-source income of such foreign branches should also be exempted from the application of the uniform capitalization rules.

H. Secondary Withholding Tax on Dividends from Certain Foreign Corporations

Present Law

U.S. persons are subject to U.S. tax on their worldwide income. Foreign taxes may be credited against U.S. tax on foreign-source income of the taxpayer. For purposes of computing the foreign tax credit, the taxpayer's income from U.S. sources and foreign sources must be determined.

Nonresident individuals who are not U.S. citizens and foreign corporations (collectively, foreign persons) are subject to U.S. tax on income that is effectively connected with the conduct of a U.S. trade or business; the U.S. tax on such income is calculated in the same manner and at the same graduated rates as the tax on U.S. persons (secs. 871(b) and 882). Foreign persons also are subject to a 30-percent gross basis tax, collected by withholding, on certain U.S.-source passive income (e.g., interest and dividends) that is not effectively connected with a U.S. trade or business. This 30-percent withholding tax may be reduced or eliminated pursuant to an applicable tax treaty. Foreign persons generally are not subject to U.S. tax on foreign-source income that is not effectively connected with a U.S. trade or business.

In general, dividends paid by a domestic corporation are treated as being from U.S. sources and dividends paid by a foreign corporation are treated as being from foreign sources. Thus, dividends paid by foreign corporations to foreign persons generally are not subject to withholding tax because such income generally is treated as foreign-source income.

An exception from this general sourcing rule applies in the case of dividends paid by certain foreign corporations. If a foreign corporation derives 25 percent or more of its gross income as income effectively connected with a U.S. trade or business for the three-year period ending with the close of the taxable year preceding the declaration of a dividend, then a portion of any dividend paid by the foreign corporation to its shareholders will be treated as U.S.-source income and, in the case of dividends paid to foreign shareholders, will be subject to the 30-percent withholding tax (sec. 861(a)(2)(B)).[704] This rule is sometimes referred to as the "secondary withholding tax." The portion of the dividend treated as U.S.-source income is equal to the ratio of the gross income of the foreign corporation that was effectively connected with its U.S. trade or business over the total gross income of the foreign corporation during the three-year period ending with the close of the preceding taxable year. The U.S.-source portion of the dividend paid by the foreign corporation to its foreign shareholders is subject to the 30-percent withholding tax.

Under the branch profits tax provisions, the United States taxes foreign corporations engaged in a U.S. trade or business on amounts of U.S. earnings and profits that are shifted out of the U.S. branch of the foreign corporation. The branch profits tax is comparable to the second-level taxes imposed on dividends paid by a domestic corporation to its foreign shareholders. The branch profits tax is 30 percent of the foreign corporation's "dividend

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[704] In the case of dividends paid to U.S. shareholders, the sourcing rule is relevant for foreign tax credit purposes.

equivalent amount," which generally is the earnings and profits of a U.S. branch of a foreign corporation attributable to its income effectively connected with a U.S. trade or business (secs. 884(a) and (b)). In arriving at the dividend equivalent amount, a branch's effectively connected earnings and profits are adjusted to reflect changes in a branch's U.S. net equity (i.e., the excess of the branch's assets over its liabilities, taking into account only amounts treated as connected with its U.S. trade or business) (sec. 884(b)). The first adjustment reduces the dividend equivalent amount to the extent the branch's earnings are reinvested in trade or business assets in the United States (or reduce U.S. trade or business liabilities). The second adjustment increases the dividend equivalent amount to the extent prior reinvested earnings are considered remitted to the home office of the foreign corporation.

If a foreign corporation is subject to the branch profits tax, then no secondary withholding tax is imposed on dividends paid by the foreign corporation to its shareholders (sec. 884(e)(3)(A)).[705] If a foreign corporation is a qualified resident of a tax treaty country and claims an exemption from the branch profits tax pursuant to the treaty, the secondary withholding tax could apply with respect to dividends it pays to its shareholders.[706] Several tax treaties (including treaties that prevent imposition of the branch profits tax), however, exempt dividends paid by the foreign corporation from the secondary withholding tax.

Sources of Complexity

Eliminating the secondary withholding tax on dividends would provide simplification in several ways. First, the secondary withholding tax imposed on dividends from certain foreign corporations has largely been replaced by the branch profits tax. Thus, taxpayers would be spared the burden of having to understand and comply with these rules that have limited applicability. Second, the IRS would be spared the difficulties in trying to enforce the tax against a foreign corporation with little or no assets in the United States at the time of the

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[705] If a foreign corporation is not subject to the branch profits tax, dividends described in sec. 861(a)(2)(B) that are paid to another foreign corporation are not eligible for treaty benefits if the foreign corporate payor or recipient is treaty shopping (i.e., is not a qualified resident of the applicable treaty country) (secs. 884(e)(3)(B) and (f)(3)).

[706] Treas. Reg. sec. 1.884-1(g)(3) provides that if certain requirements are met, the branch profits tax is not imposed on a foreign corporation that is a qualified resident of a treaty country under the following income tax treaties that were in effect on January 1, 1987: Aruba, Austria, Belgium, the People's Republic of China, Cyprus, Denmark, Egypt, Finland, Germany, Greece, Hungary, Iceland, Ireland, Italy, Jamaica, Japan, Korea, Luxembourg, Malta, Morocco, Netherlands, Netherlands Antilles, Norway, Pakistan, Philippines, Sweden, Switzerland, and the United Kingdom. The regulation is applicable so long as the income tax treaty as in effect on January 1, 1987, remains in effect, except to the extent that the treaty is modified on or after that date to expressly provide for the imposition of the branch profits tax. Several of these treaties have since been revised or updated to provide for a branch profits tax pursuant to the treaty, including Austria, Denmark, Finland, Germany, Ireland, Luxembourg, Netherlands, Sweden, and Switzerland. Most of the treaties on the list that are currently still in force and that have not been revised or updated in this regard do not permit the imposition of a secondary withholding tax.

dividend in purely foreign-to-foreign transactions.[707] Third, taxpayers would be spared some of the complicated computations necessary to determine the portion of the dividend paid by the foreign corporation that is subject to U.S. tax based on the percentage of the foreign corporation's worldwide income that is attributable to U.S. business activity.

Recommendation for Simplification

The Joint Committee staff recommends that the secondary withholding tax with respect to dividends paid by certain foreign corporations should be eliminated.[708]

There are two main purposes for the secondary withholding tax on dividends paid by certain foreign corporations.[709] First, income that is earned in the United States by a foreign corporation that is subsequently distributed as a dividend should be taxed by the United States because the United States is the "source" of the dividend. Second, the secondary withholding tax acts as a backstop to the 30-percent withholding tax imposed on dividends paid by U.S. corporations. Prior to 1986, if the secondary withholding tax did not exist, foreign persons could easily circumvent the 30-percent withholding tax on U.S.-source dividends by utilizing a foreign corporation to conduct the business operations in the United States.

In 1986, Congress enacted the branch profits tax, in essence, replacing the secondary withholding tax. Congress believed that the branch profits tax would better reduce the disparity between the U.S. tax treatment of U.S. corporations and foreign corporations that operate in the United States.[710] Congress also determined that the branch profits tax was an appropriate substitute for the shareholder level tax that applies to U.S. subsidiaries of foreign corporations. In addition, Congress believed that the branch profits tax would be more administrable than the secondary withholding tax.

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[707] There also is difficulty in monitoring foreign-to-foreign transactions for purposes of determining whether the 25-percent U.S. effectively connected income threshold is met. In addition, the Organization for Economic Cooperation and Development has questioned the imposition of this tax on extraterritorial grounds. *See* Commentary on the OECD Model Tax Convention on Income and Capital, Article 10, para. 34 (November 1997).

[708] As a result, for withholding tax purposes, dividends paid by a foreign corporation would be treated as foreign-source income. The recommendation would have the effect of continuing to apply the special sourcing rule of sec. 861(a)(2)(B) for foreign tax credit purposes.

[709] *See* American Law Institute, *Federal Income Tax Project: International Aspects of United States Income Taxation, Proposals of the American Law Institute on United States Taxation of Foreign Persons and of the Foreign Income of United States Persons*, at 140-41 (1987).

[710] *See* Joint Committee on Taxation, *General Explanation of the Tax Reform Act of 1986* (JCS-10-87), May 4, 1987, at 1036-37.

If a foreign corporation is subject to the branch profits tax, then no secondary withholding tax is imposed on dividends paid by the foreign corporation to its shareholders. The secondary withholding tax could apply to distributions by a foreign corporation if the corporation is a qualified resident of a treaty country, a treaty prevents imposition of the branch profits tax, and the treaty permits a secondary withholding tax.[711] However, several tax treaties (including those that prevent the imposition of the branch profits tax) prevent the imposition of a secondary withholding tax on dividends paid by foreign corporations out of U.S. earnings and profits.[712]

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[711] *See* sec. 884(e)(3). The secondary withholding tax could also apply to dividends that are attributable to pre-1987 earnings and profits. *See* H. Rep. 100-795 (July 26, 1988) at 286-87; S. Rep. 100-445 (August 3, 1988) at 301. Even if a treaty permits a secondary withholding tax but otherwise prevents the imposition of the branch profits tax, dividends paid by the foreign corporation to another foreign corporation attributable to the U.S.-source portion of the dividends are not eligible for treaty benefits if the foreign corporate payor or recipient is treaty shopping (i.e., is not a qualified resident of the applicable treaty country).

[712] As described above, most of the income tax treaties that are treated as not imposing a branch profits tax would also not permit a secondary withholding tax. In addition, Article 10(7) of the U.S. model income tax treaty specifically prohibits imposition of the secondary withholding tax on dividends paid by nonresident companies out of U.S. earnings and profits. *See* Department of the Treasury, Technical Explanation of the United States Model Income Tax Convention, Article 10(7) (September 20, 1996).

I. Capital Gains of Certain Nonresident Individuals

Present Law

In general

In general, resident individuals who are not U.S. citizens are taxed in the same manner as U.S. citizens. Nonresident individuals who are not U.S. citizens are subject to (1) U.S. tax on income from U.S. sources that are effectively connected with a U.S. trade or business, and (2) a 30-percent withholding tax on the gross amount of certain types of passive income derived from U.S. sources, such as interest, dividends, rents, and other fixed or determinable annual or periodical income (sec. 871(a)(1)). Bilateral income tax treaties may modify these tax rules.

Taxation of capital gains

Income derived from the sale of personal property other than inventory property generally is sourced based on the residence of the seller (sec. 865(a)). Thus, nonresident individuals who are not citizens generally are not taxable on capital gains because the gains generally are considered to be foreign-source income.[713]

Special rules apply in the case of sales of personal property by certain foreign persons. In this regard, an individual who is otherwise treated as a nonresident is treated as a U.S. resident for purposes of sourcing income from the sale of personal property if the individual has a tax home in the United States (sec. 865(g)(1)(A)(i)(II)). An individual's U.S. tax home generally is the place where the individual has his or her principal place of business. For example, if a nonresident individual with a tax home in the United States sells stocks or other securities for a gain, the individual will be treated as a U.S. resident with respect to the sale such that the gain will be treated as U.S.-source income potentially subject to U.S. tax.

In addition, if a nonresident individual maintains an office or other fixed place of business in the United States, income from the sale of personal property (including inventory property) attributable to such office or place of business is sourced in the United States (sec. 865(e)(2)(A)). If treated as U.S.-source income, the income would be subject to U.S. tax if treated as effectively connected with a U.S. trade or business. This special rule does not apply, however, in the case of inventory property that is sold by the foreign person for use, disposition, or consumption outside the United States if an office or other fixed place of business of such person outside the United States materially participated in the sale (sec. 865(e)(2)(B)).

Moreover, under section 871(a)(2), a nonresident individual who is physically present in the United States for 183 days or more during a taxable year is subject to a 30-percent tax on the excess of U.S.-source capital gains over U.S.-source capital losses. This 30-percent tax is not a withholding tax. The tax under section 871(a)(2) does not apply to gains and losses subject to

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[713] Nonresident individuals are subject to the 30-percent gross withholding tax, for example, with respect to gains from the sale or exchange of intangible property if the payments are contingent on the productivity, use, or disposition of the property. Secs. 871(a)(1)(D) and 881(a)(4).

the gross 30-percent withholding tax under section 871(a)(1) or to gains effectively connected with a U.S. trade or business. Capital gains and losses are taken into account only to the extent that they would be recognized and taken into account if such gains and losses were effectively connected with a U.S. trade or business. Capital loss carryovers are not taken into account.

Residency rules

In general, an individual is considered a resident of the United States if the individual (1) has entered the United States as a lawful permanent U.S. resident, or (2) is present in the United States for 31 or more days during the current calendar year and has been present in the United States for a substantial period of time -- 183 or more days during a three-year period weighted toward the present year (the "substantial presence test") (sec. 7701(b)). An individual meets the 183-day part of the substantial presence test if the sum of (1) the days present during the current calendar year, (2) one-third of the days present during the preceding calendar year, and (3) one-sixth of the days present during the second preceding calendar year, equals or exceeds 183 days.[714]

An exception from being treated as a U.S. resident under the substantial presence test applies if (1) the individual is present in the United States for fewer than 183 days during the current calendar year, and (2) the individual establishes that he or she has a closer connection with a foreign country than with the United States and has a tax home in that country for the year.

In general, an individual is treated as being present in the United States on any day if the individual is physically present in the United States at any time during such day. For purposes of the substantial presence test, an individual is not treated as present in the United States on any day during which (1) the individual regularly commutes to employment (or self-employment) in the United States from Canada or Mexico, (2) the individual is in transit between two points outside the United States and is physically present in the United States for less than 24 hours, or (3) the individual is temporarily present in the United States as a regular member of the crew of a foreign vessel engaged in transportation between the United States and a foreign country or U.S. possession.

In addition, for purposes of the substantial presence test, any days that an individual is present in the United States as an "exempt individual" are not counted. Exempt individuals include certain foreign government-related individuals, teachers, trainees, students, and professional athletes temporarily in the United States to compete in charitable sports events. In addition, the substantial presence test does not count days of presence in the United States of an individual who is physically unable to leave the United States because of a medical condition that arose while he or she was present in the United States.

In some circumstances, an individual who meets the definition of a U.S. resident (as described above) could also be defined as a resident of another country under the internal laws of

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[714] Presence for 122 days (or more) per year over the three-year period would be sufficient to trigger the substantial presence test.

that country. In order to avoid the double taxation of such individuals, most income tax treaties include a set of "tie-breaker" rules to determine the individual's country of residence for income tax purposes. For example, under these treaties a dual resident individual will be deemed to be a resident of the country in which he or she has a permanent home.

Sources of Complexity

The special rule under section 871(a)(2) providing for taxation of U.S.-source net capital gains of certain nonresident individuals does not have significant relevance because the rule has a very limited scope.[715] Eliminating the rule would provide simplification to nonresident individuals investing in capital assets in that such investors can be spared the burden of understanding and complying with this rule that has limited applicability.

Recommendation for Simplification

The Joint Committee staff recommends that section 871(a)(2), providing for a 30-percent tax on certain U.S.-source capital gains of nonresident individuals, should be eliminated.

There are very limited cases in which the special rule under section 871(a)(2) could apply. The rule imposes a 30-percent tax on the net U.S.-source capital gains of nonresident individuals who are not citizens and who are physically present in the United States for 183 days or more. Thus, in order for the rule to apply, two conditions must be satisfied: (1) the individual must spend at least 183 days in the United States during a taxable year without being treated as a U.S. resident, and (2) the individual's capital gains must be from U.S. sources. If these conditions are satisfied, then the 30-percent tax applies to the excess of U.S.-source capital gains over U.S.-source capital losses. However, section 871(a)(2) generally is not applicable because if the individual spends 183 days or more in the United States in most cases he or she would be treated as a U.S. resident, or if not treated as a U.S. resident, would generally not have U.S.-source capital gains.

An individual who is not a citizen and who spends 183 days or more in the United States during a calendar year generally would be treated as a U.S. resident under the substantial presence test of section 7701(b). Thus, in most cases, the individual who spends at least 183 days in the United States would not be subject to section 871(a)(2).[716] However, under the

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[715] Sec. 871(a)(2) has been described as "a relic of the past with an extremely limited scope under current law, and Congress probably would have repealed the provision if it had squarely addressed the question." Bittker and Lokken, *Fundamentals of International Taxation, U.S. Taxation of Foreign Income and Foreign Taxpayers*, para. 66.2.9 (1997).

[716] *See* the American Law Institute, *Federal Income Tax Project, International Aspects of United States Income Taxation, Proposals of the American Law Institute on United States Taxation of Foreign Persons and of the Foreign Income of United States Persons*, at 112-113 (1987) (recommending that sec. 871(a)(2) be eliminated and stating "[u]nder Section 7701(b), enacted in 1984, an individual physically present in the U.S. for 183 days in a calendar year is

substantial presence test under section 7701(b), certain days of physical presence in the United States are not counted for purposes of meeting the 183-day rule. This includes days spent in the United States in which the individual regularly commutes to employment (or self-employment) in the United States from Canada or Mexico; the individual is in transit between two points outside the United States and is physically present in the United States for less than 24 hours; the individual is temporarily present in the United States as a regular member of the crew of a foreign vessel engaged in transportation between the United States and a foreign country or U.S. possession; and certain exempt individuals. These exceptions from counting physical presence in the United States do not apply, however, for purposes of the special rule under section 871(a)(2). Thus, it is possible in certain cases for an individual to be present in the United States for at least 183 days without being treated as a U.S. resident under the substantial presence test of section 7701(b).[717]

Even if an individual spends at least 183 days in the United States but is not treated as a U.S. resident under section 7701(b), the nonresident individual's capital gains generally will be treated as foreign-source income and, thus, not subject to section 871(a)(2). In this regard, capital gains generally are from foreign sources if the individual is a nonresident, and from U.S. sources if the individual is a U.S. resident. Under a special rule, an individual is treated as a U.S. resident for sales of personal property (including sales giving rise to capital gains) if the individual has a tax home in the United States. This rule applies even if the individual is treated as a nonresident for other U.S. tax purposes. An individual's capital gains would be treated as U.S.-source income and potentially subject to section 871(a)(2) if the individual is treated as a U.S. resident under this special rule.[718]

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considered a resident, taxable at net income rates on all of his income; and accordingly the justification for Section 871(a)(2) no longer exists." [footnotes omitted]).

[717] It should be noted that there also is a difference with respect to the year over which the 183-day rule is measured for purposes of the substantial presence test and the rule under sec. 871(a)(2). The sec. 871(a)(2) tax applies to 183 days or more of presence in the United States during the taxable year, while the substantial presence test under sec. 7701(b) applies to 183 days or more of presence in the United States during the calendar year. In most cases, however, a nonresident individual's taxable year is his or her calendar year. Secs. 7701(b)(9) and 871(a)(2).

[718] The individual's income also could be treated as U.S.-source income under sec. 865(e)(2) if the individual derives income from the sale of personal property that is attributable to an office or other fixed place of business that the individual maintains in the United States. However, sec. 871(a)(2) would not apply if the income is effectively connected with a U.S. trade or business, or if the sale qualifies for the exception from U.S.-source treatment as a result of a material participation in the sale by a foreign office of the taxpayer.

Even in the limited cases in which the special rule under section 871(a)(2) could potentially apply, the 30-percent tax may not even apply under the terms of an applicable tax treaty.[719] Thus, the tax should be eliminated.

[719] Under Article 13(5) of the U.S. model income tax treaty, subject to certain exceptions, the capital gains of a nonresident individual are exempt from U.S. taxation.

J. U.S. Model Tax Treaties

Present Law

The traditional objectives of U.S. tax treaties have been the avoidance of international double taxation and the prevention of tax avoidance and evasion. Another related objective of U.S. tax treaties is the removal of the barriers to trade, capital flows, and commercial travel that may be caused by overlapping tax jurisdictions and by the burdens of complying with the tax laws of a jurisdiction when a person's contacts with, and income derived from, that jurisdiction are minimal. To a large extent, the treaty provisions designed to carry out these objectives supplement U.S. tax law provisions having the same objectives; treaty provisions modify the generally applicable statutory rules with provisions that take into account the particular tax system of the treaty partner.

U.S. policies on income tax treaties are contained in the United States Model Income Tax Convention of September 20, 1996 (the "U.S. model income tax treaty"). Some of the purposes of the U.S. model income tax treaty are explained by the Department of the Treasury (the "Treasury Department") in its Technical Explanation to the U.S. model income tax treaty:

> [T]he Model is not intended to represent an ideal United States income tax treaty. Rather, a principal function of the Model is to facilitate negotiations by helping the negotiators identify differences between income tax policies in the two countries. In this regard, the Model can be especially valuable with respect to the many countries that are conversant with the OECD Model. . . . Another purpose of the Model and the Technical Explanation is to provide a basic explanation of U.S. treaty policy for all interested parties, regardless of whether they are prospective treaty partners.[720]

The U.S. model income tax treaty has evolved over time. As explained by the Treasury Department in its Technical Explanation to the U.S. model income tax treaty:

> The Model is drawn from a number of sources. Instrumental in its development was the U.S. Treasury Department's draft Model Income Tax Convention, published on June 16, 1981 ("the 1981 Model") and withdrawn as an official U.S. model on July 17, 1992, the Model Double Taxation Convention on Income and Capital, and its Commentaries, published by the OECD, as updated in 1995 ("the OECD model"), existing U.S. income tax treaties, recent U.S. negotiating experience, current U.S. tax laws and policies and comments received from tax practitioners and other interested parties . . . Like the OECD model, the Model is intended to be an ambulatory document that may be updated from time to time to reflect further consideration of various provisions in light of experience, subsequent treaty negotiations, economic, judicial, legislative or regulatory developments in the United States, and changes in the nature or significance of

[720] Treasury Department, Technical Explanation of the United States Model Income Tax Convention, at 3 (September 20, 1996).

transactions between U.S. and foreign persons. The Technical Explanation is also intended to be ambulatory, and may be expanded to deal with new issues that may arise in the future. The Model will be more useful if it is understood which developments have given rise to alterations in the Model, rather than leaving such [judgments] to be inferred from actual treaties concluded after the release of the Model. The manner and timing of such updates will be subsequently determined.[721] (Emphasis added.)

Sources of Complexity

U.S. model tax treaties provide a framework for U.S. treaty policy. These models provide helpful information to taxpayers, the Congress, as well as foreign governments as to the Administration's policies on often complicated treaty matters. For purposes of clarity and transparency in this area, the U.S. model tax treaties should reflect the most current positions on U.S. treaty policy. Thus, they should be updated on a periodic basis to reflect changes, revisions, or new reflections of U.S. treaty policy in order to be more meaningful. The Treasury Department has not announced a policy on the manner and timing of updating U.S. model tax treaties.

Recommendation for Simplification

The Joint Committee staff recommends that the Treasury Department should update and publish U.S. model tax treaties once per Congress.

The most recent model treaty reflecting U.S. treaty policy is the 1996 U.S. model income tax treaty. Prior to that model treaty, a draft model income tax treaty was published in 1981 and subsequently withdrawn in 1992.[722] There also is a U.S. model estate and gift tax treaty that has not been modified since 1980.

A model tax treaty informs potentially affected taxpayers of the Administration's treaty policy goals. A more current model tax treaty thereby would afford taxpayers the opportunity to offer more helpful commentary to policy makers. A more current model tax treaty also would enable potentially affected taxpayers to make more informed assessments regarding certain transactions in countries in which treaty negotiations are being carried out.

In addition, tax treaties must be ratified by the Senate. The Senate Committee on Foreign Relations, assisted by the Joint Committee staff, reviews tax treaties negotiated and signed by the Treasury Department before ratification by the full Senate is considered. The U.S. model tax treaties are important as part of this review process. They help the Senate determine the Administration's most recent treaty policy and the reasons for deviations from the U.S. model treaties in a particular tax treaty. This review process would be more streamlined and meaningful if the U.S. model tax treaties were periodically updated to include all developments, including the viewpoints of the Congress on treaty matters.

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[721] *Id.* at 2.

[722] Prior to 1981, there was a 1977 model income tax treaty.

The Joint Committee staff, therefore, recommends that the Treasury Department should update and publish the U.S. model income tax treaty and the U.S. model estate and gift tax treaty once every Congress. It would be expected that the updated model treaties would reflect the most recent treaty developments, including the viewpoints of the Congress on these matters. In this regard, the Treasury Department should consult in advance with the Congress as to new treaty policies that are being considered for inclusion in an updated model treaty, as well as other issues that are relevant to the updating of U.S. treaty policy.

K. Older U.S. Tax Treaties

Present Law

The United States has entered into a number of bilateral tax treaties with other countries over the years. The traditional objectives of U.S. tax treaties have been the avoidance of international double taxation and the prevention of tax avoidance and evasion. Another related objective of U.S. tax treaties is the removal of the barriers to trade, capital flows, and commercial travel that may be caused by overlapping tax jurisdictions and by the burdens of complying with the tax laws of a jurisdiction when a person's contacts with, and income derived from, that jurisdiction are minimal. To a large extent, the treaty provisions designed to carry out these objectives supplement U.S. tax law provisions having the same objectives; treaty provisions modify the generally applicable statutory rules with provisions that take into account the particular tax system of the treaty partner.

There are a number of older U.S. tax treaties that are in force. Below is a list of U.S. income tax treaties that were signed by the United States and that went into force approximately ten or more years ago:

Treaty	Signed	Entered into Force
1. Armenia[723]	6/20/73	1/29/76
2. Australia	8/6/82	10/31/83
3. Azerbaijan	6/20/73	1/29/76
4. Barbardos	12/31/84	2/28/86
5. Belarus	6/20/73	1/29/76
6. Belgium	7/9/70	10/13/72
7. Bermuda	7/11/86	12/2/88
8. China	4/30/84	10/22/86
9. Cyprus	3/19/84	12/31/85
10. Egypt	8/24/80	12/31/81
11. Finland	9/21/89	12/30/90
12. Georgia	6/20/73	1/29/76
13. Greece	2/20/50	12/30/53
14. Hungary	2/12/79	9/18/79
15. Iceland	5/7/75	12/26/75
16. India	9/12/89	12/18/90
17. Indonesia	7/11/88	12/30/90
18. Jamaica	5/21/80	12/29/81
19. Japan	3/8/71	7/9/72
20. Korea	6/4/76	9/20/79
21. Kyrgyzstan	6/20/73	1/29/76

[723] The U.S.-U.S.S.R. income tax treaty, signed in 1973, is still in effect for Armenia, Azerbaijan, Belarus, Georgia, Kyrgyzstan, Moldova, Tajikstan, Turkmenistan, and Uzbekistan.

22. Moldova	6/20/73	1/29/76
23. Morocco	8/1/77	12/30/81
24. New Zealand	7/23/82	11/2/83
25. Norway	12/3/71	11/29/72
26. Pakistan	7/1/57	5/21/59
27. Philippines	10/1/76	10/16/82
28. Poland	10/8/74	7/22/76
29. Romania	12/4/73	12/26/76
30. Spain	2/22/90	11/21/90
31. Tajikstan	6/20/73	1/29/76
32. Trinidad &Tobago	1/9/70	12/30/70
33. Tunisia	6/17/85	12/26/90
34. Turkmenistan	6/20/73	1/29/76
35. United Kingdom	12/31/75	4/25/80
36. Uzbekistan	6/20/73	1/29/76

Sources of Complexity

To the extent that older treaties do not reflect current policy and provide different tax outcomes than do more recent treaties, complexity for taxpayers and tax administrators increases as any one taxpayer may be subject to multiple different tax regimes on otherwise similar transactions by reason of the transactions involving different taxing jurisdictions with different treaties. While some complexity must always be present because different countries choose different tax policies, because tax treaty provisions are designed to supplement U.S. tax law provisions, the more current the treaty network, the more consistent the treaty network will be with current U.S. tax policy, reducing overall compliance burdens.

Recommendation for Simplification

The Joint Committee staff recommends that the Treasury Department should report to the Congress on the status of older U.S. tax treaties once per Congress.

Older U.S. tax treaties may contain outdated provisions or may not reflect current U.S. treaty policy or other tax law developments. While it is recognized that the negotiation and ratification process for a bilateral tax treaty is time consuming, it is also recognized that U.S. tax treaties are more meaningful and useful for taxpayers and the government in terms of carrying out the objectives of tax treaties if they reflect the tax laws and policies of the United States and the treaty partner to which they are applicable.

The Joint Committee staff recognizes that the Treasury Department has taken action to update some older U.S. tax treaties.[724] In addition, the Treasury Department has announced

[724] For example, the Treasury Department signed an updated income tax treaty with Austria in 1996 (to replace a 1956 treaty), with Denmark in 1999 (to replace a 1948 treaty), with Ireland in 1997 (to replace a 1949 treaty), with Luxembourg in 1996 (to replace a 1962 treaty),

ongoing formal negotiations to update the 1975 income tax treaty with the United Kingdom. The Treasury Department also has announced that they have scheduled formal negotiations to update the 1982 income tax treaty with Australia and the 1979 income tax treaty with Hungary. The Treasury Department also has had ongoing informal consultations to update the 1971 income tax treaty with Japan. The Joint Committee staff encourages the Treasury Department to continue their efforts in this regard.

The Congress and the public should be provided with as much information as possible as to the Treasury Department's efforts in this area. Accordingly, the Joint Committee staff recommends that the Treasury Department should report to the Congress once every Congress on the status of older U.S. tax treaties. Given the time period for negotiating tax treaties and the potential for negotiated tax treaties to become less relevant as changes in law and other developments take place, the Joint Committee staff recommends that the report cover tax treaties that have been signed and entered into force at least 10 years earlier. This report should include a discussion of the progress the Treasury Department has made with respect to each older tax treaty, the reasons for updating the treaty, and priorities the Treasury Department plans to set for updating a particular treaty. Where relevant, the report should also include a discussion of any treaties that the Treasury Department does not plan to update and the reasons for not doing so. In addition, the report should include significant changes in law and their potential impact on older tax treaties.

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with the Netherlands in 1992 (to replace a 1948 treaty), and with Switzerland in 1996 (to replace a 1951 treaty). These recently updated treaties have entered into force.

X. TAX-EXEMPT ORGANIZATION PROVISIONS

A. Percentage Limits on Grass-Roots Lobbying Expenditures of Electing Charities

Present Law

An organization does not qualify for tax-exempt status under section 501(c)(3) of the Code unless "no substantial part" of the activities of the organization is "carrying on propaganda, or otherwise attempting, to influence legislation," except as provided by section 501(h).[725] Carrying on propaganda and attempting to influence legislation are commonly referred to as "lobbying" activities. Thus, section 501(c)(3) permits a limited amount of lobbying activity without loss of tax-exempt status.

For purposes of determining whether lobbying activities are a substantial part of an organization's overall functions, an organization may choose between two standards, the "no substantial part" test of section 501(c)(3) or the "expenditure" test of section 501(h).

Whether an organization meets the "no substantial part" test is based on all the facts and circumstances. There is no statutory or regulatory guidance, and it is not clear whether the determination is based on the organization's activities, its expenditures, or both.

Alternatively, under section 501(h), certain organizations described in section 501(c)(3) can elect to be subject to the expenditure test,[726] which consists of bright-line rules that specify the dollar amount of permitted expenses on lobbying activities. Organizations that make a section 501(h) election ("electing charities") are subject to tax if the electing charity makes either "lobbying expenditures" or "grass roots expenditures" in excess of a certain amount established for each type of expenditure for each taxable year. Electing charities lose tax-exempt status if lobbying expenditures or grass-roots expenditures normally exceed a certain "ceiling amount."

Lobbying expenditures are the sum of grass-roots expenditures and "direct lobbying" expenditures.[727]

Grass-roots expenditures are defined as "any attempt to influence any legislation through an attempt to affect the opinions of the general public or any segment thereof."[728] For a communication to constitute grass-roots lobbying, it must refer to "specific legislation," reflect a view on such legislation, and encourage the recipient of the communication to take action with respect to such legislation (a "call to action").[729] A communication includes a call to action if it

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[725] Sec. 501(c)(3).

[726] Organizations that do not make a section 501(h) election are subject to the "no substantial part" test.

[727] Secs. 501(h)(2)(A), 4911(c)(1), 4911(d).

[728] Secs. 501(h)(2)(C) and 4911(d)(1)(A).

[729] Treas. Reg. sec. 56.4911-2(b)(2)(i).

incorporates one of four elements: (1) it urges the recipient to contact a legislator, employee of a government body, or any other government official or employee who may participate in the formulation of legislation with the principal purpose of influencing legislation; (2) it states the address, telephone number, or similar information of a legislator or an employee of a legislative body; (3) it provides a petition, tear-off postcard, or similar device for the recipient to communicate with government officials or employees who participate in the formulation of legislation with the principal purpose of influencing legislation; or (4) it states the position of one or more legislators on the legislation, except that a communication may name the main sponsors of legislation for purposes of identifying the legislation without constituting a call to action.[730] In addition, a communication is presumed to be grass-roots lobbying if the communication is a paid advertisement that: (1) appears in the mass media within two weeks before a vote by a legislative body or committee (but not a subcommittee) on a highly publicized piece of legislation; (2) reflects a view on the general subject of the legislation; and (3) either refers to the legislation or encourages the public to communicate with legislators on the general subject of such legislation.[731] The presumption is rebuttable if the electing charity demonstrates that the timing of the communication was not related to the legislation or that the advertisement was of a type regularly made by the electing charity without regard for the legislation.[732]

Direct lobbying expenditures are "any attempt to influence any legislation through communication with any member or employee of a legislative body, or with any government official or employee who may participate in the formulation of the legislation" if the principal purpose of the communication is to influence legislation.[733] A communication would constitute direct lobbying only if the communication "refers to specific legislation" and reflects a view on such legislation.

Certain specified activities do not constitute attempts to influence legislation and therefore expenditures for such activities are not subject to the expenditure limits for lobbying expenditures or grass-roots expenditures. In general, such activities include: (1) making available the results of nonpartisan analysis, study, or research; (2) providing technical advice or assistance to a governmental body or to a committee in response to a written request; (3) appearances before, or communications to, any legislative body with respect to a possible decision of such body that might affect the existence of the organization, its powers and duties,

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[730] Treas. Reg. sec. 56.4911-2(b)(2)(iii). The regulations provide that the first three elements constitute "direct" encouragement, whereas the fourth element is "indirect" encouragement. This distinction becomes relevant in determining whether a communication meets one of the prescribed exceptions to lobbying, i.e., an indirect call to action in a grass-roots communication may qualify as "nonpartisan analysis, study or research" (Treas. Reg. sec. 56.4911-2(b)(2)(iv)), and in determining the proper allocation of expenses between grass-roots and direct lobbying. Treas. Reg. sec. 56.4911-5(e).

[731] Treas. Reg. sec. 56.4911-2(b)(5)(ii).

[732] *Id.*

[733] Secs. 501(h)(2)(A) and 4911(d)(1)(B) and Treas. Reg. sec. 56.4911-2(b)(1).

tax-exempt status, or the deduction of contributions to the organization (so-called "self-defense" expenditures); (4) certain communications to members of the electing charity; and (5) communications with governmental officials or employees that are not intended to influence legislation.[734]

Expenses that serve both direct and grass-roots lobbying purposes, e.g. communications that are sent to members and nonmembers, or "mixed lobbying" expenditures, are subject to special rules. The regulations specify how an electing charity is to allocate mixed lobbying expenditures between direct and grass-roots lobbying purposes.[735] For example, for a mixed lobbying communication that is designed primarily for members (i.e., more than half the recipients are members) and that directly encourages grass-roots lobbying (even if it also encourages direct lobbying), the grass-roots expenditure amount includes all the costs of preparing the material used for purposes of grass-roots lobbying plus the mechanical and distributional costs associated with the communication. If a mixed lobbying communication encourages direct lobbying, but only indirectly encourages grass-roots lobbying, then the entire costs of the communication are allocated based on the proportion of members and nonmembers receiving the communication.

An electing charity faces annual expenditure limits on lobbying expenditures and on grass-roots expenditures. The limits are based on a "lobbying nontaxable amount" for the taxable year and a "grass roots nontaxable amount" for the taxable year. The lobbying nontaxable amount is the lesser of $1 million or an amount determined as a percentage of an organization's exempt purpose expenditures.[736] The grass-roots nontaxable amount is 25 percent of the organization's lobbying nontaxable amount. An electing charity that exceeds either of the spending limitations is subject to a 25 percent tax on the excess. An electing charity that exceeds both of the spending limitations is subject to a 25 percent tax on the greater of the excess of the lobbying expenditures or the grass-roots expenditures.

An electing charity that normally exceeds either of two "ceiling amounts," which are based on the expenditure limits, will lose its tax exemption.[737] The "lobbying ceiling amount" is 150 percent of the electing charity's lobbying nontaxable amount for the taxable year and the "grass roots ceiling amount" is 150 percent of the grass-roots nontaxable amount for the taxable

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[734] Sec. 4911(d)(2).

[735] Treas. Reg. sec. 56.4911-5(e).

[736] Exempt purpose expenditures generally are expenses incurred for exempt purposes, such as amounts paid to accomplish exempt purposes, administrative expenses such as overhead, lobbying expenses, and certain fundraising expenses. Exempt purpose expenditures do not include, for example, expenses not for exempt purposes, payments of unrelated business income tax, or capital expenses in connection with an unrelated business. *See* Treas. Reg. sec. 56.4911-4.

[737] Sec. 501(h)(1).

year. For this purpose, "normal" expenditures are calculated based on a four-year averaging mechanism.[738]

An electing charity must disclose lobbying expenditures annually on Schedule A of Form 990. In order to meet disclosure requirements, electing charities are required to keep detailed records of direct and grass-roots lobbying expenditures. Required records of grass-roots expenditures include (1) all amounts directly paid or incurred for grass-roots lobbying; (2) payments to other organizations earmarked for grass-roots lobbying; (3) fees and expenses paid for grass-roots lobbying; (4) the printing, mailing, and other costs of reproducing and distributing materials used in grass-roots lobbying; (5) the portion of amounts paid or incurred as current or deferred compensation for an employee's grass-roots lobbying services; (6) any amount paid for out-of-pocket expenditures incurred on behalf of the electing charity for grass-roots lobbying; (7) the allocable portion of administrative, overhead and other general expenditures attributable to grass-roots lobbying; and (8) expenditures for grass-roots lobbying of a controlled organization.[739]

Sources of Complexity

The breakdown of lobbying expenditures into direct and grass-roots expenditures is a source of complexity. The grass-roots expenditure limitation requires electing charities to determine for every lobbying activity whether the activity is direct lobbying or grass-roots lobbying. Electing charities must keep records of every grass-roots expenditure, which means that employees engaged in lobbying activities need to keep track of and allocate time spent and expenses made on grass-roots lobbying and direct lobbying. If a lobbying activity consists of both direct lobbying and grass-roots lobbying, electing charities are required to determine whether the grass-roots lobbying was direct or indirect and whether more than half of the recipients were members. The electing charity is further required to allocate the costs of such mixed lobbying communications pursuant to complicated allocation formulas and rules. Even if an electing charity has only minimal grass-roots expenditures, it is nonetheless required to track and report them. In addition, the "call to action" component of the definition of grass-roots lobbying is easy for a well-advised taxpayer to circumvent -- a communication can convincingly "persuade" a recipient to take action without directly "stating" that the recipient should contact a legislator or government employee. Thus, in practice, the grass-roots expenditure limit is not hard to avoid, but even this creates complexity because electing charities that may be subject to the limit on grass-roots lobbying, but not on lobbying generally, may spend time and resources seeking to avoid the grass-roots expenditure limit.

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[738] Treas. Reg. sec. 1.501(h)-3.

[739] *See* Treas. Reg. sec. 56.4911-6(b).

Recommendation for Simplification

The Joint Committee staff recommends that the percentage limitation on grass-roots lobbying expenditures should be eliminated.

The purpose of the 501(h) expenditure test is to ensure by using bright-line rules that no substantial part of an electing charity's activities are lobbying. Accordingly, section 501(h) caps an electing charity's permissible overall lobbying expenditures. The separate limit for grass-roots expenditures does not increase or decrease the permitted amount of total lobbying expenditures; rather it limits grass-roots lobbying as a subset of total lobbying. Thus, an electing charity can spend up to $1 million on lobbying, but no more than $250,000 of that amount may be for grass-roots lobbying.

It can be argued that there is no significant policy rationale for the separate limitation on grass-roots lobbying. The purpose of grass-roots lobbying and direct lobbying are the same -- to adopt or change legislation. Only the means are different. Direct lobbying involves communications with those who make legislation. Grass-roots lobbying reflects an organization's effort to communicate with the public about issues and to encourage the public to take action. Grass-roots lobbying and direct lobbying appear to be equally consistent with exempt purposes, as long as total lobbying does not become substantial.

In the absence of a significant policy rationale supporting the distinction between grass-roots lobbying and direct lobbying, the Joint Committee staff believes that the complexity caused by the distinction justifies elimination of the grass-roots expenditure limitation. If the grass-roots expenditure limitation is eliminated, electing charities would still be subject to the same overall limit on lobbying expenditures but would not be required to classify lobbying activities as direct or grass-roots, keep separate records for grass-roots expenditures and direct lobbying expenditures, or allocate the expenses of mixed lobbying expenditures between a grass-roots portion and a direct lobbying portion. Nor would electing charities with significant grass-roots lobbying activities and insignificant direct lobbying activities have to spend time and resources designing communications that avoid the grass-roots lobbying definition.

B. Excise Tax Based on Investment Income

Present Law

In general

Under section 4940(a) of the Code, private foundations that are recognized as exempt from Federal income tax under section 501(a) of the Code are subject to a two-percent excise tax on their net investment income. Private foundations that are not exempt from tax, such as certain charitable trusts,[740] also are subject to an excise tax under section 4940(b) based on net investment income and unrelated business income. Unlike certain other excise taxes imposed on private foundations, the tax based on investment income does not result from a violation of substantive law by the private foundation; it is solely an excise tax.

Net investment income is determined under the principles of Subtitle A of the Code, except to the extent those principles are inconsistent with section 4940. Net investment income is defined as the amount by which the sum of gross investment income and capital gain net income exceeds the deductions relating to the production of gross investment income.[741] Net investment income also is determined by applying section 103 (generally providing an exclusion for interest on certain State and local bonds) and section 265 (generally disallowing the deduction for interest and certain other expenses with respect to tax-exempt income).[742] Special definitions of gross investment income and capital gain net income are provided for purposes of the excise tax.[743]

The two-percent rate of tax is reduced to one-percent if certain requirements are met in a taxable year.[744] The requirements are that the foundation's qualifying distributions (generally, amounts paid to accomplish exempt purposes)[745] must be at least a certain amount and the foundation cannot have been subject to tax under section 4942[746] for any of the five years preceding the taxable year (the "base period"). The required amount of qualifying distributions is the sum of two elements: the amount of the foundation's assets for the taxable year multiplied by the average over the base period of the percentage of assets distributed as qualifying distributions in a year divided by the assets of the foundation for the year (the "average

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[740] *See* sec. 4947(a)(1).

[741] Sec. 4940(c)(1).

[742] Sec. 4940(c)(5).

[743] Secs. 4940(c)(2) and 4940(c)(4).

[744] Sec. 4940(e).

[745] Sec. 4942(g).

[746] Section 4942 imposes a tax on private foundations for failure to distribute a certain amount of income in a taxable year.

percentage payout for the base period"); plus one percent of the net investment income of the foundation for the taxable year.

The tax on taxable private foundations under section 4940(b) is equal to the excess of the sum of the excise tax that would have been imposed under section 4940(a) if the foundation were tax exempt and the amount of the unrelated business income tax that would have been imposed if the foundation were tax exempt, over the income tax imposed on the foundation under subtitle A of the Code.

Private foundations (taxable and tax exempt) are required to pay estimated taxes of the section 4940 tax in quarterly installments in the same manner as corporate estimated tax payments.[747] "Exempt operating foundations" are exempt from the section 4940 tax.[748]

The amount of tax paid under section 4940 reduces a foundation's "distributable amount" under section 4942.[749] Accordingly, the minimum amount of qualified distributions a foundation has to make to avoid tax under section 4942 is reduced by the amount of section 4940 excise taxes paid.

Amounts collected pursuant to the tax based on investment income are not earmarked for use in administering the tax law for tax-exempt organizations.

Legislative background

Congress enacted section 4940 in 1969 as part of a package of new excise taxes applicable to private foundations. The legislative history to section 4940 shows different approaches to the tax in the House and Senate. The House viewed the tax as both an income tax and a "user fee" that would finance the government's oversight of exempt organizations and proposed a rate of 7.5 percent on net investment income.[750] The Senate favored an "audit-fee tax" based on a percentage of the fair market value of a foundation's assets, and not an income tax. Under the Senate's view, the level of tax should be set at a rate incident to the cost of

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[747] Treas. Reg. sec. 1.6302-1.

[748] Sec. 4940(d)(1). To be an exempt operating foundation, an organization must (1) be an operating foundation (as defined in section 4942(j)(3)), (2) be publicly supported for at least 10 taxable years, (3) have a governing body no more than 25 percent of whom are disqualified persons and that is broadly representative of the general public, and (4) have no officers who are disqualified persons. Sec. 4940(d)(2). Exempt operating foundations generally include organizations such as museums or libraries that devote their assets to operating charitable programs but have difficulty meeting the "public support" tests necessary not to be classified as a private foundation. For an organization to qualify as an exempt operating foundation it must obtain a ruling letter from the IRS. Announcement 85-88.

[749] Sec. 4942(d)(2).

[750] H. Rep. 413 (1969), Part 1 at 19.

supervision and the tax should not be understood as withdrawal of the income tax exemption.[751] The bill reported from conference was a compromise: the rate of tax was lowered to four-percent and the tax was not treated as an income tax or based on the value of a foundation's assets, but was defined as an excise tax on net investment income.[752]

In 1974, the Subcommittee on Foundations of the Senate Finance Committee recommended that the rate of tax be reduced to two-percent because the four-percent rate produced revenues more than double the amount spent by the IRS in administering all exempt organizations. In 1978, Congress reduced the rate of the excise tax to two-percent, noting that the tax "produced more than twice the revenue needed to finance the operations of the Internal Revenue Service with respect to tax-exempt organizations . . . [and in] many cases, the tax actually has reduced charitable expenditures" because it reduces the minimum qualified distributions under section 4942.[753]

In 1984, Congress added the "exempt operating foundation" provision to exempt certain foundations from the tax and added the availability of the one-percent rate. The Congress noted in the legislative history for the rate reduction that the excise tax collected in 1982 exceeded the total costs of administering the combined exempt organization and employee plans programs.[754]

Sources of Complexity

The excise tax based on investment income creates complexity because every private foundation, except exempt operating foundations, is required to calculate net investment income, which is a technical and difficult calculation. Indeed, the IRS often has to rule whether certain income is includible in the calculation of net investment income.[755] In addition, the two-tier nature of the tax means that private foundations have to calculate their average percentage payout for the base period and decide whether to increase charitable distributions in order to obtain the lower rate. Solely because of this excise tax, foundations are required to make quarterly estimated tax payments. Additional complexity exists for taxable private foundations because such foundations are required to calculate the tax on net investment income as well as any unrelated business income tax that would have been owed if the foundation were a taxable foundation.

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[751] S. Rep. 552 (1969), at 27.

[752] H.R. Conf. Rep. 782 (1969), at 278.

[753] S. Rep. 263 (1978), at 218.

[754] Joint Committee on Taxation, *General Explanation of the Revenue Provisions of the Deficit Reduction Act of 1984* (JCS-41-84), December 31, 1984, at 672.

[755] *See, e.g.*, Priv. Ltr. Rul. 200003055 (ruling that gross investment income does not include proceeds from section 401(a) pension plans).

Recommendation for Simplification

The Joint Committee staff recommends that the excise tax based on net investment income should be eliminated.

The excise tax based on the net investment income of private foundations was originally intended as a fee to fund administration of exempt organizations generally. However, even in its early years, the tax raised considerably more revenue than the IRS spent on supervision. Today, the IRS 2001 fiscal year budget for exempt organizations is about $58 million, compared to revenue from section 4940 in 1999 of about $500 million. Thus, the tax continues to generate more revenue than necessary. In addition, there is no evidence that the amount of excise tax collected affects in any way the amount that is appropriated to the IRS for administration of programs related to exempt organizations. Thus, funds generated by the excise tax are not earmarked for their intended purpose, resulting in a tax on private foundations for purposes of the general treasury. In addition, because the tax paid by foundations under section 4940 counts toward a foundation's minimum qualified distributions, elimination of the tax would result in many cases in increases in qualified distributions (i.e., charitable activity).

The tax has added complexity to the taxation of private foundations. Elimination of the tax would relieve private foundations of having to make the necessary calculations of net investment income, file estimated tax returns, and consider the optimal level of charitable activity in terms of the rate of tax.[756]

If the excise tax based on investment income were not eliminated,[757] the tax also could be revised to generate less revenue and at the same time become less complex. For example, the tax could be based on a percentage of the value of a private foundation's assets at the end of a taxable year, and would not be required to be paid quarterly. Such an option would not require calculations of net investment income and would avoid the complexities of a two-tiered tax.

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[756] Elimination of the tax would not obviate the need for exempt operating foundations. Unlike other foundations, grants to exempt operating foundations by a non-exempt operating foundation are not subject to the expenditure responsibility rules. Sec. 4945(d)(4)(A).

[757] H.R. 804, introduced in the House on February 28, 2001 by Representative Cliff Stearns, would eliminate the excise tax.

XI. FARMING, DISTRESSED COMMUNITIES, AND ENERGY PROVISIONS

A. Cost-Sharing Payments

Present Law

There are a number of programs under which Federal and State governments make payments to taxpayers that represent a share of the cost of certain improvements made to land. In general, these programs relate to improvements that further conservation, protect or restore the environment, improve forests, or provide a habitat for wildlife. Prior to 1978, these payments were included in gross income, absent a specific exclusion. These expenditures do not normally improve the income-producing capacity of the property and, because they are shared by the taxpayer, they lessen the likelihood of the taxpayer having funds with which to pay any tax on the portion contributed by the Government.[758] Because the adverse tax consequences might discourage participation in these programs, the Code provides an exclusion from income for these payments to defer their inclusion until the time the underlying property is sold.[759]

Gross income does not include the excludable portions of payments received under the following programs:

(1) The rural clean water program authorized by section 208(j) of the Federal Water Pollution Control Act (33 U.S.C. 1288(j)).

(2) The rural abandoned mine program authorized by section 406 of the Surface Mining Control and Reclamation Act of 1977 (30 U.S.C. 1236).

(3) The water bank program authorized by the Water Bank Act (16 U.S.C. 1301 et seq.).

(4) The emergency conservation measures program authorized by title IV of the Agricultural Credit Act of 1978.

(5) The agricultural conservation program authorized by the Soil Conservation and Domestic Allotment Act (16 U.S.C. 590a).

(6) The great plains conservation program authorized by section 16 of the Soil Conservation and Domestic Policy Act (16 U.S.C. 590p(b)).

(7) The resource conservation and development program authorized by the Bankhead-Jones Farm Tenant Act and by the Soil Conservation and Domestic Allotment Act (7 U.S.C. 1010; 16 U.S.C. 590a et seq.).

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[758] Joint Committee on Taxation, *General Explanation of the Revenue Act of 1978* ((JCS-7-79), March 12, 1979, at 314.

[759] Sec. 126; Joint Committee on Taxation, *General Explanation of the Revenue Act of 1978* (JCS-7-79), March 12, 1979, at 314.

(8) The forestry incentives program authorized by section 4 of the Cooperative Forestry Assistance Act of 1978 (16 U.S.C. 2103).

(9) Any small watershed program administered by the Secretary of Agriculture which is determined by the Secretary of the Treasury or his delegate to be substantially similar to the type of programs described in paragraphs (1) through (8).

(10) Any program of a State, possession of the United States, a political subdivision of any of the foregoing, or the District of Columbia under which payments are made to individuals primarily for the purpose of conserving soil, protecting or restoring the environment, improving forests, or providing a habitat for wildlife. [760]

The Federal Agriculture Improvement and Reform Act of 1996 ("1996 Farm Act") established the Environmental Quality Incentives Program.[761] The Environmental Quality Incentives Program combines into a single program the functions of four conservation programs, including the agricultural conservation program and great plains conservation program referred to above.[762] The Environmental Quality Incentives Program provides technical assistance, cost share and incentive payments and educational assistance. To be eligible to enter into a contract under the Environmental Quality Incentives Program, an owner or producer of a livestock or agricultural operation must submit to the Secretary of Agriculture for approval a plan of operations that incorporates such conservation practices, and is based on such principles, as the Secretary of Agriculture considers necessary to carry out the program, including a description of structural practices and land management practices to be implemented and the objectives to be met by the plan's implementation.

The term "structural practices" means the establishment on eligible land of a site-specific animal waste management facility, terrace, grassed waterway, contour grass strip, filterstrip, tailwater pit, permanent wildlife habitat, or other structural practice that the Secretary determines is needed to protect, in the most cost-effective manner, water, soil, or related resources from degradation.[763] It also includes the capping of abandoned wells on eligible land.[764] The total amount of cost share and incentive payments to any person under the Environmental Quality Incentives Program may not exceed $10,000 for any fiscal year, or $50,000 for any multiyear contract.[765] The Secretary of Agriculture may exceed the annual payment amount on a case-by-

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[760] Sec. 126(a)(1)-(10).

[761] Pub. Law No. 104-127, secs. 334 and 336 (1996).

[762] The Environmental Quality Incentives Program combined the functions of the agricultural conservation program, the great plains conservation program, the water quality incentives program, and the Colorado River Basin Salinity Control program.

[763] 16 U.S.C. sec. 3839aa-1(2) and (5)(A).

[764] 16 U.S.C. sec. 3839aa(5)(B).

[765] 16 U.S.C. sec. 3839aa-7(a).

case basis if needed to achieve the purposes of the Environmental Quality Incentives Program, and if consistent with maximizing environmental benefits per dollar expended.[766]

Sources of Complexity

The 1996 Farm Act repealed the authority for the agricultural conservation program and replaced the existing cost sharing program with the Environmental Quality Incentives Program. The Code does not reflect the consolidation of conservation programs made by the 1996 Farm Act.

Recommendation for Simplification

The Joint Committee staff recommends that the statute should be amended to reflect that the agricultural conservation program authorized by the Soil Conservation and Domestic Allotment Act is now carried out as part of the Environmental Quality Incentives Program.[767]

The agricultural conservation program has been replaced with the Environmental Quality Incentives Program. The Code should be modified to reflect this change to the extent that the payments under the Environmental Quality Incentives Program are for cost-sharing conservation measures. [768]

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[766] 16 U.S.C. sec. 3839aa-7(b).

[767] As part of its deadwood recommendations, the Joint Committee staff recommends the elimination of the exclusion for payments under the great plains conservation program. According to the Department of Agriculture, the last payment under contracts for under the authority of that program will be made, at the latest, by September 30, 2001.

[768] In Rev. Rul. 97-55, 1997-2 C.B. 20, the IRS recognized the Environmental Quality Incentives Program as a program for which section 126 applies to the extent the cost-share payments are with respect to a small watershed under section 126(a)(10).

B. Reforestation Expenses

Present Law

Section 194 provides for an 84-month amortization period for up to $10,000 of qualified reforestation expenditures.

Section 48(b) provides a 10-percent credit on up to $10,000 of qualified amortizable basis in timber property. The amount amortized under section 194 is reduced by one half of the amount of credit claimed under section 48(b).[769]

Both the credit and amortization share the same definition for qualifying expenditures. Generally, qualifying reforestation expenditures include direct costs incurred in connection with forestation or reforestation by planting or seeding, including costs of the seeds or seedlings, costs for the preparation of the site, and costs for labor and tools including depreciation of equipment used in planting or seeding.

Sources of Complexity

The intent of the two Code sections is to accelerate cost recovery for reforestation expenses. Achieving this goal through both a special amortization rule and credit requires multiple calculations relating to the same expense and additional record keeping.

Recommendation for Simplification

The Joint Committee staff recommends that the Congress should replace the separate seven-year amortization and credit for $10,000 of reforestation expenses with expensing of a specified amount of reforestation expense.

Expensing could provide approximately the same tax benefit for qualified reforestation expenditures without requiring two distinct calculations and without requiring the additional record keeping to carry forward the taxpayer's unamortized basis in the expenditures through eight taxable years.

Under present law, for $10,000 of qualified expenditures, the taxpayer may claim a credit equal to $1,000 for the year in which the expenditures are incurred. In addition, the taxpayer may amortize $9,500 ($10,000 less half the credit claimed) over 84 months at the rate of $113.095 per month. The amortization period is deemed to begin on the first day of the first month beginning the second half of the taxpayer's taxable year. Thus, the taxpayer may claim $678.57 of deductible expense in the year in which the expenses are incurred, $1,357.14 of deductible expense in each of the subsequent six taxable years, and the remaining $678.57 of deductible expense in the seventh taxable year subsequent to the year in which the expenses were incurred. Assuming the taxpayer is a 35-percent marginal rate taxpayer and assuming a discount rate of 10-percent, the present value of the tax reduction provided by the reforestation credit and

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[769] Sec. 50(c).

84-month amortization is approximately $2,530.[770] Under the same assumptions, the present value of the tax reduction provided by immediate expensing of $10,000 of qualified reforestation expenses would be approximately $3,182.

[770] The illustrative calculation assumes all amounts are valued at the end of the period in which they occur.

C. Capital Gains Treatment to Apply to Outright Sales of Timber by Landowners

Present Law

Under present law, a taxpayer disposing of timber held for more than one year is eligible for capital gains treatment in three situations. First, if the taxpayer sells or exchanges timber which is a capital asset (sec. 1221) or property used in the trade or business (sec. 1231), the gain generally is long-term capital gain; however, if the timber is held for sale to customers in the taxpayer's business, the gain will be ordinary income. Second, if the taxpayer disposes of the timber with a retained economic interest, the gain is eligible for capital gain treatment (sec. 631(b)). Third, if the taxpayer cuts standing timber, the taxpayer may elect to treat the cutting as a sale or exchange eligible for capital gains treatment (sec. 631(a)).

Sources of Complexity

Present law requires a factual determination of whether the taxpayer is a dealer in timber in order for an outright sale of timber to be eligible for capital gain treatment because, in general, sales by a dealer in timber are not eligible for capital gains treatment. This determination depends on very subjective tests as to whether the property is held for sale to customers. Determinations of dealer status may lead to controversy and litigation. Dealers may obtain capital gain treatment by retaining an economic interest in the timber.

Recommendation for Simplification

The Joint Committee staff recommends that the sale of timber held more than one year by the owner of the land from which the timber is cut should be entitled to capital gain treatment and that the provision relating to a retained economic interest should be eliminated.

The recommendation would eliminate the need to make subjective determinations of dealer status with respect to sales of timber. The recommendation would eliminate a source of controversy and litigation. In addition, the present-law rule requiring that an economic interest be retained by the seller may lead to poor timber management because the buyer, when cutting and removing timber, has no incentive to protect young or other uncut trees because the buyer only pays for the timber that is removed and measured. Under present law, in order for sellers to obtain the most favorable tax treatment, they may be forced to enter into less beneficial contracts with the buyer. Under present law, the buyer only pays for the timber that is removed and measured. In a fraudulent transaction, the measured timber "reported" to the seller for fulfillment of the contract may not correspond to the amount of timber delivered to a mill. The recommendation would mitigate a buyer's potential to defraud the seller by such under-scaling timber by providing sellers with alternative contractual arrangements that would receive comparably favorable tax treatment.

D. Qualifications for the Zero-Percent Capital Gain Rate in the D.C. Enterprise Zone

Present Law

The Taxpayer Relief Act of 1997 designated certain economically distressed areas within the District of Columbia as the "D.C. Enterprise Zone," within which businesses and individual residents are eligible for special tax incentives. In general, the census tracts that comprise the D.C. Enterprise Zone are (1) all census tracts that were part of the D.C. enterprise community, and (2) all additional census tracts within the District of Columbia where the poverty rate is not less than 20 percent.[771] The D.C. Enterprise Zone designation is scheduled to terminate on December 31, 2003.[772]

In general, a qualifying business within the D.C. Enterprise Zone is entitled to the following tax incentives: (1) a 20-percent wage credit for the first $15,000 of wages paid to an employee who is a resident of the District of Columbia, (2) an additional $20,000 ($35,000 beginning in 2002) of section 179 expensing for qualifying zone property, and (3) expanded tax-exempt financing for certain qualifying zone facilities.[773] To qualify for the additional section 179 expensing and the expanded tax-exempt financing, the qualifying business must be an "enterprise zone business," which requires (among other requirements) that at least 50 percent of the gross income of the entity be derived from the active conduct of a qualified business within the zone.[774]

Certain businesses within the D.C. Enterprise Zone also qualify for a zero-percent capital gains rate for certain business assets or investments that are held for more than five years.[775] The zero-percent capital gains rate applies to businesses located in census tracts with at least a 10-percent poverty rate (as opposed to the other tax incentives that are available only in census tracts with at least a 20-percent poverty rate).[776] However, businesses qualifying for the capital gains rate must receive at least 80 percent of their gross income from the active conduct of a qualified business within the D.C. Enterprise Zone (as opposed to the 50 percent threshold that applies with respect to the section 179 expensing and the expanded tax-exempt financing rules for qualifying facilities).[777]

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[771] Sec. 1400(b).

[772] Sec. 1400(f).

[773] Sec. 1400(a)(2).

[774] Sec. 1397C(b)(2).

[775] Sec. 1400B.

[776] Sec. 1400B(d).

[777] Sec. 1400B(c)(2).

Sources of Complexity

The complexity caused by the differing poverty rates and gross income thresholds affects businesses in the D.C. Enterprise Zone in several ways. For example, a new business, if well-advised, would be compelled to evaluate the consequences of locating its business in an area that could qualify for the zero percent capital gains rate but not for the other tax incentives (because of the different poverty rate rules). A more likely scenario, however, would be a new business that is unaware of the different poverty rates and incorrectly assumes that its location qualifies the business for all the tax incentives.

As to businesses located in census tracts that qualify for all the tax incentives, the different rules regarding the gross income requirements also is a source of complexity. As a result, a business may be unaware of the higher gross income requirement for the zero-percent capital gains and erroneously assume that it qualifies for the zero-percent capital gains rate. Moreover, the business may not realize its mistake until after having held the qualifying asset for five years.

Recommendation for Simplification

The Joint Committee staff recommends that, if the D.C. Enterprise Zone is to be extended for a significant period of time,[778] then the poverty rates and the gross income thresholds applicable in connection with the zero-percent capital gains rate should be conformed to those rates and thresholds that apply to the other tax incentives with respect to the D.C. Enterprise Zone. Under the recommendation, a new businesses would qualify for the zero-percent capital gains rate if (1) more than 50 percent (rather than 80 percent) of its gross income is from the active conduct of a qualified business within the zone and, (2) the business is located in census tracts with at least a 20-percent (rather than 10 percent) poverty rate.

The recommendations would eliminate complexity, as well as traps for unwary, for businesses that locate in the D.C. Enterprise Zone. For example, a business may erroneously assume that qualification for the zero-percent capital gains rate means that the business also qualifies for the other tax incentives available within the D.C. Enterprise Zone (or, alternatively, a business that qualifies for the other tax incentives may erroneously assume that it qualifies for the zero-percent capital gains rate). The recommendation would eliminate such confusion by providing a single gross income and single poverty test for determining whether a new business satisfies the definition of an enterprise zone business (and thus qualifies for all the tax incentives).

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[778] As previously noted, the designation of the D.C. Enterprise Zone is scheduled to expire on December 31, 2003.

E. Uniform Rules and Incentives for Economically Distressed Areas

Present Law

Empowerment zones

The Omnibus Budget Reconciliation Act of 1993 ("1993 Act") authorized the designation of nine empowerment zones to provide tax incentives for businesses to locate within targeted areas.[779] The Taxpayer Relief Act of 1997 ("1997 Act") authorized the designation of twenty-two additional empowerment zones.[780] The Community Renewal Tax Relief Act of 2000 ("Community Renewal Act") authorized the designation of nine new empowerment zones (bringing the total to 40 empowerment zones) by January 1, 2002.[781] To be designated as an empowerment zone, the nominated area must satisfy certain size, population, and poverty criteria (that vary depending on whether the area is urban or rural).

Once fully effective in 2002, the 40 empowerment zones will permit businesses located in the empowerment zones to qualify for the following tax incentives: (1) a 20-percent wage credit for the first $15,000 of wages paid to a zone resident who works in the empowerment zone,[782] (2) an additional $35,000 (beginning in 2002) of section 179 expensing for qualifying zone property;[783] (3) expanded tax-exempt private activity bond rules to finance qualifying facilities in empowerment zones;[784] (4) the ability to roll over capital gain from the sale or exchange of any qualified empowerment zone asset purchased after December 21, 2000 and held for more than one year;[785] and (5) an increased inclusion (to 60 percent) of gain from the sale of qualified small business empowerment zone stock purchased after December 21, 2000 and held for more than five years.[786] The tax incentives with respect to the 40 empowerment zones generally are available through December 31, 2009.

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[779] Sec. 1391(b)(2). Two empowerment zones (those located in Los Angeles and Cleveland) were authorized by the 1997 Act but generally have the same benefits as those authorized by the 1993 Act.

[780] Sec. 1391(g)(1). The two additional empowerment zones are the Los Angeles and Cleveland zones described in the previous note.

[781] Sec. 1391(h)(1) and (2).

[782] Sec. 1396(b).

[783] Sec. 1397A(a).

[784] For empowerment zones and enterprise communities authorized by the 1993 Act, the bonds are subject to the annual private activity bond State volume cap (currently equal to $50 per resident of each State, or if greater, $150 million per State).

[785] Sec. 1397B.

[786] Sec. 1202(a)(2).

Enterprise communities

Also authorized by the 1993 Act was the designation of 95 enterprise communities (65 in urban areas and 30 in rural areas) designed to provide tax incentives for businesses to locate within designated areas.[787] Businesses located in the enterprise communities are eligible for expanded tax-exempt financing similar to that available to businesses in empowerment zones (but not the other tax incentives). The tax incentives with respect to the enterprise communities generally are available during the 10-year period of 1995 through 2004.

Renewal communities

The Community Renewal Act also authorized the designation of 40 renewal communities (at least 12 in rural areas) from areas nominated by States and local governments, within which special tax incentives will be available.[788] Renewal communities must be designated by January 1, 2002, with the associated tax incentives generally being available beginning on January 1, 2002 through December 31, 2009.

To be designated as a renewal community, a nominated area must meet the following criteria: (1) each census tract must have a poverty rate of at least 20 percent; (2) in the case of an urban area, at least 70 percent of the households have incomes below 80 percent of the median income of households within the local government jurisdiction; (3) the unemployment rate is at least 1.5 times the national unemployment rate; and (4) the area is one of pervasive poverty, unemployment, and general distress.[789] Those areas with the highest average ranking of eligibility factors (1), (2), and (3) above generally will be designated as renewal communities.[790]

There are no geographic size limitations placed on renewal communities. Instead, the boundary of a renewal community must be continuous. In addition, the renewal community must have a minimum population of 4,000 if the community is located within a metropolitan statistical area (at least 1,000 in all other cases), and a maximum population of not more than 200,000.[791]

The following tax incentives generally are available for businesses in renewal communities: (1) a zero-percent capital gains rate with respect to gain from the sale of a

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[787] Sec. 1391(b)(1).

[788] Sec. 1400E(a)(2).

[789] Sec. 1400E(c)(3).

[790] With respect to the first 20 designations of nominated areas as renewal communities, preference is to be given to nominated areas that are enterprise communities and empowerment zones under present law that otherwise meet the requirements for designation as a renewal community.

[791] Sec. 1400E(c)(2).

qualified community asset held more than five years;[792] (2) a 15-percent wage credit on the first $10,000 of qualified wages paid to each employee who (a) is a resident of the renewal community, and (b) performs substantially all employment services within the renewal community for the employer;[793] (3) an allocation of up to $12 million of "commercial revitalization expenditures" to each renewal community located within the State for each calendar year after 2001 and before 2010, which taxpayers can elect either to (a) deduct one-half of the commercial revitalization expenditures for the taxable year the building is placed in service or (b) amortize all the expenditures ratably over the 120-month period beginning with the month the building is placed in service;[794] and (4) an additional $35,000 of section 179 expensing for qualified renewal property placed in service after December 31, 2001, and before January 1, 2010.[795]

District of Columbia Enterprise Zone

The 1997 Act designated certain economically depressed census tracts within the District of Columbia as the "D.C. Enterprise Zone," within which businesses and individual residents are eligible for special tax incentives.[796] In addition to the tax incentives generally available with respect to empowerment zones (i.e., a 20-percent wage credit, an additional $20,000 ($35,000 beginning in 2002) of section 179 expensing, and expanded tax-exempt financing incentives[797]), the D.C. Enterprise Zone also has a zero-percent capital gains rate that applies to gain from the sale of certain qualified D.C. Enterprise Zone assets acquired after December 31, 1997 and held for more than five years.[798] The D.C. Enterprise Zone is scheduled to expire on December 31, 2003.[799]

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[792] Sec. 1400F.

[793] Sec. 1400H.

[794] Sec. 1400I.

[795] Sec. 1400J.

[796] Sec. 1400(a)(2).

[797] The issuance of tax-exempt economic development bonds by a qualifying D.C. Enterprise Zone business is subject to the District of Columbia's annual private activity bond volume limitation. However, the aggregate face amount of all outstanding qualified enterprise zone facility bonds per qualified D.C. Enterprise Zone business may not exceed $15 million (rather than $3 million).

[798] Sec. 1400B.

[799] Sec. 1400(f).

Sources of Complexity

The various regimes are designed to achieve a common objective -- to identify targeted geographic areas that suffer from pervasive poverty, unemployment and general distress, and provide tax incentives to encourage businesses to locate in these areas. The special designation is expected to result in greater employment opportunities for area residents and greater economic activity generally. Offering different tax incentives greatly complicates the economic decision-making process for businesses.

Additional complexity arises because of a lack of a consistent definition to identify the geographic areas of economic distress. For example, each class of geographic area -- an enterprise community, an empowerment zone, and a renewal community -- has its own set of eligibility criteria. Furthermore, the criteria used to designate the empowerment zones pursuant to the 1997 Act differ from those used to designate empowerment zones pursuant to the 1993 Act. Similarly, the criteria to be used in the designation of nine new empowerment zones under the Community Renewal Act differ from those to be used in the designation of the 40 renewal communities, both of which require designation by January 1, 2002. Thus, a State or local government agency that is seeking to nominate a distressed area will be required to calculate different sets of eligibility criteria and submit multiple applications to different agencies.

The disparate tax incentives also will result in administrative complexity for the Treasury Department and the IRS -- the Treasury Department will be required to issue more guidance, and the IRS will be faced with greater reporting and compliance issues. State and local government agencies will face similar problems, particularly if a State has both an empowerment zone and a renewal community.

Recommendation for Simplification

The Joint Committee staff recommends that a uniform package of tax incentives should be adopted for businesses that locate in targeted geographic areas. In addition, the targeted geographic areas that would be eligible for the tax incentives should be determined based on the application of a consistent set of economic measurements.

The present-law patchwork of tax incentives for distressed areas results in complexity in several respects. Significant complexity results from the lack of uniform tax benefits. For well-advised businesses, particularly those with flexibility in terms of location, the different tax benefits add complexity in their decision-making analysis. Thus, for example, in determining where a business should locate a manufacturing facility, the business must weigh the relative merits of a higher wage credit plus rollover of qualified capital gains (available in empowerment zones) versus a lower wage credit and a zero-percent capital gains rate (available in renewal communities). Businesses that are not so well-advised may not be aware of the different tax benefits. Table 23, which follows this recommendation, summarizes the various types of tax incentives for designated economically distressed areas.

Offering different tax incentives greatly complicates the economic decision-making process for businesses and creates administrative complexity for the Treasury Department, the

IRS, and the State and local economic development agencies. To eliminate these complexities, a uniform package of tax incentives should be adopted for businesses that locate in targeted geographic areas. In addition, the targeted geographic areas that would be eligible for the tax incentives should be determined based on the application of a consistent set of economic measurements.

Table 23. -- Summary of Tax Incentives for Designated Economically Distressed Areas

Zone or Community Tax Incentive	Enterprise Communities	Empowerment Zones	D.C. Enterprise Zone	Renewal Communities
Wage credit	Not available	An employer of a business located in an empowerment zone is entitled to a 20 percent wage credit on the first $15,000 of qualifying wages paid to each employee who resides in the empowerment zone.	Same as for empowerment zones except that the employee must reside within the District of Columbia.	Beginning in 2002, an employer of a business located in a renewal community is entitled to a 15 percent wage credit on the first $10,000 of qualifying wages paid to each employee who resides in the renewal community.
Additional section 179 expensing	Not available	A business in an empowerment zone is entitled to an additional $20,000 ($35,000 beginning in 2002) in section 179 expensing.	Same as for empowerment zones.	Same as for empowerment zones (beginning in 2002).
Tax-exempt bonds	Qualified businesses in enterprise communities are eligible to use the proceeds from tax-exempt financing. However, the tax-exempt financing is subject to the State private activity bond volume cap as well as a per-business size limitation ($3 million for each business within an enterprise community with a maximum of $20 million for all zones and communities).	Qualified businesses in empowerment zones are eligible for tax-exempt financing. Depending on when the zone was designated, the tax-exempt financing is either subject to (1) the State private activity bond volume cap and a per-business size limitation (Round I zones), or (2) a per-zone volume limitation depending on the type and population of the zone (Round II zones). Beginning in 2002, the per-zone volume limitations will apply to all empowerment zones.	Qualified businesses in the D.C. Enterprise Zone are eligible to use the proceeds from tax-exempt financing. However, the tax-exempt financing is subject to the State private activity bond volume cap as well as a per-business size limitation ($15 million for each business with a maximum of $20 million for all zones and communities).	Not available
Special rules for qualifying capital gains (special rules for	Not available		Qualifying D.C. Zone assets (i.e., corporate stock, partnership interests, and business property) acquired after December 31, 1997 and	Qualifying community assets (i.e., corporate stock, partnership interests, and business property) acquired after December 31, 2001 and held for more than 5 years qualifies for a zero-percent

Table 23. -- Summary of Tax Incentives for Designated Economically Distressed Areas

Zone or Community Tax Incentive	Enterprise Communities	Empowerment Zones	D.C. Enterprise Zone	Renewal Communities
qualifying capital gains, cont'd)			held for more than 5 years qualifies for a zero-percent capital gains rate.	capital gains rate.
		A taxpayer can roll over capital gain from the sale of any qualified empowerment zone asset purchased after December 21, 2000 and held more than one year to the extent the proceeds are used to purchase other qualifying zone assets in the same zone within 60 days of the sale.	No rollover provision.	No rollover provision.
		A taxpayer can exclude 60 percent of gain (rather than the general rule allowing a 50 percent exclusion) from the sale of qualified small business empowerment zone stock purchased after December 21, 2000 and held for more than five years.	No increased exclusion for qualified small business zone stock.	No increased exclusion for qualified small business community stock.
Enhanced depreciation deduction ("commercial revitalization deduction")	Not available	Not available	Not available	Each State is allocated a total of $12 million of "commercial revitalization expenditures" for each renewal community in the State, which is allocated to taxpayers. In lieu of depreciation, a taxpayer can elect to (a) deduct 50 percent of the allocated expenditure amount or (b) amortize the expenditures ratably over 10 years.

Source: Joint Committee on Taxation

F. Permit Expensing of Certain Geological and Geophysical Costs

Present Law

Under present law, current deductions are not allowed for any amount paid for new buildings or for permanent improvements or betterments made to increase the value of any property or estate.[800] Treasury Department regulations define capital amounts to include amounts paid or incurred (1) to add to the value, or substantially prolong the useful life, of property owned by the taxpayer or (2) to adapt property to a new or different use. The Code does not provide rules specific to the recovery of geological and geophysical costs. In Revenue Ruling 77-188, [801] the Internal Revenue Service provided guidance regarding the proper income tax treatment of geological and geophysical costs.

Revenue Ruling 77-188

In Revenue Ruling 77-188[802] (hereinafter referred to as the "1977 ruling"), the IRS provided guidance regarding the proper tax treatment of geological and geophysical costs. The ruling describes a typical geological and geophysical exploration program as containing the following elements:

- It is customary in the search for mineral producing properties for a taxpayer to conduct an exploration program in one or more identifiable project areas. Each project area encompasses a territory that the taxpayer determines can be explored advantageously in a single integrated operation. This determination is made after analyzing certain variables such as (1) the size and topography of the project area to be explored, (2) the existing information available with respect to the project area and nearby areas, and (3) the quantity of equipment, the number of personnel, and the amount of money available to conduct a reasonable exploration program over the project area.
- The taxpayer selects a specific project area from which geological and geophysical data are desired and conducts a reconnaissance-type survey utilizing various geological and geophysical exploration techniques. These techniques are designed to yield data that will afford a basis for identifying specific geological features with sufficient mineral potential to merit further exploration.
- Each separable, noncontiguous portion of the original project area in which such a specific geological feature is identified is a separate "area of interest." The original project area is subdivided into as many small projects as there are areas of interest located and identified within the original project area. If the circumstances permit a

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[800] Sec. 263(a).

[801] 1977-1 C.B. 76

[802] *Id.*

detailed exploratory survey to be conducted without an initial reconnaissance-type survey, the project area and the area of interest will be coextensive.

- The taxpayer seeks to further define the geological features identified by the prior reconnaissance-type surveys by additional, more detailed, exploratory surveys conducted with respect to each area of interest. For this purpose, the taxpayer engages in more intensive geological and geophysical exploration employing methods that are designed to yield sufficiently accurate sub-surface data to afford a basis for a decision to acquire or retain properties within or adjacent to a particular area of interest or to abandon the entire area of interest as unworthy of development by mine or well.

The 1977 ruling provides that if, on the basis of data obtained from the preliminary geological and geophysical exploration operations, only one area of interest is located and identified within the original project area, then the entire expenditure for those exploratory operations is to be allocated to that one area of interest and thus capitalized into the depletable basis of that area of interest. On the other hand, if two or more areas of interest are located and identified within the original project area, the entire expenditure for the exploratory operations is to be allocated equally among the various areas of interest.

If no areas of interest are located and identified by the taxpayer within the original project area, then the 1977 ruling states that the entire amount of the geological and geophysical costs related to the exploration is deductible as a loss under section 165. The loss is claimed in the taxable year in which that particular project area is abandoned as a potential source of mineral production.

The 1977 ruling further provides that if an oil or gas property is acquired or retained within or adjacent to that area of interest, the entire geological and geophysical exploration expenditures, including those incurred prior to the identification of the particular area of interest but allocated thereto, are to be allocated to the property as a capital cost under section 263(a). If more than one property is acquired, it is proper to determine the amount of the geological and geophysical costs allocable to each such property by allocating the entire amount of the costs among the properties on the basis of comparative acreage.

If, however, no property is acquired or retained within or adjacent to that area of interest, the entire amount of the geological and geophysical costs allocable to the area of interest is deductible as a loss under section 165 for the taxable year in which such area of interest is abandoned as a potential source of mineral production.

In 1983, the IRS issued Revenue Ruling 83-105,[803] which elaborates on the positions set forth in the 1977 ruling by setting forth seven factual situations and applying the principles of the 1977 ruling to those situations. In addition, Revenue Ruling 83-105 explains what constitutes an "abandonment as a potential source of mineral production."

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[803] 1983-2 C.B. 51.

Sources of Complexity

Taxpayers incur geological and geophysical costs for the purpose of obtaining and accumulating data that will serve as a basis for the acquisition and retention of oil or gas properties by taxpayers exploring for the minerals. The proper income tax treatment of geological and geophysical costs associated with oil and gas production has been the subject of a number of court decisions and administrative rulings. In general, courts have ruled that such costs are capital in nature and are not deductible as ordinary and necessary business expenses. Accordingly, the costs attributable to such exploration are allocable to the cost of the property acquired or retained.[804] However, the determinations are highly factual. As specified in the 1977 ruling, modest changes in the taxpayer's circumstances relating to project areas, areas of interest, and property acquired or retained result in certain geological and geophysical costs being fully amortizable, partially amortizable and partially currently deductible, or fully currently deductible. The highly factual nature of these determinations increases compliance burdens for the taxpayer and administrative burdens on the IRS.

Recommendation for Simplification

The Joint Committee staff recommends that taxpayers should be permitted immediate expensing of geological and geophysical costs.

The timing of the recovery of geological and geophysical costs depends upon the factual situation of the property to which such expenses are allocated. The proposal would reduce complexity by eliminating the need for allocation of such expenses across various properties and by eliminating the need to make factual determinations relating to those properties such as what constitutes an area of interest and determinations of when a property is abandoned.

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[804] The term "property" includes an economic interest in a tract or parcel of land notwithstanding that a mineral deposit has not been established or proven at the time the costs are incurred.

XII. EXCISE TAXES

A. Highway Trust Fund Excise Taxes

Present Law

In general

Six separate excise taxes are imposed to finance the Federal Highway Trust Fund program. Three of these taxes are imposed on highway motor fuels. The remaining three are a retail sales tax on heavy highway vehicles, a manufacturers' excise tax on heavy vehicle tires, and an annual use tax on heavy vehicles. The six taxes are summarized below.

Highway motor fuels taxes

The Highway Trust Fund[805] motor fuels tax rates are as follows:

Gasoline	18.3 cents per gallon
Diesel fuel and kerosene	24.3 cents per gallon
Special motor fuels	18.3 cents per gallon generally[806]

[805] These fuels are subject to an additional 0.1-cent-per-gallon excise tax to fund the Leaking Underground Storage Tank ("LUST") Trust Fund. *See*, secs. 4041(d) and 4081(a)(2)(B). That tax is imposed as an "add-on" to other existing taxes; thus, most of the simplification recommendations discussed in this section for motor fuels taxes also would apply to the LUST tax.

[806] The statutory rate for certain special motor fuels is determined on an energy equivalent basis, as follows:

Liquefied petroleum gas (propane)	13.6 cents per gallon
Liquefied natural gas	11.9 cents per gallon
Methanol derived from petroleum or natural gas	9.15 cents per gallon
Compressed natural gas	48.54 cents per MCF

See sec. 4041(a)(2) and (3) and 4041(m).

Collection of taxes

Gasoline, diesel fuel, and kerosene.--Gasoline, diesel fuel, and kerosene are taxed when the fuels are removed from a refinery or registered pipeline or barge terminal (sec. 4081(a)(1)). Typically, these fuels are transferred by pipeline or barge in large quantities ("bulk") to terminal storage facilities that geographically are located closer to destination retail markets. A fuel is taxed when it "breaks bulk," i.e., when it is removed from the refinery or terminal, typically by truck or rail car, for delivery to a smaller wholesale facility or a retail outlet. The party liable for payment of the taxes is the "position holder," i.e., the person shown on the records of the terminal facility as owning the fuel.

All persons owning these motor fuels before tax is paid must be registered with the IRS (sec. 4101). Additionally, terminal facilities must register with the IRS as a condition of storing untaxed (or undyed) motor fuels (including motor fuels that are not owned by the terminal operator). Sale or other transfer of fuel to an unregistered party or removal to an unregistered facility before the fuel breaks bulk results in imposition of tax on that transaction. If the fuel subsequently is entered into and removed from a registered terminal, a second tax is imposed. Refund claims are allowed to prevent double taxation.

In general, all fuel removed from a registered terminal facility is subject to tax, without regard to whether the ultimate use of the fuel is taxable (e.g., non-taxable use for heating or other off-highway business use such as farming). Exceptions are provided allowing diesel fuel and kerosene to be removed for use in a non-taxable use or in an intercity bus or a train eligible for a reduced tax rate if the fuel is indelibly dyed at the time of removal.[807] All gasoline removals are subject to tax.

The compressed natural gas tax rate is equivalent only to 4.3 cents per gallon of the rate imposed on gasoline and other special motor fuels rather than the full 18.3-cents-per-gallon rate. The tax rate for the other special motor fuels is equivalent to the full 18.3 cents per gallon gasoline and special motor fuels tax rate.

[807] As a condition of registering to store untaxed fuels, terminals that store kerosene must offer for sale both dyed and undyed kerosene and terminals that offer for sale diesel fuel must offer both dyed and undyed diesel fuel. This requirement was enacted in 1997 (Pub. Law No. 105-277) to be effective on July 1, 1998. Subsequently, the effective date was extended to July 1, 2000, and then to January 1, 2002 (Pub. Law No. 105-178 and Pub. Law No. 106-170). A parallel fuel dyeing regime exists under the Clean Air Act. Those provisions require dyeing of "high sulfur" diesel fuel as a method of enforcing a Clean Air Act prohibition on using high sulfur fuel on the highway. The ability of partially exempt inter-city buses to use low-sulfur diesel fuel and kerosene dyed under tax rules identical to those of the Clean Air Act could result in illegal on-highway use of high-sulfur diesel fuel in violation of that Act. Similar Clean Air Act compliance issues arise in connection with other exempt highway uses such as State and local government and certain private transit vehicles using diesel fuel or kerosene. Most aviation jet fuel is a special grade of kerosene. The Code allows undyed aviation-grade kerosene to be removed from terminals without payment of the Highway Trust Fund tax if (1) the kerosene is removed by pipeline to an airport or (2) the fuel is removed for aviation use by or on behalf of a

Refunds or income tax credits may be claimed (generally by consumers) for fuels on which tax is paid and which ultimately are used in a non-taxable use. The rules governing how and by whom a refund is claimed differ by type of fuel, by end use, and by dollar amount of the claim. Except in the case of "gasohol" (gasoline blended with ethanol) and kerosene sold from certain "blocked pumps" for which weekly claims are allowed, no more than one claim per quarter may be filed. Refund claims may be filed only if prescribed dollar thresholds are satisfied. If the dollar amounts are not satisfied in a calendar year, refunds must be claimed as credits on income tax returns. Unlike income tax refunds, excise tax refunds generally do not bear interest if they are not paid within set periods. However, interest does accrue on gasohol and kerosene "blocked pump" refunds if not paid within 20 days.

Finally, as stated above, most refunds must be claimed by consumers (who are deemed to bear the burden of the tax). Exceptions are provided for fuels sold to States and local governments and farmers, and for kerosene sold from blocked pumps for heating purposes. Those refunds must be claimed by actual taxpayers, wholesale distributors, or ultimate vendors.

Special motor fuels.--The special motor fuels tax is imposed on retail sale of the fuel, or on use if the fuel is consumed before a retail sale occurs.

Exemptions and reduced rates

Numerous exemptions (and partial exemptions) for specified uses of taxable fuels (or for specified fuels) are provided under present law. Typically, these exemptions are for governments or for uses not involving use of (and thereby damage to) the highway system. These exempt uses include:

(1) use in State or local government and nonprofit educational organization vehicles;

(2) use in certain buses engaged in transporting students and employees of schools;

(3) use in private local mass transit buses having a seating capacity of at least 20 adults (not including the driver) when the buses operate under contract with (or are subsidized by) a State or local governmental unit;

(4) use of gasoline or special motor fuels in an off-highway business use or of diesel fuel or kerosene in an off-highway use (whether or not a business use).

Diesel fuel and kerosene used in certain inter-city buses is taxed at a special, reduced rate of 7.3 cents per gallon.

Ethanol and methanol derived from renewable sources (e.g., biomass) are eligible for an income tax credit (the "alcohol fuels credit") equal under present law to 53 cents per gallon

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registered aviation fuel dealer. The dealer in turn is responsible for payment of any Airport and Airway Trust Fund tax that may be due on the kerosene.

(ethanol)[808] and 60 cents per gallon (methanol).[809] These tax credits are provided to blenders of the alcohols with other taxable fuels, or to retail sellers of unblended alcohol fuels. Part or all of the benefits of the income tax credit may be claimed through reduced excise taxes paid, either in reduced-tax sales or by expedited blender refunds on fully taxed sales of gasoline.

Non-fuels excise taxes

Retail sales tax on tractors, heavy trucks, and heavy trailers

A 12-percent retail sales tax is imposed on the first retail sale of tractors, heavy trucks (over 33,000 pounds) and trailers (over 26,000 pounds).[810] The taxable weight is the "gross vehicle weight," which is the fully loaded, certified weight. In general, this tax is imposed on the price of a fully equipped highway vehicle. However, the price of certain equipment unrelated to the highway transportation function of the vehicle is excluded from the tax base (sec. 4053). Additionally, a credit against the tax is allowed for the amount of tire excise tax imposed on manufacturers of new tires installed on the vehicle.

The term first retail sale includes the first sale of a "remanufactured" vehicle (sec. 4052(a)). Whether modifications to a vehicle constitute a "repair" or the manufacture of a new (remanufactured) vehicle involves significant factual determinations and is the subject of frequent disputes between the IRS and taxpayers.

Manufacturers tax on heavy vehicle tires

Tires designed for use on heavy highway vehicles are subject to a graduated tax, based on the weight of the tire (sec. 4071).

40 pounds or less	No tax
40-70 pounds	15 cents per pound 40 pounds
70-90 pounds	4.50 plus 30 cents per pound over 70 pounds
Over 90 pounds	$10.50 plus 50 cents per pound over 90 pounds

Retread tires are not subject to tax except when the retreading covers the entire outer surface of the tire (i.e., is "bead to bead").

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[808] The 53-cents-per-gallon credit is scheduled to decline to 51 cents per gallon over the period 2001 through 2007. The credit is scheduled to expire after the earlier of (1) expiration of the Highway Trust Fund excise taxes or (2) December 31, 2007.

[809] Ethanol produced by certain "small producers" is eligible for an additional 10 cents per gallon producer tax credit. Eligible small producers are defined as persons whose production capacity does not exceed 30 million gallons and whose annual production does not exceed 15 million gallons.

[810] Sec.

Annual use tax for heavy vehicles

An annual use tax is imposed on heavy highway vehicles, at the rates below.[811]

Under 55,000 pounds	No tax
55,000-75,000 pounds	$100 plus $22 per 1,000 pounds over 55,000
Over 75,000 pounds	$550

The annual use tax is imposed for a taxable period of July 1 through June 30. Generally, the tax is paid by the person in whose name the vehicle is registered. In certain cases, taxpayers are allowed to pay the tax in quarterly installments. Exemptions and reduced rates are provided for certain "transit-type buses," trucks used for fewer than 5,000 miles on public highways (7,500 miles for agricultural vehicles), and logging trucks.[812]

Sources of Complexity

The mix of the Highway Trust Fund excise taxes was last adjusted in 1982. The multiple separate taxes for different industry segments reflect an attempt to assign tax burdens in relation to assumed damage to the highways by those segments. The most current Department of Transportation cost allocation study available in 1982 indicated that heavy vehicles damaged the highways proportionately more than automobiles and light trucks. Thus, the three non-fuels excise taxes are imposed in addition to the motor fuels taxes to increase the tax burden on heavier vehicles.

This attempt to reflect highway damage in the tax structure fails to take into account taxpayer difficulties in complying with the non-fuels taxes, particularly in light of the significant dependence of the non-fuels taxes on highly factual determinations. Similarly, it is an inefficient use of IRS resources to address the relatively complex factual determinations required by these taxes for the small amounts of Federal revenue involved.

Furthermore, complexity in the Highway Trust Fund excise taxes is increased by (1) an historically created patchwork of differing rules for claiming similar refunds on similar products (or by different exempt users), (2) several partial or complete exemptions from the taxes designed to further perceived social or economic goals, and (3) the structuring of some taxes that involve relatively small amounts of revenues to affect large numbers of taxpayers directly or to require highly factual determinations.

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[811] Sec. 4081.

[812] *See generally*, sec. 4483.

Recommendations for Simplification

Recommendation 1: Reduce the number of separate taxes imposed to finance the Highway Trust Fund

The Joint Committee staff recommends that the number of taxes imposed to finance Highway Trust Fund programs should be reduced by eliminating or consolidating the non-fuels taxes. The rates at which the fuels taxes or the restructured non-fuels taxes are imposed could be adjusted to ensure that future funding for Trust Fund programs is not affected.

Unlike taxes the revenues from which are retained in the General Fund of the Treasury, excise taxes dedicated to Trust Funds typically are designed to reflect a cost-benefit relationship between the taxpayer and the beneficiaries of the Trust Fund programs being financed. As described above, the decision to structure the Highway Trust Fund excise taxes consistent with the findings of a Department of Transportation cost allocation study adds significant complexity to the Code. This complexity results from reliance on multiple, separate excise taxes that yield relatively small amounts of Federal revenue, but require significant factual determinations. In some cases, these taxes directly impact large numbers of taxpayers whose individual tax obligations are relatively small.

Historically, approximately 90 percent of the revenues for the Highway Trust Fund have been produced by the motor fuels excise taxes. For example, in Fiscal Year 2000, the motor fuels excise taxes yielded gross receipts of $30.1 billion. The heavy vehicle retail sales tax produced $3.1 billion, the tire excise tax yielded $436 million, and the annual use tax yielded $900 million. The Joint Committee staff recommendation would retain the historical user charge nature of these taxes, but would shift some emphasis from academic cost allocation studies in favor of simplified compliance.

Compliance issues are high relative to revenue yield for the non-fuels excise taxes. For example, the retail sales tax applies to the first sale of a new or "remanufactured" vehicle. Statutory and regulatory safe harbors are provided for determining when a repair is so extensive that a vehicle has been remanufactured with the result that a new tax is imposed. These safe harbors are based on relative values before and after the modifications, change in transportation function, and extension of the useful life or transportation function of the vehicle. In practice, the safe harbors are sufficiently imprecise that many transactions are subject to IRS audit challenge, often long after the transaction is complete. Thus, the vendor may lose the opportunity to pass the tax through to the customer who purchased a vehicle as a result of innocent mistakes in applying the present rules.

Other factual issues arise from the fact that the tax applies only to highway vehicles.[813] The definition of highway vehicle is unclear in the case of vehicles that are used both on and off highway (e.g., heavy construction equipment). Similarly, certain types of equipment unrelated to

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[813] The definition of highway vehicle also is important for determining whether fuel is subject to tax.

the transportation function of a vehicle, but which are mounted on the vehicle, are exempt from tax. The determination of whether this equipment is related to the transportation function of the vehicle (and is therefore taxable) results in numerous IRS and taxpayer audit disputes as well.

Finally, despite the relatively small portion of Highway Trust Fund revenues it yields, the annual use tax on heavy vehicles includes not only special rules such as those for logging and agricultural vehicles which give rise to factual uncertainty, but also directly involves as "taxpayers" every heavy vehicle owner in the United States. Many such vehicle owners own only a single or a few vehicles, making IRS enforcement efforts inefficient if tax is not paid voluntarily. Similarly, Mexican- and Canadian-registered trucks operating in the United States are subject to the tax if they travel over 5,000 U.S. miles in a year. The only mechanism for monitoring compliance in these instances is border checks by the U.S. Customs Service. As a result, the costs associated with enforcement exceed the tax collected in many cases.

The Joint Committee staff recommendation could be accomplished by any of several modifications to the current tax structure. First, the three non-fuels excise taxes could be eliminated and the rates of the motor fuels taxes could be increased to protect Trust Fund program funding. Some would suggest that such a change would "under tax" heavy vehicle users at the expense of automobile and light truck users; however, reliance on the motor fuels taxes would have significant tax administration advantages. Because the gasoline, diesel fuel, and kerosene excise taxes are imposed at "narrow" points in the distribution chain of those fuels, there are significantly fewer persons directly involved in the calculation and remittance of the taxes.[814] Further, the items subject to tax are clearly identifiable; therefore, the current complex factual determinations and accompanying audit disputes presented by the heavy vehicle retail sales tax would be eliminated.

Alternatively, separate taxes imposed on heavier vehicles could be retained, but in a consolidated form requiring fewer factual determinations (to reduce taxpayer uncertainty and IRS audit disputes) and/or yielding greater revenue per tax (to promote more productive use of IRS resources). For example, the three current taxes could be consolidated into a single weight-distance tax imposed on heavy vehicles. Such a tax would be more responsive to the cost-benefit principle that tax liability should be based on highway damage done than are any of the current non-fuels excise taxes because it would be directly related to miles driven. A weight distance tax would raise a similar issue regarding number of taxpayers to that presented by the current heavy vehicle annual use tax: all truck owners would be taxpayers. However, vehicle dealers and manufacturers and tire manufacturers no longer would be taxpayers. Further, if structured based on gross vehicle weight and total miles driven, the tax would not present many of the factual uncertainties that arise with the current heavy vehicle retail sales tax.[815]

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[814] The special motor fuels excise tax is imposed at the retail level; however, revenues from that tax and users of those fuels represent only a small fraction of the total motor fuels revenues and users.

[815] An example of a simplified weight-distance tax structure would be a tax at a fixed rate per mile (based on gross vehicle weight) for each mile driven. Gross vehicle weight would be defined as the maximum certified weight of the vehicle (the same as under the current heavy

Finally, on a more limited basis, the retail sales tax and the tire tax could be consolidated. While such a modification would eliminate at least one set of current taxpayers, taxpayer uncertainty and complexity would not be reduced if the heavy vehicle retail sales tax were retained because of the inherent factual uncertainties over whether actions constitute repair or remanufacture. Imposed at a higher rate, the retail sales tax would increase the pressure on these factual determinations for taxpayers and the IRS. While not reducing complexity, the increased dollar significance of the issues could justify expenditure of more resources by taxpayers and the IRS on tax compliance.

Similarly, if the tire tax were retained at an increased rate, the current exemption for retread tires should be reviewed because a higher tax rate on new tires would increase current market distortions in favor of untaxed retreads. Elimination of the tire tax, on the other hand, would make new tires more competitive, and potentially achieve some safety benefits.

Recommendation 2: Clarify the definition of "highway vehicle"

The Joint Committee staff recommends that the definition of highway vehicle should be clarified to eliminate taxpayer uncertainty about the taxability of motor fuels and retail sales (if the retail sales tax is retained).

In most cases, motor fuels are taxable only when used in a highway vehicle. Similarly, the retail sales tax on heavy highway vehicles does not apply to off-road vehicles or to equipment that is unrelated to the transportation function of a highway vehicle. As described above, there is no uniform definition of what is a highway vehicle or of what equipment forms a component of such a vehicle. Parties currently are litigating the classification of many heavy vehicles (e.g., highway construction trucks and trucks equipped to dig holes for utility poles alongside highways) in an attempt to exempt the vehicles (and fuel used in them) from these taxes despite the fact that much of their working time is spent on highways. Additionally, in the case of equipment installed on a highway vehicle, the present-law determination can be so highly factual that the manner in which the equipment is attached to the vehicle chassis determines whether the equipment is subject to tax.

A uniform definition of highway vehicle that includes within that definition (1) all equipment customarily used on such a vehicle and (2) all vehicles permitted to drive on highways would eliminate the current taxpayer confusion and resulting IRS audit disputes.

Recommendation 3: Eliminate the installment payment option for the heavy vehicle annual use tax (if that tax is retained)

The Joint Committee staff recommends that the option to pay the heavy vehicle annual use tax in quarterly installments be eliminated (if that tax is retained).

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vehicle retail sales tax). Mileage data currently is reported to the Department of Transportation and is used to apportion State motor fuels tax liability among States so this information is readily available today as well.

The heavy vehicle annual use tax is imposed once per twelve-month period, July 1 through June 30. Taxpayers are allowed to pay the tax (maximum of $550 per truck) in quarterly installments. The "taxpayer" for this tax is the vehicle owner. This results in this tax having the greatest number of persons actually remitting tax of any Highway Trust Fund tax. Further, many taxpayers are liable only for relatively small amounts of tax.

Low compliance by smaller owner-operators and taxable vehicles having base registrations in Canada or Mexico led the Congress to require States to verify with the IRS that the tax has been paid before issuing annual State registrations.[816] In the case of taxpayers that elect quarterly installment payments, the IRS has no procedure for ensuring that installments subsequent to the first one actually are paid. Thus, it is possible for taxpayers to receive State registrations when only the first quarterly installment is paid. Similarly, it is possible for taxpayers repeatedly to pay the first quarterly installment and continue to receive State registrations because the IRS has no computerized system for checking past compliance when it issues certificates of payment for the current year. In the case of taxpayers owning only one or a few vehicles, it is not cost effective for the IRS to monitor and enforce compliance.

If this tax is retained, eliminating the quarterly installment option would eliminate current opportunities for tax evasion without requiring devotion of IRS resources to non-cost-effective enforcement activities.

Recommendation 4: Simplify motor fuels refund and tax collection procedures[817]

The Joint Committee staff recommends that several technical modifications should be made to the present Code provisions governing motor fuels refund procedures and tax collection:

(a) Timing and threshold requirements for claiming quarterly refunds should be consolidated to allow a single claim to be filed on an aggregate basis for all fuels.

(b) To the extent necessary to implement item (a), differing present-law exemptions should be conformed.

(c) Clarification of the party exclusively entitled to a refund should be provided in cases in which present law is unclear.

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[816] This requirement is in transportation provisions governing eligibility for Highway Trust Fund monies.

[817] If appropriate, these recommendations would apply to the aviation gasoline and jet fuels taxes as well. See the section on Airport and Airway Trust Fund Excise Taxes.

(d) The regulatory definition of "position holder" (the party liable for payment of the gasoline, diesel fuel, and kerosene taxes) should be modified to recognize certain two-party terminal exchange agreements between registered parties.

(e) The condition of registration requiring terminals to offer for sale both undyed and dyed diesel fuel and kerosene should be repealed.

Refund provisions

Under present law, numerous differing refund rules create complexity for consumers as well as for IRS personnel who have to review refund claims. The Joint Committee staff recommendation would conform eligibility for exemptions with regard to fuel uses that are nontaxable, the persons entitled to claim refunds, and the time in which processing must occur if no interest is to be paid to claimants. Thus, to the maximum extent consistent with ensuring tax compliance, a single claim could be filed for all amounts due a person with respect to tax included in the price of any taxable fuel used in non-taxable use. Further, because of the multiple circumstances giving rise to refunds, flexibility should be provided with regard to timing and amendment of refund claims to the extent that compliance objectives are not harmed.

Person entitled to claim refunds.--Because the motor fuels excise taxes are imposed at points in the chain of distribution away from the consumer, most exemptions are realized by means of refunds. In many cases, the rules governing these exemptions date from periods before the tax collection regimes of present law were enacted. Some refunds are payable to wholesale distributors and ultimate vendors while others may be claimed only by consumers. When refunds are available to intervening parties that also are excise-tax taxpayers, certain refunds may be claimed as credits against current excise tax liability while others may not.

Differing definitions of nontaxable use.--The uses on which tax is not imposed differ between the gasoline and diesel fuel and kerosene taxes. An example of such a difference is the off-highway use fuels tax exemption. For gasoline, only off-highway "business" use is exempt; for diesel fuel and kerosene, all off-highway use is exempt.[818]

Timing of refund claims.--Excise tax refunds for which actual refund claims are filed typically may be filed quarterly (if a minimum dollar threshold is met) and generally do not bear interest. In certain cases (e.g., ethanol blenders and ultimate vendors of kerosene in certain cases) persons may file claims as frequently as weekly and interest is payable on the claim if not paid within 20 days. Consumers that do not satisfy the minimum dollar thresholds must claim refunds as credits against income tax for the year in which the claim accrues. Finally, refunds

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[818] If these exemptions were conformed to include non-business off-highway use of gasoline, the modifications would have to include a different source of revenue for the wetlands sub-account of the Aquatic Resource Trust Fund's Sport Fish Restoration Account. That sub-account is funded with assumed receipts from gasoline taxes on non-business fuel for off-highway small engines (e.g., snow blowers and all-terrain vehicles).

payable to persons that actually remit tax to the IRS typically may be claimed as credits against semi-monthly excise tax deposits.

Recognition of certain two-party terminal exchange agreements

An additional part of this recommendation would modify the regulatory definition of "position holder" to recognize the provisions of two-party terminal exchange agreements among registered parties -- at least in the case of ethanol blending transactions. The IRS investigates persons as a condition of their owning non-tax-paid motor fuels or purchasing gasoline at reduced tax rates to be blended with ethanol. As of January 2001, there were 981 registered position holders and 1280 registered ethanol blenders. It is common industry practice for position holders to serve customers of other position holders, e.g., where Company A's terminal is more conveniently located for wholesale or retail customers of Company B.[819] In such cases, the motor fuel is removed in the name of the exchange agreement partner (Company B in the example) rather than that of the actual customer.

When ethanol is to be blended with gasoline being removed, the tax due on the gasoline is reduced. Failure to recognize these two-party terminal exchange agreements eliminates the availability of reduced-tax-rate removals of the gasoline to be blended with ethanol. Instead, the blender (actual customer) removing the gasoline has to pay the full gasoline tax and file a refund claim. Such refund claims may be filed weekly and must be paid by the IRS within 20 days or interest accrues on the unpaid claims.

Assuming that the IRS adequately monitors the trustworthiness of position holders as a condition of their registration, recognizing the two-party terminal exchange agreements should not reduce compliance.[820] However, such a move would reduce the number of refund claims that must be filed and processed as well as eliminating the "float" cost to blenders.

Eliminate terminal dyeing mandate

The requirement that, as a condition of registration, terminals offer dyed diesel fuel if they sell diesel fuel, and offer dyed kerosene if they sell kerosene was enacted in 1997 because of fears that dyed kerosene would be unavailable in certain markets. Most commonly sold heating oil is either diesel fuel, kerosene, or a mix of the two fuels. When the present tax rules were enacted, availability of dyed fuel was considered important to ensure that home heating oil customers would not have to purchase tax-paid fuel and subsequently file refund claims.

The initial July 1, 1998, effective date for this "terminal mandate" has been delayed two times. Currently, the terminal mandate is scheduled to become effective on January 1, 2002.

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[819] All gasoline and diesel fuel is "generic" until proprietary additives are injected on removal from a terminal facility to make the gasoline "branded" or unique to the company under whose name it is marketed at retail.

[820] Full implementation of a planned IRS computer tracking system for motor fuels currently under development should reduce, if not eliminate, potential tax evasion from implementation of this recommendation.

Since 1997, dyed fuel has become available in markets where there is a demand for the fuel. Because market forces are supplying the demand for dyed fuel, the only effect of the provision is potentially to require a terminal where there is no such demand to install dye injection equipment for diesel fuel and kerosene. The Joint Committee recommendation would eliminate this unnecessary private sector mandate.

B. Airport and Airway Trust Fund Excise Taxes

Present Law

In general

Four separate excise taxes are imposed to finance the Federal Airport and Airway Trust Fund program. The taxes are:

(1) ticket taxes imposed on commercial passenger transportation;

(2) a waybill tax imposed on freight transportation; and

(3) two separate fuels taxes imposed on gasoline and jet fuel used in commercial aviation and non-commercial aviation.[821]

The taxes are summarized below.

Non-fuels taxes on commercial transportation by air

Passenger transportation.--Most domestic air passenger transportation is subject to a two-part excise tax.[822] First, an *ad valorem* tax is imposed at the rate of 7.5 percent of the amount paid for the transportation. Second, a flight segment tax of $2.75 per segment is imposed. The flight segment tax is scheduled to increase to $3 (January 1, 2002-December 31, 2002). Beginning on January 1, 2003, and each January 1 thereafter, the flight segment tax will be indexed annually for inflation occurring after calendar year 2001. A flight segment is defined as transportation involving a single take-off and a single landing. For example, travel from New York to San Francisco, with an intermediate stop in Chicago, consists of two flight segments (without regard to whether the passenger changes aircraft in Chicago).

The flight segment component of the tax does not apply to segments to or from qualified "rural airports." A rural airport is defined as an airport that (1) in the second preceding calendar

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[821] The tax rates vary both by fuel and by the type of aviation in which the fuel is used. Commercial aviation is defined as transportation "for hire" of passengers or freight. All other air transportation is defined as non-commercial aviation. Because these definitions are based on whether an amount is paid for the transportation, it is possible for the same aircraft to be used at times in commercial aviation and at times in non-commercial aviation. This determination is made on a flight-by-flight basis. For example, a corporate-owned aircraft transporting employees of the corporation is engaged in non-commercial aviation (and subject only to fuels excise tax) while the same aircraft when transporting non-employees is engaged in commercial aviation (and subject to a mix of ticket and fuels taxes).

[822] Special rules apply to transportation between the 48 contiguous States and Alaska or Hawaii (or between Alaska and Hawaii) and to certain transportation between the United States and points within the "225-mile zone" of Canada or Mexico or within that zone (when the transportation is purchased within the United States).

year had fewer than 100,000 commercial passenger departures, and (2) either (a) is not located within 75 miles of another airport that had more than 100,000 such departures in that year, or (b) is eligible for payments under the Federal "essential air service" program.

International air passenger transportation is subject to a tax of $12.80 per arrival or departure in lieu of the taxes imposed on domestic air passenger transportation. The international air transportation tax rate is indexed for inflation annually, effective on each January 1. The definition of international transportation includes certain purely domestic transportation that is associated with an international journey. Under these rules, a passenger traveling on separate domestic segments integral to international travel is exempt from the domestic passenger taxes on those segments if the stopover time at any point within the United States does not exceed 12 hours.

Both of the preceding taxes apply only to transportation for which an amount is paid. Thus, free travel such that awarded in "frequent flyer" programs and non-revenue travel by airline industry employees is not subject to tax. However, amounts paid to air carriers (in cash or in kind) for the right to award free or reduced-fare transportation are treated as amounts paid for taxable air transportation, subject to the 7.5 percent *ad valorem* tax rate (but not the flight segment rate or the international air passenger tax). This tax applies to payments, whether made within the United States or elsewhere, if the rights to transportation for which the payments are made can be used in whole or in part for transportation that if purchased directly, would be subject to either the domestic or international air passenger taxes.

Passengers and transportation providers both are liable for payment of the air passenger excise taxes. Transportation providers are subject to special penalties if they do not separately disclose the amount of the passenger taxes on tickets and in advertising.

Freight transportation.--Domestic air cargo transportation is subject to a 6.25 percent *ad valorem* excise tax. The tax applies only to transportation that both begins and ends in the United States. The legislative history accompanying the creation of the Airport and Airway Trust Fund stated that separate charges for accessorial ground services were to be excluded from the tax base, but did not define accessorial ground services. The Code is silent on this issue. Historically, charges for services as ground pick up and delivery were provided by non-air carriers. Presently, however, integrated air carriers provide these and other ground services. It is understood that some transportation providers have attempted to exclude costs allocable to ground support services (e.g., terminal handling and sorting or aircraft loading and unloading) from the tax base. Further, carriers are reported to have attempted to use different corporate structures to reduce the amount of tax below that imposed on competitors that offer the same service.

Unlike the air passenger taxes, only shippers are liable for payment of the air freight tax. Transportation providers are subject to penalties if they fail to make reasonable efforts to collect the tax. There is no disclosure requirement for the air freight tax.

Aviation fuels taxes

Both aviation gasoline and jet fuel are subject to excise taxes. The tax rates are lower for commercial aviation (also subject to the non-fuels taxes described above) than for non-commercial aviation (subject only to fuels taxes). The fuels tax rates are show below.[823]

Aviation gasoline --

Commercial aviation	4.3 cents per gallon
Non-commercial aviation	19.3 cents per gallon

Jet fuel --

Commercial aviation	4.3 cents per gallon
Non-commercial aviation	21.8 cents per gallon

The aviation gasoline tax is collected in the same manner as the Highway Trust Fund excise tax on gasoline. That is, tax is imposed on all gasoline removed from a registered pipeline or barge terminal in a transaction where the fuel "breaks bulk." (Typically, fuel breaks bulk when it is loaded into a rail car or a truck from the pipeline or barge terminal.) The person liable for the tax is the owner of the fuel on the terminal records (the "position holder"). All parties owning non-tax-paid gasoline must be registered with the Internal Revenue Service. Exemptions generally are realized by refunds of tax previously paid.

The aviation jet fuel tax is imposed when the fuel is sold by a wholesale distributor. Most jet fuel is kerosene. The Highway Trust Fund provisions generally require payment of the highway excise tax on kerosene when the fuel is removed from a terminal unless the kerosene is dyed. A special exception to the dyeing requirement applies to aviation-grade kerosene. Aviation-grade kerosene may be removed from terminals without payment of the Highway Trust Fund excise taxes and without being dyed if it is removed for use as airplane fuel (1) by pipeline connected to an airport or (2) by or on behalf of a registered aviation fuel dealer.

Sources of Complexity

The Airport and Airway Trust Fund excise tax structure generally pre-dates creation of the Trust Fund in 1970. Notwithstanding a partial restructuring of the air passenger taxes in 1997, many provisions of the taxes reflect an industry organizational structure that no longer exists. For example, certain of these provisions, such as the ambiguous meaning of the air freight exclusion for "accessorial ground services" and the general provisions governing liability for tax, increase administrative complexity, both for taxpayers, tax collectors (air carriers), and for the IRS.

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[823] Aviation fuels are subject to an additional 0.1-cent-per-gallon tax to fund the Leaking Underground Storage Tank ("LUST") Trust Fund. The LUST tax is not discussed in this section; however, the tax is an add-on tax and could be affected by changes to the structure of the fuels taxes.

Recommendations for Simplification

Recommendation 1: Clarify liability provisions applicable to commercial air transportation taxes

The Joint Committee staff recommends that the Code should be amended to impose liability for the commercial air transportation taxes exclusively on transportation providers.

Historically, the commercial air transportation taxes were imposed on consumers rather than on transportation providers. In the case of the passenger transportation tax, transportation providers are jointly liable with consumers.[824] Transportation providers are required to collect and remit the air freight tax, but are liable only for penalties (as opposed to the tax itself) if they fail to make reasonable efforts to collect. The provisions imposing liability on consumers originated when fares charged by transportation providers were governmentally regulated. Imposing the taxes on consumers rather than transportation providers eliminated the taxes as an issue in ratemaking proceedings.

Neither passenger nor freight transportation charges are regulated by the government today. The taxes, like many other governmental and private charges or fees imposed on air transportation appropriately are viewed as transportation provider costs of doing business. Market conditions permitting, these amounts like other provider business costs can be recovered through fare adjustments. Amending the Code to impose the commercial air transportation taxes exclusively on transportation providers would more closely track the reality of current tax administration while eliminating the possibility of IRS action against consumers for nonpayment of tax. Such a change also would eliminate possible confusion as to transportation provider responsibility.

Recommendation 2: Eliminate Code penalties for failure to disclose commercial air passenger tax on tickets and in advertising

The Joint Committee staff recommends that the Code penalties for failure to disclose commercial air passenger tax on tickets and in advertising should be eliminated. Department of Transportation consumer protection disclosure requirements would remain in force for these as well as other currently regulated fees and charges.

The current requirement that the amount of tax be separately stated on air passenger tickets and in all transportation provider advertising is a consumer protection measure which is unrelated to revenue objectives of the tax. Consumer disclosure requirements for the many other governmental and private charges imposed on air passengers are established by Department of Transportation ("DOT") regulations.

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[824] The current passenger transportation provisions were enacted in 1997. Before that time, the passenger tax provisions were identical to those that continue to apply to the air freight tax.

In addition to requiring dedication of the IRS resources to a non-revenue activity, the current Code penalties add unnecessary complexity for transportation providers. First, providers must ensure that their advertising and tickets comply with two different sets of requirements -- the Code provisions and the DOT regulations. Further, because a portion of the current domestic air passenger tax is calculated on a per-segment basis, the advertising disclosure provisions can become highly complex for carriers and consumers. Travel between city pairs may at times be non-stop; alternatively, the same travel could involve an intermediate landing and take-off (with possible change of aircraft) en route. The amount of tax differs depending on which of these routings is chosen even though the actual fare may be the same. Transportation providers do not know the ultimate routing for an individual passenger until the transportation is purchased (e.g., a reservation is made). Thus, advertising must indicate that actual tax may vary depending on the route taken.

Eliminating the Code penalties for failure to disclose the air passenger tax would simplify the rules governing transportation providers without reducing consumer protection because the DOT regulations would continue in force.

Recommendation 3: <u>Clarify the appropriate base for the commercial air freight tax</u>

The Joint Committee staff recommends that a uniform, statutory definition of the tax base for the commercial air freight tax should be enacted with any exclusion for accessorial ground services being specifically defined.

Unlike the commercial air passenger tax, present law does not require that the air freight tax be separately stated on waybills. This is true notwithstanding that shippers, not transportation providers, are liable for the tax. Thus, in practice although not in form, the tax currently is imposed on transportation providers rather than on shippers. The exclusion for accessorial ground services that originated in legislative history accompanying creation of the Airport and Airway Trust Fund has led to numerous disputes as to the appropriate base to which the *ad valorem* tax rate should be applied. Identical transportation provided at the same cost by different providers currently may be subject to different amounts of tax depending on the way in which the transportation provider reports the tax.

It is understood that some providers take the position on their tax returns that costs of numerous activities in which they engage as part of the seamless transportation of freight (as well as general corporate overhead allocable to those activities) are excluded from the base. Examples of such activities include terminal sorting, movement of freight between terminal facilities and aircraft, loading and unloading of aircraft and traditional accessorial services such as downtown pickup and delivery to the airport. The IRS frequently challenges such allocations on audit.

The current state of the law provides significant financial incentives to service providers that succeed in excluding as many costs as possible from the tax base. The tax is hidden from consumers and competition forces relatively uniform shipping rates across transportation providers; therefore, reducing the tax directly increases after-tax profit.

Providing a clear statutory definition of the appropriate tax base would simplify administration of the law by eliminating IRS-transportation provider disputes. Further, such a definition would provide a "level playing field" for all transportation providers by eliminating the tax as a competitive factor. Finally, such a definition would be consistent with the user tax policy underlying these Trust Fund taxes because shipments would bear the same tax (assuming competition forced rates to be the same) on identical transportation regardless of who was the transportation provider.

Recommendation 4: Review classification of certain non-scheduled passenger service as commercial transportation

The Joint Committee staff recommends that the current definition of commercial air transportation, as applied to non-scheduled transportation, should be reviewed and, where appropriate, conformed to Federal Aviation Administration aircraft safety and pilot licensing regulations.

As described above, commercial air transportation is defined as transportation "for hire." That is, transportation for which an amount is charged is subject to the passenger ticket and freight waybill taxes and the reduced fuels tax rates without regard to whether the transportation is scheduled service. Further, except for non-scheduled service on certain small aircraft (generally not exceeding 6,000 pounds certificated weight), these taxes apply without regard to the size of the aircraft. An additional exception applies to transportation provided to employees of corporations under common control with the transportation provider. All other air transportation ("noncommercial aviation") is subject to higher fuels tax rates in lieu of the ticket and waybill taxes. The determination of whether transportation is "for hire" is made on a flight-by-flight basis depending on the actual financial arrangements for the flight.

All aircraft are subject to safety regulation by the Federal Aviation Administration ("FAA"), and pilots must be licensed by the FAA. The FAA certification rules differ for pilots not engaged in providing scheduled service and for pilots of aircraft typically used in providing scheduled air transportation. The present-law definitions require transportation providers that are not engaged in providing scheduled air service to maintain records of each flight and the financial terms surrounding it to ensure that the appropriate tax is paid on that transportation. Better coordination of the Federal tax definitions and the FAA safety and pilot certification rules would eliminate the need for this recordkeeping in cases where the aircraft was operated exclusively under the rules governing nonscheduled service.

Recommendation 5: Simplify fuels tax refund and tax collection procedures

The Joint Committee staff recommends that the present-law Code provisions governing aviation fuel refund and tax collection procedures should be coordinated with comparable rules for Highway Trust Fund excise taxes to the extent possible.

The aviation gasoline excise tax is imposed under the same provisions that impose the excise taxes on highway gasoline, diesel fuel, and kerosene. The aviation jet fuel excise tax is imposed at the wholesale level; however, the most common jet fuel is high quality kerosene, a

product that is subject to the Highway Trust Fund excise tax system when it is not removed for use in an airplane. Because the distribution system for these products involves many of the same parties regardless of whether the fuel is used in a highway or an aviation use, the tax collection and refund procedures should be coordinated wherever possible. The staff recommendation that Highway Trust Fund excise tax refund claim rules be consolidated would apply to aviation fuels taxes as well.

Additionally, the staff recommendation includes proposed changes to aviation-fuels-specific refunds such as the present rules governing refunds of fuels taxes to certain aerial applicators (crop dusters). For example, in the case of fuel consumed by aerial applicators spraying farm crops, the current requirement that farmers assign claims to the aircraft operators would be eliminated and allocation rules limiting the refunds to tax on fuel calculated to have been used while actually flying over farmland would be repealed.

C. Harbor Maintenance Trust Fund Excise Tax and Tax on Passenger Transportation by Water

Present Law

The Code contains provisions imposing a 0.125-percent excise tax on the value of most commercial cargo loaded or unloaded at U.S. ports (other than ports included in the Inland Waterway Trust Fund system). The tax also applies to amounts paid for passenger transportation using these U.S. ports. Exemptions are provided for (1) cargo donated for overseas use, (2) cargo shipped between the U.S. mainland and Alaska (except for crude oil), Hawaii, and/or U.S. possessions and (3) cargo shipped between Alaska, Hawaii, and/or U.S. possessions. Receipts from this tax are deposited in the Harbor Maintenance Trust Fund.

The U.S. Supreme Court has held that the harbor maintenance excise tax is unconstitutional as applied to exported cargo because it violates the "Export Clause" of the U.S. Constitution. The tax remains in effect for imported cargo. Imposition of the tax on passenger transportation with respect to passengers on cruises that originate, stop, or terminate, at U.S. ports has been upheld.

A separate, $3 per passenger General Fund excise tax is imposed on international passenger transportation by water. This tax applies to travel on a commercial passenger vessel by passengers embarking or disembarking in the United States if the travel extends over one or more nights. The tax also is imposed on commercial vessel transportation of passengers engaged in gambling aboard the vessel beyond the territorial waters of the United States (i.e., more than 3 miles from shore). The tax does not apply to a voyage on any vessel owned or operated by the United States or a State or any agency or political subdivision, nor does it apply to a voyage of fewer than 12 hours between two U.S. ports. A passenger vessel is any vessel having berth or stateroom accommodations for more than 16 passengers.

Sources of Complexity

The current Harbor Maintenance tax provisions are unenforceable as applied to exported cargo. Applying the tax only to imported cargo raises issues under international trade agreements to which the United States is a party and that restrict imposition of taxes on imports that are not imposed on domestically produced goods. Finally, the separate present-law General Fund tax on certain transportation by water in many respects duplicates the remaining portion of the Harbor Maintenance Trust Fund excise tax.

Recommendation for Simplification

The Joint Committee staff recommends that the Harbor Maintenance Trust Fund excise tax and the General Fund tax on passenger transportation by water should be eliminated.

Elimination of the current Harbor Maintenance Trust Fund excise tax provisions related to exported cargo will conform the tax law to the U.S. Supreme Court decision. Eliminating the tax as applied to imports further will eliminate questions with regard to U.S. obligations under its

international trade agreements. Eliminating the tax is not expected to have an adverse effect on harbor dredging operations financed through the Harbor Maintenance Trust Fund because, at the present time, the Trust Fund has (and is projected to continue to have) a large balance. Further, only small amounts currently are being appropriated from the Trust Fund. General Fund appropriations are available to cover any shortfalls in Trust Fund revenues that might develop.

There is no tax policy reason for imposing a General Fund excise tax on passenger water transportation. In addition, there is no policy reason for retaining the portion of the Harbor Maintenance tax that is imposed on passenger transportation. In both cases, the taxes produce small amounts of revenue relative to the overall Federal budget while imposing administrative burdens both on taxpayers and on the Government. However, if a decision is made to retain a passenger tax, the two present excise taxes on passengers traveling by water in part are duplicative. Consolidating these taxes would provide simplification.

D. Aquatic Resources Trust Fund Excise Taxes

Present Law

The Aquatic Resources Trust Fund is comprised of two accounts. First, the Boat Safety Account is funded by a portion of the receipts from the excise tax imposed on motorboat gasoline and special motor fuels.[825] Transfers to the Boat Safety Account are limited to amounts not exceeding $70 million per year. In addition, these transfers are subject to an overall annual limit equal to an amount that will not cause the Account to have an unobligated balance in excess of $70 million.

Second, the Sport Fish Restoration Account receives the balance of the motorboat gasoline and special motor fuels receipts that are transferred to the Trust Fund. This Account also is funded with receipts from an *ad valorem* manufacturer's excise tax on sport fishing equipment. The general *ad valorem* rate is 10 percent; the rate is reduced to 3 percent for electric outboard motors and certain fish finders. Examples of the items of sport fishing equipment subject to the 10-percent rate include fishing rods and poles, fishing reels, fly fishing lines and certain other fishing lines, fishing spears, spear guns, spear tips, items of terminal tackle, tackle boxes and containers designed to hold fish, fishing vests, landing nets, and portable bait containers.

A separate sub-account in the Sport Fish Restoration Account, the Wetlands Sub-Account, is funded with a portion of the general gasoline tax equal to the tax on gasoline used in nonbusiness off-highway use of small-engine outdoor power equipment.

Expenditures from the Boat Safety Account are subject to annual appropriations. Expenditures from the Sport Fish Restoration Account (including the Wetlands Sub-Account) are made pursuant to a permanent appropriation, enacted in 1951.

Sources of Complexity

The *ad valorem* excise tax on sport fishing equipment requires highly factual determinations as to the articles subject to tax. In several instances, substantially identical items are marketed to consumers, but the tax is unevenly applied. For example, general utility boxes or storage boxes serve much the same function as, and compete for sales in the market for use as, tackle boxes; however, only boxes manufactured as "tackle boxes" are subject to the tax.

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[825] A total tax rate of 18.4 cents per gallon is imposed on gasoline and special motor fuels used in motorboats. Of this rate, 0.1 cent per gallon is dedicated to the Leaking Underground Storage Tank Trust Fund. Of the remaining 18.3 cents per gallon, 11.5 cents per gallon (through October 1, 2001), is transferred to the Aquatic Resources Trust Fund. These transfers are scheduled to increase to 13 cents per gallon (October 1, 2001-September 30, 2003) and 13.5 cents per gallon (October 1, 2003-September 30, 2005), after which time no transfers will occur. Tax collected in excess of these amounts is retained in the General Fund of the Treasury. The motorboat gasoline and special motor fuels taxes are collected under the same rules as apply to the Highway Trust Fund excise taxes on those fuels.

Recommendations for Simplification

The Joint Committee staff recommends that the sport fishing equipment excise tax should be eliminated.

The sport fishing equipment excise tax serves no tax policy objective. Rather, like many Trust Fund excise taxes, the underlying policy is that of linking tax burdens with beneficiaries of specific Federal programs to a greater extent than General Fund financing would provide. However, in the case of the sport fishing equipment tax, present law's attempt to include as many items of fishing equipment as possible rather than focusing on a limited number of items producing higher tax revenues per item leads to unnecessary administrative complexity for taxpayers and for the Government. Further, because numerous taxable items compete in the market with other items having a similar function, but not specifically designed for fishing use, the tax creates competitive problems for manufacturers of these items.

The Sport Fish Restoration Account spending program can be protected, at least in part, by dedicating additional receipts from the motorboat gasoline and special motor fuels to the program. Such an additional dedication would have the additional benefit of providing administrative simplification for the Treasury Department officials responsible for Trust Fund accounting and management. To the extent that additional spending is desired, General Fund appropriations are available.

Funding for the Wetlands Sub-Account of the Sport Fish Account results from inconsistent exemptions for off-highway use between the taxes on gasoline and diesel fuel. This tax is discussed in the Joint Committee staff's recommendation regarding simplification of the Highway Trust Fund motor fuels taxes.

E. Federal Aid to Wildlife Fund and Non-Regular Firearms Excise Taxes

Present Law

Taxable articles

The Federal Aid to Wildlife Fund (the "Wildlife Fund") program is financed with receipts from *ad valorem* excise taxes imposed on the sale by the manufacturer of a taxable item or on its importation. The Wildlife Fund supports grants for State wildlife programs. Expenditures from the Fund are made pursuant to a permanent 1951 appropriation.

Item	Tax Rate
Bows having a draw weight of 10 lbs. or more	11 percent of mfr.'s price
Arrow components (shafts, points, nocks, and vanes) for arrows 18" or more in length (or suitable for use with a taxable bow, if shorter)	12.4 percent of mfr.'s price
Pistols and revolvers	10 percent of mfr.'s price
Firearms other than pistols and revolvers	11 percent of mfr.'s price
Shells and cartridges	11 percent of mfr.'s price

Separate General Fund excise taxes are imposed on the making or transfer of "non-regular" firearms or explosive devices. The term "non-regular" firearm includes machine guns, explosive devices such as bombs, grenades, small rockets, and mines, sawed-off shotguns or rifles, silencers, and certain concealable weapons.

Non-regular firearms occupational taxes

In addition to excise taxes on the manufacture and transfer of non-regular firearms, present law imposes annual occupational excise taxes on importers and manufacturers ($1,000 per year per premise) of and on dealers ($200 per transfer) of these weapons.[826] These taxes are administered by the Bureau of Alcohol, Tobacco, and Firearms (the "BATF") in conjunction with non-tax Federal firearms laws.

Sources of Complexity

There is no tax policy reason for imposing excise taxes on selected products. Rather, the policy underlying these taxes reflects a goal of Federal Trust Funds: closer linkage between taxpayers and programs from which they benefit than is possible with General Fund-financed programs. From a Federal budgetary standpoint, the Wildlife Fund taxes produce small amounts of revenue.

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[826] The taxable period is July 1 through June 30.

The Wildlife Fund excise taxes not only impose administrative burdens on taxpayers and the Federal Government for relatively small amounts of revenue, but they also require more complex calculations than many larger-revenue producing Federal excise taxes because of their *ad valorem* rate. The fixed-amount-per-unit tax rates seen with most other Federal excise taxes require only a volume calculation. The *ad valorem* rate of the Wildlife Fund taxes requires both volume and sales price calculations. Additionally, when sales occur between related parties, constructive sales price rules must be applied to ensure that tax liability is not understated by below-market prices.

Finally, industry representatives have raised concerns about unfair competition with imported arrows as a result of the tax on arrow components. Because the tax is imposed the sale or importation of components rather than completed arrows, completed arrows imported into the United States bear no tax. Attempts to impose such a tax on imported arrows raises questions under the "national treatment" and "non-tariff barrier" restriction provisions of U.S. international trade agreements.

Recommendation for Simplification

The Joint Committee staff recommends that these small revenue taxes should be eliminated. Alternatively, if the taxes are retained, consideration should be given to (1) consolidating certain of the taxes and (2) changing the tax rates to fixed-amount-per-unit rates in lieu of the present *ad valorem* rate structure.

Taxpayer and IRS resources dedicated to collection of the Wildlife Fund excise taxes are high relative to the revenues produced. Tax law simplification would be furthered if the dedicated taxes were eliminated and the Wildlife Fund program financed with general revenue appropriations.

Absent complete elimination of the taxes accompanied by General Fund financing for the programs, the tax law would be simplified if the present taxes on bows and arrow components were consolidated to tax only bows or arrows. In such a case, a fixed-amount-per-unit rate additionally should be considered to eliminate the need to determine sales prices of all taxable items.

Further, if a tax on arrows or components is retained, certain alleged international trade effects should be addressed. The incidence of this tax was moved from completed arrows to components in 1997 because there were perceived to be fewer component manufacturers than there are arrow manufacturers. Thus, currently, there is no tax on domestically manufactured arrows although the sales price of the arrows does bear the manufacturer's tax on shafts, points, nocks, and veins used in their production. Because there is no tax directly imposed on domestic arrows, taxing imported arrows raises trade law questions. Similarly, because the sale of the taxable arrow components occurs outside the United States, no tax is imposed on the components when they enter the United States as part of a foreign-manufactured arrow. This creates an incentive to assemble arrows in other countries (e.g., Canada) and import them: absence of the 10-percent components tax as a cost of production provides a price advantage.

F. Black Lung Trust Fund Excise Tax

Present Law

A $1.10 per ton excise tax is imposed on coal mined in the United States from underground mines. The rate is 55 cents per ton for coal mined in surface mining operations. The tax cannot exceed 4.4 percent of the coal's selling price. No tax is imposed on lignite.

Gross receipts from the excise tax are dedicated to the Black Lung Trust Fund to finance benefits under the Federal Black Lung Benefits Act. Currently, the Black Lung Trust Fund is in a deficit position because previous spending was financed with interest-bearing advances from the General Fund.

The coal excise tax rates are scheduled to decline to 50 cents per ton for underground-mined coal and 25 cents per ton for surface-mined coal on January 1, 2014, or any earlier January 1 on which there is no balance of repayable advances from the Black Lung Trust Fund to the General Fund.

In *Ranger Fuel Corp. v. U.S.*,[827] the U.S. District Court for the Eastern District of Virginia declared the coal excise tax unconstitutional as applied to coal mined for export. This decision was not appealed by the Government because the issue was identical to that decided by the U.S. Supreme Court in *U.S. v. U.S. Shoe Corp.*[828]

Source of Complexity

Notwithstanding the decision in the *Ranger Fuel* case, the Code still provides for imposition of a tax on coal mined for export. However, no tax is being collected.

Recommendation for Simplification

The Joint Committee staff recommends that the Code provisions on exported coal should be conformed to eliminate the provisions imposing tax on coal mined for export.

Code provisions imposing a tax that would be unconstitutional, if collected, are a source of confusion for taxpayers. The Code should reflect the current state of the law.

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[827] 33 F. Supp. 2d (E.D. Va. 1998).

[828] 522 U.S. 360 (1998).

G. Communications Excise Tax

Present Law

A three percent Federal excise tax is imposed on amounts paid for communications services.[829] Communications services are defined as "local telephone service," "toll telephone service" and "teletypewriter exchange service."[830]

Local telephone service is the provision of voice quality telephone access to a local telephone system that provides access to substantially all persons having telephone stations constituting a part of the system. Toll telephone service is defined as telephonic ("voice") quality communication for which (1) there is a toll charge that varies with the distance and elapsed transmission time of each individual call and payment for which occurs in the United States, or (2) a service (such as WATS service) which, for a flat periodic charge, entitles the subscriber to an unlimited number of telephone calls to or from an area outside the subscriber's local system area.

The person paying for the service (i.e., the consumer) is liable for payment of the tax. Service providers are required to collect the tax; however, if a consumer refuses to pay, the service provider is not liable for the tax and is not subject to penalty for failure to collect if reasonable efforts to collect have been made. Instead, the service provider must report the delinquent consumer's name and address to the Treasury Department, which then must attempt to collect the tax.

Special rules, enacted in 1997, apply to the sale of "prepaid telephone cards." These cards are subject to tax when they are sold by a telecommunications carrier to a non-carrier (e.g., a retail store) rather than when communications services are provided to the consumer. The base to which the tax is applied is the face amount of the card. The non-carrier is responsible for paying the tax to the carrier.

Present law exempts numerous types of service from one or both of the tax on local service or toll service. Examples of these exemptions are private communications services (from the tax on local service); news and other public press organizations (from the tax on toll service); use by certain charitable organizations and States and local governments; and radio and broadcast networks (from the tax on toll service).

Sources of Complexity

The present telephone excise tax provisions were enacted before development of most modern technology -- the growth of computers and new electronic means of communication (e.g., the Internet). Many services that traditionally were provided using equipment of the service providers now are provided using computers and switching equipment owned by the

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[829] Sec. 4251.

[830] Teletypewriter exchange service refers to a data system that is understood to be no longer in use.

consumer. In such a case, only a portion of the service is subject to tax -- the portion for which "an amount is paid" as opposed to the service provided using consumer-owned equipment. Thus, it is possible for larger businesses to purchase telephone equipment (including private lines or microwave relays in some cases) and thereby reduce significantly their tax liability relative to the tax paid for similar services by smaller businesses and individuals who must contract with third parties for identical services.

Additionally, the growth of the Internet has blurred lines between "data" and "voice" quality service. This blurring of lines between taxable and nontaxable services leads to confusion for service providers who have to decide what services are taxable. Competitive issues arise when service providers treat charges for similar services differently.

The complexity arising from the present tax further is compounded by the pace at which the communications sector is changing. For example, elimination of government regulation of monopoly service providers has led to significant increases in the number of businesses providing what traditionally were seen as utility services.

Finally, some consumers regularly refuse to pay the telephone tax billed to them as a war protest. (The tax historically was imposed and re-imposed to finance various wartime needs.) The relatively small amount of tax involved per protestor makes it uneconomic for the IRS to use its limited resources to pursue collection.

Recommendation for Simplification

The Joint Committee staff recommends that the present Federal communications excise tax should be eliminated.

If the tax is not eliminated, the staff recommends that --

(1) liability for the tax be shifted to telecommunications service providers so that unpaid tax would be collected as part of regular bad debt collections;

(2) the present Code provisions be updated to reflect current technology, and

(3) broad grants of regulatory authority be provided to the Treasury Department to allow it continually to update the tax base to reflect future technological changes.

Tax policy is neutral as to what goods and services are taxed. Thus, there is no compelling policy argument for imposing taxes on communications services. However, ensuring that whatever excise taxes are imposed are applied evenly across intended taxpayer populations and do not impose undue administrative burdens on taxpayers and tax collectors is an important consideration when a tax is imposed.

The present communications excise tax provisions largely date to the early 1940's. Because of technological changes since their enactment, the provisions are so obsolete that, in

many cases, they either fail to capture many services that traditionally were seen as within the scope of the communications tax or they capture those services unevenly. The speed at which computer technology is changing makes it difficult to write tax provisions today that will accurately reflect the state of the industry even within a relatively few years. These considerations give rise to significant uncertainty in the administration of the present communications excise tax, as well as significant doubts that statutory modifications could be enacted that would make the tax administratively viable in the longer term.

If a communications excise tax is retained notwithstanding these concerns, modifications should be enacted, including significantly broader Treasury Department regulatory authority to allow the tax to be adapted to future technological change. Additionally, as the communications industry increasingly is freed of government regulation, the rationale for imposing the tax on consumers (rather than on service providers) is eliminated. (Because the tax was historically imposed on consumers, and with service providers acting only as collectors, the tax was not an issue on rate regulation proceedings.) Even on the limited services (e.g., local service) that still are subject to government regulation, imposing the tax on service providers should not be an undue burden. The commonplace, and much higher, taxes and fees imposed by States and local governments today on communications services ensure that their regulatory bodies are fully cognizant of any need to pass such charges on to consumers.

H. Ozone-Depleting Chemicals Excise Tax

Present Law

An excise tax is imposed on ozone-depleting chemicals sold or used in the United States (sec. 4681). The tax is determined by multiplying a base tax amount (which changes annually) by the specific chemical's "ozone-depleting factor." The base amount for calendar year 2001 is $8.05 per pound. The base amount is scheduled to increase by $0.45 per pound each year. Twenty ozone-depleting chemicals are subject to the tax.

The excise tax also applies to imported products that were manufactured using chemicals that would have been taxable had the manufacture occurred in the United States (e.g., imported electronic products the manufacture of which involves chemical "washes"). In the case of imported products, the tax equals the tax that would have been imposed on the chemicals used in the manufacture had that activity occurred in the United States unless the taxpayer demonstrates that a different process resulting in less tax was used.

Subject to limited exceptions, the Montreal Protocol and the Clean Air Act ban the use of the same chemicals that are subject to the tax.

Sources of Complexity

Because of the Montreal Protocol and Clean Air Act provisions on ozone-depleting chemicals, the tax is in substance being phased out. Additionally, administration of the tax on imported substances requires complicated determinations as to what tax would have been imposed had the imported product been manufactured in the United States.

Recommendation for Simplification

The Joint Committee staff recommends that the ozone-depleting chemicals excise tax should be eliminated.

The principal policy reason for imposing an excise tax on ozone-depleting chemicals is environmental, rather than tax. The Montreal Protocol and Clean Air Act in substance have eliminated the environmental rationale for this tax by phasing out use of the chemicals in the signatory nations. In addition, the tax on imported products manufactured using ozone-depleting chemicals is difficult to administer because it requires a determination regarding manufacturing processes used in foreign countries. This complexity also may support elimination of the tax.

I. Alcohol Excise Taxes

Present Law

Taxes on alcoholic beverages

Separate excise taxes are imposed on distilled spirits, wine, and beer. Both the tax rates and the volumetric measures on which the taxes are imposed differ depending on the type of beverage.

The tax rates are shown below.

Beverage	Tax Rate
Distilled spirits (sec. 5001)	$13.50 per proof gallon[1]
Wine (sec. 5042):[2]	
Still wines --	
No more than 14 percent alcohol	$1.07 per wine gallon[3]
More than 14 percent but not more than 21 percent	$1.57 per wine gallon
More than 21 percent but not more than 24 percent alcohol	$3.15 per wine gallon
More than 24 percent alcohol	Taxed at the distilled spirits rate
Hard apple cider	$0.226 per wine gallon
Sparkling wines --	
Champagne and other naturally sparkling wines	$3.40 per wine gallon
Artificially carbonated wines	$3.30 per wine gallon
Beer (sec. 5051)	$18.00 per barrel (31 gallons) generally[4]

1. A proof gallon is a U.S. liquid gallon consisting of 50 percent alcohol.
2. Domestic wineries having aggregate annual production not exceeding 250,000 gallons are entitled to a tax credit equal to 90 cents per gallon (the amount of the wine tax increase enacted in 1990) on the first 100,000 gallons of wine (other than champagne and other sparkling wines) removed in a calendar year. The credit is phased out by 1 percent for each 1,000 gallons produced in excess of 150,000 gallons. The credit reduces the effective tax rate on these wines from $1.07 per wine gallon to $0.17 per wine gallon (the rate that applied before 1990 when the credit was enacted). The credit has been the subject of a challenge under the General Agreement on Trade and Tariffs ("GATT").
Hard apple cider production from "small" domestic wineries, defined as above, receives a credit of 5.6 cents per gallon of cider produced. Production of hard apple cider and other wines eligible for the small winery production credit is aggregated in applying the per-winery volume limits of the credit. (This credit rate produces the same effective tax rate on hard apple cider produced by small wineries as is imposed on other still wines having an alcohol content of more than 14 percent.)
3. A wine gallon is a U.S. liquid gallon, without regard to alcoholic content.
4. The $18 per barrel rate equals approximately 58 cents per gallon. The tax rate is $7 per barrel (approximately 22.6 cents per gallon) on the first 60,000 barrels of beer removed each year by domestic brewers producing less than 2 million barrels of beer during the calendar year. This reduced rate provision was the subject of a GATT challenge.

Liability for these taxes arises when the beverage is produced or imported. Under the current bonded production facility system, payment generally is due on removal of the domestically produced beverages from the facility where produced. Foreign alcoholic beverages that are bottled before importation are taxed on removal from the first U.S. warehouse into which they are entered. Foreign alcoholic beverages that are imported in bulk and transferred to a domestic facility for bottling are taxed as if domestically produced.

Present law includes a tax credit (sec. 5010) that reduces the effective tax rate on alcohol in a distilled spirits product that is derived from fruit to the lower, wine tax rates. There is no requirement that the "wine" be produced from any particular type of fruit or that wine coloring or that wine flavoring be evident in the distilled spirits product. For example, it is understood that some of the "wine" with respect to which the credit currently is claimed is produced from table grapes, oranges, and grapefruits and that, in some cases, the wine is filtered to eliminate both color and flavoring. There is no limit other than Federal alcoholic beverage product labeling rules on the amount of a distilled spirits product that may be comprised of this fruit-derived alcohol. Additionally, present law includes a separate tax credit that eliminates the distilled spirits tax on certain "flavorings" added to distilled spirits products.

Alcohol occupational taxes

The Bureau of Alcohol, Tobacco, and Firearms (the "BATF") regulates alcoholic beverage production, importation, and distribution in the United States. This regulation includes Federal control over production facilities, operation of production facilities, and product packaging and labeling. Some of the statutory provisions underlying this regulatory system are contained in the Code. In other cases, regulation is coordinated between the Code and separate, non-tax statutes.

As part of this Federal regulatory regime, annual occupational taxes are imposed on each premise of alcoholic beverage producers, wholesale distributors, and retailers. Additionally, occupational taxes are imposed on proprietors of facilities using alcohol for nonbeverage or industrial uses. These taxes are payable annually, for the twelve-month period from July 1 through June 30. The tax rates are shown below.

Tax	Tax Rate
Producers (secs. 5081 and 5091):	$1,000 per year[831]
Wholesale distributors (sec. 5111)	$500 per year
Retailers (sec. 5121)	$250 per year
Distilled spirits nonbeverage use facilities (sec. 5131)	$500 per year
Distilled spirits industrial use facilities (sec. 5276)	$250 per year

[831] The tax rate is $500 per year per premise for businesses with gross receipts of less than $500,000 in the preceding taxable year. Certain small alcohol fuel (e.g., ethanol) producers are exempt from the tax. Secs. 5081(c) and 5181(c)(4).

Cover over of rum tax revenues to Puerto Rico and the U.S. Virgin Islands

An amount equal to $13.25 per proof gallon of the excise tax imposed on rum imported or brought into the United States is covered over (paid) to Puerto Rico and the U.S. Virgin Islands. The $13.25 rate is temporary. After December 31, 2001, the cover over rate is scheduled to return to its permanent level of $10.50 per proof gallon.

The payment is made with respect to all rum entering the United States on which tax is paid, not just rum originating in the two possessions. Each possession receives a payment equal to the applicable tax rate imposed on rum imported or brought in from that possession as well as an allocable share of applicable tax rate imposed on rum from other countries.

The timing of payments to the two possessions differ, both between possessions and between tax on rum from the respective possession and rum from other countries. Before enactment of Public Law 106-200 in 2000, there was a statutory conflict between the Code and provisions of the Virgin Islands Organic Act regarding timing of payments and the agency with authority to make the payments. Public Law 106-200 clarified that the rules of the Code govern over those of the Organic Act. However, the timing of payments still differs. For example, all payments to Puerto Rico are made monthly in arrears; payments to the Virgin Islands are made in advance (based on estimates) in the case of rum imported from that possession and monthly in arrears in the case of rum imported from other countries. The BATF administers all payments to Puerto Rico and payments to the Virgin Islands for rum from other countries; the Interior Department administers payments to the Virgin Islands from rum imported from that possession (pursuant to agreement with the BATF).

Sources of Complexity

The principal source of complexity in present law comes from reliance on three separate taxes, each having its own rate structure, for the three types of taxable alcoholic beverages. Not only has the separate tax structure led to different regulatory rules for distilled spirits, wine, and beer production facilities, it creates incentives to recharacterize the source of alcohol to benefit from reduced tax rates.

An additional source of complexity is the presence of annual occupational taxes, imposed at various rates. These taxes are linked to recordkeeping and other requirements important to the overall Federal regulation of alcohol, but serve no tax policy purpose.

Recommendations for Simplification

Recommendation 1: Consolidate alcoholic beverage tax and regulatory regimes

The Joint Committee staff recommends that the three separate excise taxes currently imposed on alcoholic beverages should be consolidated into a single tax, with the rate being based on alcohol content of the beverage. The Code provisions governing operation of alcohol production and distribution facilities similarly should be consolidated to the extent consistent with overall operation of Federal alcohol regulation laws.

Alcoholic beverage taxes have been imposed for revenue purposes since the Revolutionary War period. The taxes further have a social policy goal of reducing alcohol consumption. The product being taxed is "alcohol;" thus, there is no tax policy reason for taxing the product at different rates based on its origin. Further, some studies have found that consumption patterns are based on alcohol content as well. Consolidating the three alcoholic beverage taxes into a single rate structure would simplify administration of the tax law while furthering social policy objectives of the excise tax.

Secondary effects of consolidating the taxes into a single tax based on alcohol content also would further simplification. Elimination of the current distilled spirits tax credit for alcohol derived from fruit (sec. 5010) and the small domestic winery credit and small domestic brewer reduced rate benefits would be conforming amendments to adoption of a single alcoholic beverage tax rate. (See, Recommendation 2, below.)

Recommendation 2: <u>Repeal special tax rate provisions (if separate rate structure is retained)</u>

The Joint Committee staff recommends that, if the current three-tax structure is retained, the current provisions providing reduced rates for production from certain small facilities and for distilled spirits beverages containing alcohol derived from fruit should be eliminated.

The current provisions taxing wine and beer from smaller domestic production facilities at reduced rates have been found to violate U.S. trade obligations under the GATT. The provisions result in identical beverages bearing different tax rates, depending on where and when they are produced. Additionally, the provisions require special recordkeeping of annual production levels to determine the tax applicable to a given gallon of product. In the case of wine distributed through the bonded warehouse system under which tax liability is transferred with the beverage to marketing organizations for small wineries, this recordkeeping burden is greater because the marketing organization must monitor the production of individual members of the organization. The potential loss of the lower effective tax rates can, at the margin, lead producers to reduce production below the optimum market levels. Finally, the provisions require dedication of additional Government resources to ensure compliance.

The tax credit for alcohol in distilled spirits beverages that is derived from fruit encourages substitution of this alcohol for regular distilled spirits, solely to obtain a tax benefit. This substitution in turn interacts with distilled spirits labeling laws, requiring new product delineations. Often, these delineations are unclear to consumers -- who fail to note the difference between a regular distilled spirits product and a similar distilled spirits "specialty" product. The credit further adds administrative complexity both for taxpayers and for the Government because the source of alcohol in the same product may vary (within tolerances) over time. The amount of tax due varies correspondingly with the source of alcohol. Taxing all alcohol in a distilled spirits product, regardless of its source, at the same rate would eliminate this complexity.

Recommendation 3: Eliminate alcohol occupational taxes

The Joint Committee staff recommends that the alcohol occupational taxes should be eliminated.

The annual alcohol occupational taxes are in the nature of business license fees. As described above, the BATF administers an extensive regulatory system for alcoholic beverages. Under present budgetary rules, occupational tax receipts are deposited in the General Fund of the Treasury rather than being used directly to offset the cost of BATF activities. The tax rates are not set in any way to reflect those costs.

Further, the relatively low tax rates are potential sources of innocent (as well as intentional) noncompliance by taxpayers. Because of the per-taxpayer amount involved in the case of truly small businesses (e.g., bars and taverns), it is not cost effective for the BATF to pursue collection. However, after several years of nonpayment, the liability (including interest and penalties) can become substantial, leading to enforcement proceedings and potentially large financial burdens for small businesses. (Statutory periods for assessment remain open when no returns are filed.)

Recommendation 4: Consolidate rum cover over payment rules

The Joint Committee staff recommends that the rules governing cover over of rum excise taxes to Puerto Rico and the U.S. Virgin Islands should be consolidated.

Since enactment of Public Law 106-200, authority to make rum cover over payments to Puerto Rico and the U.S. Virgin Islands is consolidated in the BATF. However, the Interior Department still makes payments with respect to the taxes derived from rum imported from the Virgin Islands (under BATF supervision). BATF authorizes administers all payments to Puerto Rico and payments to the Virgin Islands with respect to rum imported from other countries. Further, the timing of payments to the two possessions and with respect to rum from the possession and rum imported from other countries remains different.

Consolidating the responsibility for making all payments in the BATF and prescribing a single payment schedule for all amounts due to each possession would simplify the Federal Government's administration of this revenue-sharing program. Additionally, transferring all amounts due to each possession according to a single schedule could assist Puerto Rico and the U.S. Virgin Islands in their budget processes.

J. Tobacco Excise Taxes

Present Law

Tobacco products taxes

Excise taxes are imposed on cigarettes and a variety of other tobacco products. The taxes are imposed on removal of the products by a manufacturer, or in the case of products manufactured in other countries, when the products are imported or brought into the United States.

The taxable products and tax rates are shown below.

Product	Tax Rate	
	2001	2002 and thereafter
Cigarettes (sec. 5701(b)):		
Small cigarettes[1]	$17/1000[3]	$19.50/1000
Large cigarettes[2]	$35.70/1000	$40.95/1000
Cigars (sec. 5701(a)):[4]		
Small cigars	$1.594/1000	$1.828/1000
Large cigars	18.063% of mfr. price, but not over $32.50/1000	20.719% of mfr. price, but not over $48,75/1000
Smokeless tobacco:		
Snuff (sec. 5701(e)(1)	$0.51/lb.	$0.585/lb.
Chewing tobacco (sec. 5701(e)(2))	$0.17/lb.	$0.195/lb.
Pipe tobacco and "roll-your-own" tobacco (secs. 5701(f) and (g))	$0.9567/lb.	$1.0969/lb.
Cigarette papers (sec. 5701(c))	$0.0106/pkg. of 50 papers or part thereof	$0.0122/pkg. of 50 papers or part thereof
Cigarette tubes (sec. 5701(d))	$0.213/pkg. of 50 tubes or part thereof	$0.0244/pkg. of 50 tubes or part thereof

1) Small cigarettes are cigarettes weighing no more than three pounds per thousand. Virtually all tobacco excise tax revenues are derived from the tax on small cigarettes.

2) Large cigarettes are cigarettes weighing more than three pounds per thousand. Large cigarettes (measuring more than 6.5 inches in length) are taxed at the rate prescribed for small cigarettes, counting each 2.75 inches (or fraction thereof) as one cigarette.

3) This rate equals 34 cents per pack of 20 cigarettes. The increased rate scheduled to take effect in 2002 equals 39 cents per pack of 20 cigarettes.

4) Small and large cigars are distinguished by weight, with the same three-pound break point as cigarettes. Most taxable cigars are large cigars.

Tobacco occupational tax

Manufacturers and exporters of taxable tobacco products (including cigarette papers and tubes) are subject to an annual occupational excise tax of $1,000 per year per premise (sec. 5731). The tax rate is reduced to $500 per year, per premise for businesses with gross receipts of

less than $500,000 in the preceding taxable year. The occupational tax is imposed with respect to the twelve-month period from July 1 through June 30. This tax is part of a larger system of Federal regulation of tobacco manufacturers and exporters. Among the Federal regulations are requirements that these parties receive permits to conduct business and post bonds as necessary to ensure payment of relevant tobacco products excise taxes.

Sources of Complexity

The principal source of complexity in the tobacco excise taxes arises from imposition of numerous separate taxes that, in many cases, yield only small amounts of revenue. Some justify the taxes based on social and health policies discouraging consumption of tobacco. However, from a tax policy and administration perspective, the taxes impose burdens associated with complying with bonded premise rules and filing of semi-monthly tax returns both on taxpayers and on the BATF.

Recommendations for Simplification

Recommendation 1: Consolidate small-revenue yielding taxes on tobacco products

The Joint Committee staff recommends that the present excise taxes on pipe tobacco, roll-your-own tobacco, and cigarette papers and tubes should be consolidated into a single tax on pipe and roll-your-own tobacco.

The separate excise taxes on cigarette paper and tubes originated during a period when consumers frequently bought loose smoking tobacco and made their own cigarettes. Before 2000, there was no tax on "roll-your-own" tobacco. Because the Code now imposes tax on purchases of loose smoking tobacco, the taxes on cigarette papers and tubes are duplicative. Eliminating these taxes would reduce administrative burdens required to comply with the taxes on manufacturers of those products (as well resource demands on the BATF) without undercutting the social and health objectives of the tobacco products excise taxes.

Recommendation 2: Eliminate *ad valorem* component of cigar tax rate

The Joint Committee staff recommends that the tax rate imposed on cigars should be modified to eliminate the *ad valorem* component.

Unlike the other tobacco excise taxes, the tax on large cigars is imposed at an *ad valorem* rate, subject to a fixed amount cap. The *ad valorem* rate is determined by reference to manufacturers' price. When cigars are transferred by manufacturers to related party wholesale distributors or retailers, constructive sales price rules must be used to determine the tax. Establishing constructive sales prices is inherently factual, resulting in audit disputes between the BATF and taxpayers. Converting the cigar tax rate to a fixed amount per unit like the rates imposed on other tobacco products would eliminate these factual determinations.

Recommendation 3: Eliminate tobacco occupational tax

The Joint Committee staff recommends that the tobacco occupational tax should be eliminated.

The annual tobacco occupational tax is in the nature of a business license fee. Under present budgetary rules, occupational tax receipts are deposited in the General Fund of the Treasury rather than being used directly to offset the cost of BATF activities regulating the tobacco industry. The tax rates also are not set in any way to reflect those costs. If annual charges such as these are to be imposed on manufacturers and exporters, the charges are more appropriately imposed as cost-based user fees, to offset the BATF's direct costs of administering Federal tobacco regulatory provisions contained in the Code.

XIII. TAX-EXEMPT BONDS

A. Eliminate Five-Percent Disproportionate Use Limit

Present Law

Interest on debt incurred by States or local governments is excluded from income if the proceeds of the borrowing are used to carry out governmental functions of those entities or the debt is repaid with governmental funds. In addition to these "governmental" tax-exempt bonds, States and local government may issue "private activity" tax-exempt bonds for certain purposes that are specified in the Internal Revenue Code. Private activity bonds are bonds where the State or local government serves as a conduit providing financing to private businesses or individuals.

The determination of whether a bond is a governmental bond or a private activity bond is based on (1) the amount of bond proceeds used for private business uses (and corresponding private security involved) or (2) the amount of loans made to private parties (whether or not business parties) with the proceeds. In general, the private business use/payment limit for a governmental bond is 10 percent. The private loan limit equals the lesser of five percent or $5 million. The annual volume of most private activity bonds is restricted by State volume limits.

In addition to the general private use and payment limits, governmental bond issuers are subject to a State's private activity bond volume limit for any permitted private business use financed with a bond issue that exceeds $15 million. This requirement effectively reduces the private use limits on larger bond issues because of volume limit constraints.

Finally, no more than five percent of governmental bond proceeds may be used for a private purpose that is unrelated to a governmental activity also being financed with the bond issue (the "unrelated and disproportionate use limit").

Source of Complexity

The "unrelated and disproportionate use limit" requires factual determinations as to whether a specific ancillary activity is related to the governmental purpose being financed with proceeds of the bond issue. The penalty for an erroneous determination is loss of tax-exemption on interest for the entire bond issue.

Recommendation for Simplification

The Joint Committee staff recommends that the unrelated and disproportionate use limit should be eliminated.

The general 10-percent and five-percent/$5 million private use, payment, and loan limits combined with the State private activity bond volume limit requirement for larger issues effectively control excess private business use of governmental bond proceeds without the factual determination required by the unrelated and disproportionate use limit.

B. Consolidate Prohibited/Restricted Use Facilities Rules

Present Law

In general

The Code denies tax-exemption to interest on private activity bonds if any portion of bond proceeds is to be used for financing an airplane, skybox, or other private luxury box, health club facility, facility primarily used for gambling, or store the principal business of which is the sale of alcoholic beverages for consumption off premises.[832] This restriction does not apply to qualified 501(c)(3) bonds used to finance a health club facility.[833]

Qualified redevelopment bonds

"Qualified redevelopment bonds" are bonds issued as part of an issue 95 percent or more of the net proceeds of which is to be used for one or more redevelopment purposes in a designated "blighted area." The bonds must be issued pursuant to state law authorization and under an existing redevelopment plan. The payment of interest and principal on the issue must be financed, in effect, by taxes of general application or earmarked real estate tax increases. In addition, each real property interest in the designated blighted area that is acquired by a governmental unit and transferred to a nongovernmental person must be transferred for fair market value. No owner or user of property located in the financed area can be subject to a charge or fee which similarly situated owners or users of comparable property outside such area are not subject.

Proceeds of qualified redevelopment bonds may not be used to provide (including the provision of land for) any private or commercial golf course, country club, massage parlor, hot tub facility, suntan facility, racetrack or other facility used for gambling, or any store the principal business of which is the sale of alcoholic beverages for consumption off premises. No more than 25 percent of the proceeds of qualified redevelopment bonds can be used to provide a retail food and beverage facility, an automobile sales and service facility, a recreation or entertainment facility, a tennis club, a skating facility, or a racquet sports facility.[834]

Tax-exempt enterprise zone facility bonds

Enterprise zone facility bonds are issued to finance "enterprise zone facilities" located in "enterprise communities" or "empowerment zones" if the principal users of such facilities are

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[832] Sec. 147(e).

[833] Sec. 147(h)(2).

[834] By virtue of incorporation by reference, some businesses prohibited by section 147(e) simultaneously fall within the 25 percent limitation and the prohibited use rules. These include liquor stores, gambling facilities, suntan facilities, racetracks, golf courses, country clubs and massage parlors. Sec. 144(c)(6)(A).

"qualified enterprise zone businesses." Ninety-five percent or more of the net proceeds of the bonds must be used to provide an enterprise zone facility. An enterprise zone facility is defined as any qualified zone property the principal user of which is an "enterprise zone business," and any land that is functionally related and subordinate to such property.[835] An enterprise zone business is defined by Code section 1397B, with certain modifications not relevant here.

As noted above, the principal users of an enterprise zone facility must be qualified enterprise zone businesses. Excluded from the definition of qualified enterprise zone business are any private or commercial golf course, country club, massage parlor, hot tub facility, suntan facility, racetrack or other facility used for gambling, or any store the principal business of which is the sale of alcoholic beverages for consumption off premises.[836]

Qualified small-issue bonds

For qualified small-issue bonds issued before December 31, 1986, and bonds issued to refund such bonds, a qualified small-issue bond could be used to (1) finance the acquisition, construction or improvement of land or depreciable property or (2) redeem bonds issued to finance such property.[837] No portion of the proceeds of a qualified small-issue bond may be used to provide the following: any private or commercial golf course, country club, massage parlor, tennis club, skating facility (including roller skating, skateboard, and ice skating), racquet sports facility (including handball or racquetball court), hot tub facility, suntan facility or racetrack.[838] In addition, no more than 25 percent of the net proceeds of the issue may be used to finance certain retail and entertainment facilities. These facilities include retail food and beverage service facilities, automobile sales or service facilities, and facilities for provision of recreation or entertainment.[839]

For bonds issued after December 31, 1986, qualified small-issue bonds can be used only for financing of certain smaller manufacturing facilities or the acquisition of farm land and equipment for first-time farmers.[840] As a result of the narrower purposes for which qualified small-issue bonds may be issued, the list of prohibited businesses applicable to pre-December 31, 1986 qualified small-issue bonds is irrelevant to qualified small-issue bonds issued after that date.

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[835] Sec. 1394(b).

[836] Secs. 1397B and 144(c)(6)(B).

[837] Sec. 144(a).

[838] Sec. 144(a)(8)(B).

[839] Sec. 144(a)(8)(A).

[840] Secs. 144(a)(12)(B) and 147(c)(2).

Sources of Complexity

The types of businesses for which the proceeds of private activity bond issues may not be used vary depending on the type of bond. These prohibitions are located in various places in the Code. In addition, the Code limits to 25 percent the amount of net proceeds that should be spent for certain other business for qualified redevelopment bonds but does not impose a similar limitation on empowerment zone facility bonds. Further, by virtue of incorporation by reference, the statutory provisions pertaining to qualified redevelopment bonds include many facilities under both the restricted use provision and the prohibited use provision. For example, the Code simultaneously provides that 25 percent of the proceeds and no part of the proceeds may be used for a gambling facility.[841]

Recommendation for Simplification

The Joint Committee staff recommends that the prohibitions on using private activity bond proceeds for certain business should be conformed for all such bonds and consolidated into one Code section.

The Joint Committee staff believes that the Code would be simplified by consolidating into one section the list of businesses for which private activity bond proceeds cannot be used. Under the Joint Committee staff proposal there would be no restricted use provisions, and one consolidated list of prohibited businesses for all private activity bonds. Under the proposal, financing for the following businesses would be prohibited: golf courses, country clubs, massage parlors, hot tub facilities, suntan facilities, racetracks or other facilities used primarily for gambling, health club facilities, skyboxes or private luxury boxes, airplanes, or stores the principal business of which is the sale of alcoholic beverages for consumption off premises.[842]

The 25-percent restricted use provisions that apply to qualified redevelopment bonds but not enterprise zone facility bonds should be eliminated in light of the similar purposes of these bonds. Further, because the 25-percent restricted use and prohibited business provisions for qualified small issue bonds apply only to bonds issued before December 31, 1986, these provisions should be repealed as deadwood.

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[841] Sec. 144(c)(6)(A), (imposing a 25-percent limitation on facilities described in 147(e), which includes gambling facilities) and sec. 144(c)(6)(B) (which provides that no portion of the proceeds may be used for gambling facilities).

[842] Under the Joint Committee staff recommendation, this restriction would not apply to qualified 501(c)(3) bonds that finance a health club facility.

C. Provisions Rendered or Being Rendered Obsolete by the Passage of Time

1. Deadwood Provisions

a. Mortgage revenue bonds--Federal disaster area modifications

Present Law

In general

Subject to certain requirements, interest earned on qualified mortgage bonds is exempt from taxation. Qualified mortgage bonds are used to finance owner-occupied residences. These bonds are subject to several additional limitations, which include income and purchase price limitations, as well as a requirement that the homebuyer not have an ownership interest in the principal residence in the preceding three years (the "first time homebuyer" requirement).

Generally, in order for a bond to be a qualified mortgage bond, the mortgagor's family income cannot exceed 115 percent of the applicable median family income. Adjustments are made for targeted area residences, for areas that have high housing costs in relation to income, and for family size. Further, 95 percent or more of the net proceeds of qualified mortgage bond loans must be used to finance residences for first-time homebuyers. Exceptions are made for financing of targeted area residences, qualified home improvement loans, and qualified rehabilitation loans.

A residence financed with a mortgage funded by qualified mortgage bonds may not have a purchase price in excess of 90 percent of the average area purchase price for that residence. Adjustments are made for targeted area residences, and the number of families for which a residence is designed.

A targeted area residence is one located in either (1) a census tract in which at least 70 percent of the families have an income which is 80 percent or less of the state-wide median income or (2) an area of chronic economic distress. For targeted area residences, the income requirement is satisfied when no more than one-third of the targeted area loans are made without regard to any income limits and the remainder of the targeted area mortgages are made to mortgagors whose family income is 140 percent or less of the applicable median family income. The first time homebuyer requirement does not apply to targeted area residences. In addition, the purchase price limitation is raised from 90 percent to 110 percent of the of the average area purchase price for targeted area residences.

Special rules for Federal disaster areas

The Taxpayer Relief Act of 1997 temporarily relaxed certain of the qualified mortgage bond rules for residences located in Federal disaster areas.[843] Persons purchasing residences

[843] Pub. Law No. 105-34, sec. 914 (1997); sec. 143(k)(11). Section 143(k)(11) provides:

located in these areas were excepted from the first-time homebuyer rule. Further, the purchase price requirements and income requirements were to be applied as if the residence were a targeted area residence. These special rules applied to bonds issued after December 31, 1996, and before January 1, 1999.

Sources of Complexity

The utility of the Federal disaster area provision expired on January 1, 1999, and, therefore, it is deadwood.

Recommendation for Simplification

The Joint Committee staff recommends that the special qualified mortgage bond rules for residences located in Federal disaster areas should be eliminated as deadwood.

The modifications for Presidentially declared disaster areas apply only to loans financed with bonds issued in 1997 and 1998. Because the end date for issuing bonds under this provision, January 1, 1999, has passed, the provision is deadwood and should be eliminated.

b. Interim authority for governors regarding allocation of private activity bond volume limits

Present Law

In general

Interest on most private activity bonds is taxable unless the aggregate face value of the bonds, when added to the aggregate face value of previously issued private activity bonds for the calendar year, does not exceed a certain volume.[844] The Tax Reform Act of 1986 provided a uniform volume limit in lieu of prior separate volume limitations that were imposed upon

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(11) Special Rules For Residences Located in Disaster Areas.--In the case of a residence located in an area determined by the President to warrant assistance from the Federal Government under the Robert T. Stafford Disaster Relief and Emergency Assistance Act (as in effect on the date of the enactment of the Taxpayer Relief Act of 1997), this section shall be applied with the following modifications to financing provided with respect to such residence within 2 years after the date of the disaster declaration:

(A) Subsection (d) (relating to 3-year requirement) shall not apply.

(B) Subsections (e) and (f) relating to purchase price requirement and income requirement) shall be applied as if such residence were a targeted area residence.

The preceding sentence shall apply only with respect to bonds issued after December 31, 1996, and before January 1, 1999.

[844] Sec. 146(a).

industrial development bonds, student loan bonds, and qualified mortgage bonds (other than qualified veterans' mortgage bonds). Generally, the volume limit applies to most private activity bonds issued after August 15, 1986.

Unless State law makes a different allocation (or the State's governor made a different allocation during an interim period) the volume limit is divided in two. One-half is allocated to all State agencies (which are treated as a single unit) and one-half is allocated to all other issuers.

Special rules: interim period

State governors were granted temporary authority to proclaim a different formula for allocating the State ceiling among the governmental units (or authorities) in their State having authority to issue private activity bonds.[845] The governors' authority did not apply to bonds issued after the earlier of (1) the last day of the first calendar year after 1986 during which the legislature of the State met in regular session, or (2) the effective date of any State legislation with respect to the allocation of the State ceiling.

Sources of Complexity

Because all of the State legislatures have met since 1986, the provision giving governors interim authority to allocate the private activity bond volume limit is no longer needed in the Code.

Recommendation for Simplification

The Joint Committee staff recommends that the temporary gubernatorial authority to allocate the volume limit should be eliminated.

Over 14 years have elapsed since the temporary gubernatorial authority provision was enacted. It is clear that all of the State legislatures have met in regular session in the interim. Thus, governors no longer may exercise the temporary authority.

2. Other provisions

a. Consolidate qualified mortgage bonds and qualified veterans' mortgage bonds

Present Law

Qualified mortgage bonds

Qualified mortgage bonds are bonds the proceeds of which are used to finance the purchase, or qualifying rehabilitation or improvement, of single-family, owner-occupied residences located within the jurisdiction of the issuer of the bonds (sec. 143). Persons receiving qualified mortgage bond financed loans must satisfy home purchase price and borrower income limits, and a first-time homebuyer requirement. Part or all of the interest subsidy provided by

[845] Sec. 146(e)(2).

qualified mortgage bonds is recaptured if the borrower experiences substantial increases in income and disposes of the subsidized residence within nine years after purchase. Issuance of qualified mortgage bonds is limited by the State annual private activity bond volume limitations.

Qualified veterans' mortgage bonds

Qualified veterans' mortgage bonds are bonds the proceeds of which are used to finance the purchase, or qualifying rehabilitation or improvement, of single-family, owner-occupied residences of qualified veterans located within the jurisdiction of the issuer of the bonds. Persons receiving qualified veterans' mortgage bond loans must be veterans who served on active duty at some time before January 1, 1977 and who applied for the financing before the later of the date 30 years after the last date on which the borrower left active service, or January 31, 1985. There are no restrictions on purchase price or borrower income, and no first-time homebuyer requirement for qualified veterans' mortgage bond loans. A qualified veterans' mortgage bond may be issued only by those States that issued such bonds before June 22, 1984. Annual issuance of qualified veterans' mortgage bonds is subject to a State veterans limit, but not to be general State volume units applicable to most other private activity bonds.

Sources of Complexity

Two similar provisions to provide mortgage interest subsidies create duplicate administrative agencies in those States that issue both qualified mortgage bonds and qualified veterans' mortgage bonds. Two similar provisions to provide mortgage interest subsidies to homebuyers may create confusion among potentially qualifying beneficiaries. The two similar provisions also may create confusion among potential lenders and require separate but similar reporting to oversight agencies.

Recommendation for Simplification

The Joint Committee staff recommends that only one mortgage interest subsidy should be provided through the issuance of tax-exempt private activity bonds.

The qualified veterans' mortgage bond provision is nearing deadwood status because the universe of potential beneficiaries is small and growing smaller with the passage of time. Present law does not preclude States from granting veterans a preference in qualification for mortgages provided under the qualified mortgage bond provision. If a veteran can qualify under the qualified mortgage bond provision, retention of the qualified veterans' mortgage bond program provides its additional benefits to veterans who either are not first-time homebuyers, who purchase houses of greater value than the qualified mortgage bond purchase price limitations, or who have incomes in excess of the qualified mortgage bond income limitations.

b. Eliminate $150 million limit for qualified 501(c)(3) bonds

Present Law

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

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

The Taxpayer Relief Act of 1997 ("1997 Act") repealed the $150 million limit for bonds, issued after the date of its enactment, to finance capital expenditures incurred after the date of enactment (August 5, 1997).

Sources of Complexity

Because this provision of the 1997 Act applies only to bonds issued with respect to capital expenditures incurred after the date of enactment, the $150 million limit continues to govern the issuance of other non-hospital qualified 501(c)(3) bonds (e.g., advance refunding bonds with respect to capital expenditures incurred before the date of enactment, or new-money bonds for capital expenditures incurred before that date). Thus, there are two rules governing qualified 501(c)(3) bonds for capital expenditures. The application of a particular rule depends on whether the capital expenditures were incurred before of after the date the 1997 Act was enacted.

Recommendation for Simplification

The Joint Committee staff recommends that the $150 million limit should be eliminated as it relates to capital expenditures incurred before the date of enactment of the Taxpayer Relief Act of 1997.

As noted above, the $150 million volume limit continues to apply to qualified 501(c)(3) bonds for capital expenditures incurred on or before August 5, 1997. (Typically, these will be advance refunding bonds). The limit does not apply to bonds to finance capital expenditures incurred after that date. In commenting on the repeal of the $150 million limit, the Senate Finance Committee report asserted that it wanted correct the disadvantage the limit placed on 501(c)(3) organizations relative to substantially identical governmental institutions:

> The Committee believes a distinguishing feature of American society is the singular degree to which the United States maintains a private, non-profit sector of private higher education and other charitable institutions in the public service. The Committee believes it is important to assist these private institutions in their advancement of the public good. The Committee finds particularly inappropriate the restrictions of present law which place these section 501(c)(3) organizations at a financial disadvantage relative to substantially identical governmental institutions. For example, a public university generally has unlimited access to tax-exempt bond financing, while a private, non-profit university is subject to a $150 million limitation on outstanding bonds from with it may benefit. The Committee is concerned that this and other restrictions inhibit the ability of America's private, non-profit institutions to modernize their educational facilities. The Committee believes the tax-exempt bond rules should treat more equally State and local governments and those private organizations which are engaged in similar actions advancing the public good.[846]

Although the conference report on that legislation noted the continued applicability of the $150 million limitation to refunding and new-money bonds, no reason was given for retaining this rule.[847] Thus, it appears that eliminating the discrepancy between pre-August 5, 1997 and post-August 5, 1997 capital expenditures would not violate the policy underlying the repeal of the $150 million limitation. The Joint Committee staff believes that eliminating the $150 million limitation will result in simplification because there will be one rule for qualified 501(c)(3) bonds that finance capital expenditures.

c. Eliminate qualified small-issuer exception for certain bank-qualified bonds

Present Law

Generally no interest deduction is allowed with respect to indebtedness incurred or continued to purchase or carry obligations the interest on which is not subject to tax ("tax-exempt bonds"). In the case of a qualified financial institution, however, a deduction is allowed for interest on indebtedness incurred or continued to purchase or carry certain tax-exempt bonds of a qualified small-issuer. A qualified financial institution is defined as: (1) any person who accepts deposits from the public in the ordinary course of such person's trade or business, and is subject to Federal or State supervision as a financial institution, or (2) is a corporation described as a bank for purposes of qualifying for the bad debt loss rules (sec. 585(a)(2)). A qualified small-issuer is defined as an issuer that is reasonably expected to issue $10 million or less of governmental tax-exempt bonds in the year when the bonds subject to the exception will be issued.

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[846] S. Rep. 105-33 (June 20, 1997), at 24-25.

[847] H. Rep. 105-220 (July 30, 1997), at 372-373.

Sources of Complexity

The qualified small-issuer exception requires issuers and prospective holders of debt to comply with relatively complicated rules. The complexity involved with tracking bond issuance and designations of bonds eligible for the special exception is unnecessary with the advent of State bond pools that now provide an acceptable low-cost means for qualified small issuers to issue debt without regard to the qualified small issuer exception.

Recommendation for Simplification

The Joint Committee staff recommends that the qualified small-issuer exception should be eliminated.

The proliferation of State bond pools has made the qualified small-issuer exception largely irrelevant. It is easier and usually cheaper for most small issuers to borrow through the State bond pools rather than arranging a separate public or private placement. Further, the increased requirements regarding investment by banks in community development projects under the Community Reinvestment Act have reduced the need to provide a tax incentive for these institutions to purchase and carry small issuer and other government debt. The elimination of a special set of rules for qualified small-issuer debt would streamline and make uniform the interest disallowance rules.

d. Modify public notice requirements

Present Law

To be a qualified private activity bond, the bond must satisfy a public approval requirement including providing reasonable public notice for a hearing. Regardless of State and local law, reasonable public notice must include notice "published in one or more newspapers of general circulation available to residents of that locality or if announced by radio or television broadcast to those residents."[848]

Sources of Complexity

Most public hearings relating to private activity bonds are sparsely attended. Restricting public notice requirement to newspapers, radio, and television may increase compliance cost.

Recommendation for Simplification

The Joint Committee staff recommends that the "public notice" requirement should be allowed to be satisfied by other media, e.g., notice via the Internet in addition to radio and television, if the objective of reasonable coverage of the population can be met. The Joint Committee staff further recommends that, in lieu of a public hearing, the public comment requirement should be allowed to be satisfied by written response and Internet correspondence.

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[848] Treas. Reg. sec. 5f.103-2(g)(3).

The proposal would reduce compliance burden by offering issuers less costly ways to obtain relevant public scrutiny of proposed bond issues.

D. Arbitrage Rebate Provisions

Present Law

In general

Interest on debt incurred by States or local governments is excluded from income if the proceeds of the borrowing are used to carry out governmental functions of those entities or the debt is repaid with governmental funds (sec. 103). Interest on bonds that nominally are issued by States or local governments, but the proceeds of which are used (directly or indirectly) by a private person and payment of which is derived from funds of such a private person is taxable unless the purpose of the borrowing is approved specifically in the Code or in a non-Code provision of a revenue Act. These bonds are called "private activity bonds." The term "private person" includes the Federal Government and all other individuals and entities other than States or local governments. The Code includes several exceptions permitting States or local governments to act as conduits providing tax-exempt financing for private activities.

Arbitrage restrictions on tax-exempt bonds

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

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

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

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

Sources of Complexity

Tracking investment returns on tax-exempt bond proceeds requires resources of States and local governments. Particularly in the case of construction projects extending over more than one year, this complexity must be weighed against the financial incentives for these tax-exempt entities to issue bonds earlier and in larger amounts than necessary for the governmental projects to be financed in order to invest bond proceeds for profit.

The policy underlying the arbitrage rebate exception for bonds of small governmental units is to reduce the complexity for these entities because they may not have in-house financial staff to engage in the expenditure and investment tracking necessary for rebate compliance. The exception further is justified by the limited potential for arbitrage profits at small issuance levels and limitation of the provision to governmental bonds, which frequently require voter approval. The economic value of present-law $5 million annual issuance limit under the small governmental unit rebate exception has been eroded by the passage of time. Increasing the limit to $10 million would not expand the exception beyond legitimately small governmental units.

Recommendations for Simplification

Recommendation 1: Extend the spend-down exception for construction bond proceeds to 36 months

The Joint Committee staff recommends that the present-law construction bond exception to the arbitrage rebate requirement should be extended from 24 months to 36 months, with prescribed intermediate spending requirements.

Construction of governmental facilities often requires more than 24 months. During construction, periodic payments are made to contractors. If these payments are made at reasonably prompt intervals, the potential for investing tax-exempt bond proceeds for profit is limited and issuers are not encouraged to issue bonds in advance of the time required to meet expenditures. Extending the present-law construction period spend-down exception to allow somewhat longer construction projects to qualify would expand the number of bond issuers that are not required to undertake arbitrage rebate calculations without creating excessive incentives for arbitrage-motivated issuance of this tax-subsidized debt.

Recommendation 2: Liberalize the small governmental issuer exception

The Joint Committee staff recommends that the basic amount of governmental bonds that small governmental units may issue without being subject to the arbitrage rebate requirement should be increased from $5 million to $10 million. Thus, these governmental units could issue up to $15 million of governmental bonds in a calendar year provided that at least $5 million of the bonds are used to finance public schools.

The general $5 million limit on governmental bonds eligible for the small governmental issuer exception has not been increased since its enactment in 1986. The passage of time has resulted in fewer government issuers being eligible for this exception. Increasing the basic

amount to $10 million would ease compliance for these small governments while maintaining, the integrity of the arbitrage rebate rules in cases where the size of the bond issues make issuing bonds in larger amounts or earlier than needed with the intent of earning and retaining arbitrage profits a significant factor.

XIV. ESTATE AND GIFT TAX PROVISION
Conform Certain Family-Owned And Small Business Provisions

Present Law

Estate and gift tax rules--in general

A gift tax is imposed on lifetime transfers and an estate tax is imposed on transfers at death. The gift tax and the estate tax are unified so that a single graduated rate schedule applies to cumulative taxable transfers made by a taxpayer during his or her lifetime and at death. The unified estate and gift tax rates begin at 18 percent on the first $10,000 in cumulative taxable transfers and reach 55 percent on cumulative taxable transfers over $3 million.[849] In addition, a 5-percent surtax is imposed on taxable transfers at death between $10 million and the amount necessary to phase out the benefits of the graduated rates.

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

Special-use valuation

For estate tax purposes, the value of property generally is its fair market value, i.e., the price at which the property would change hands between a willing buyer and a willing seller, neither being under any compulsion to buy or sell and both having reasonable knowledge of relevant facts.

Under section 2032A, if certain conditions are met, the executor may elect to value real property included in a decedent's estate which is devoted to farming or closely-held business use on the basis of that property's value as a farm or in the closely held business, rather than its fair market value determined on the basis of its highest and best use. Currently, the maximum reduction in value of such real property resulting from an election under section 2032A is $750,000. For decedents dying after 1998, the $750,000 maximum reduction in value is indexed annually for inflation occurring after 1997. The 2001 inflation-adjusted maximum reduction in value is $800,000.[850]

The election to use special-use valuation may be made not later than the time for filing the estate tax return, including extensions.[851] In addition, a written agreement signed by each person in being who has an interest in any qualified real property with respect to which special-use valuation is elected must be filed with the estate tax return. The agreement must show the consent of each of the parties to the application of the recapture tax provisions, discussed below,

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[849] After application of the unified credit, the unified estate and gift tax rates effectively begin at, for example, 37 percent in 2001.

[850] Rev. Proc. 2001-13, 2001-3 I.R.B. 337 (January 16, 2001).

[851] Sec. 2032A(d)(1).

and also their consent to be personally liable for any recapture tax imposed with respect to the qualified heir's interest in the property.[852]

Qualification by the estate

To qualify for special-use valuation: (1) the decedent must have been a citizen or resident of the United States at his death;[853] (2) the value of the farm or closely-held business assets in the decedent's estate, including both real and personal property (but reduced by debts attributable to the real and personal property) must be at least 50 percent of the decedent's gross estate (reduced by debts and expenses);[854] (3) at least 25 percent of the adjusted value of the gross estate must be qualified farm or closely-held business real property;[855] (4) the real property qualifying for special-use valuation must pass to a qualified heir;[856] (5) such real property must have been owned by the decedent or a member of his family and used or held for use as a farm or closely-held business for at least 5 of the last 8 years prior to the decedent's death;[857] and (6) there must have been material participation[858] in the operation of the farm or closely-held business by the decedent or a member of his family in at least 5 years out of the 8 years immediately preceding the decedent's death.[859]

For purposes of the 50-percent and 25-percent tests, the value of property is determined without regard to its special-use value.[860] The term "qualified heir" means a member of the decedent's family, including his spouse, lineal descendants, parents, aunts, and uncles of the decedent and their descendants.[861]

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[852] Sec. 2032A(a)(1), (d)(2).

[853] Sec. 2032A(a)(1)(A).

[854] Sec. 2032A(b)(1)(A).

[855] Sec. 2032A(b)(1)(B).

[856] Sec. 2032A(b)(1).

[857] Sec. 2032A(b)(1)(C).

[858] Whether there has been "material participation" by an individual in the operation of a farm or closely-held business is to be determined in a manner similar to the manner in which material participation is determined for purposes of the tax on self-employment income with respect to the production of agricultural or horticultural commodities under present law. Secs. 1402(a)(1) and 2032A(e)(6).

[859] Sec. 2032A(b)(1)(C).

[860] Sec. 2032A(b)(3).

[861] Sec. 2032A(e)(1) and (2).

Real property may qualify for special-use valuation if it is located in the United States and is devoted to either: (1) use as a farm for farming purposes or (2) use in a trade or business other than farming.[862]

Recapture of estate tax

Under the special-use valuation rules, if, anytime within 10 years after the death of the decedent, the property is disposed of to non-family members or ceases to be used for farming or other closely-held business purposes, the entire Federal estate tax benefits from the reduced valuation are to be recaptured.[863] The recaptured estate tax is the amount of estate tax that would have been imposed if the special-use valuation rules did not apply, over the amount of estate tax actually imposed using the special-use valuation.

Qualified conservation contribution

A "qualified conservation contribution" of an interest in qualified special-use property is not considered a disposition; thus, such a contribution would not cause the recapture tax. A "qualified conservation contribution" is the the contribution to a qualified organization of the donor's entire interest, a remainder interest, or a restriction on the use of the property granted in perpetuity[864] for: (1) the preservation of land areas for outdoor recreation by, or for the education of, the general public; (2) the protection of a relatively natural habitat of fish, wildlife, or plants, or similar ecosystem; (3) the preservation of open space; or (4) the preservation of an historically important land area or certified historic structure.[865]

Family-owned business deduction

An estate is permitted a deduction in computing the amount of the estate's taxable estate for the adjusted value of a "qualified family-owned business interest," up to a total of $675,000. This deduction, plus the value of the unified credit effective exemption amount, may not exceed $1.3 million. In 2001 the unified credit effective exemption amount is $675,000; thus, for estates that elect to take the $675,000 qualified family-owned business deduction, the unified credit effective exemption amount would be limited to $625,000, so the combined benefit amount would not exceed $1.3 million. If the qualified family-owned business deduction is less than $675,000, then the unified credit effective exemption amount is increased, but not above the

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[862] Sec. 2032A(b)(2).

[863] Sec. 2032A(c)(2). The maximum recapture is, however, limited to the amount realized on disposition of the property minus the special-use value of the property. Sec. 2032A(c)(2)(A)(ii).

[864] Secs. 170(h)(2) and 2032A(c)(8).

[865] Sec. 170(h)(4).

amount which would apply to the estate without regard to the qualified family-owned business deduction, by the excess of $675,000 over the amount of the allowed deduction.[866]

Qualifying property interests

For purposes of this provision, a qualified family-owned business interest is defined as any interest in a trade or business (regardless of the form in which it is held) with a principal place of business in the United States if ownership of the trade or business is held at least 50 percent by one family, 70 percent by two families, or 90 percent by three families, as long as the decedent's family owns at least 30 percent of the trade or business. Under the provision, members of an individual's family are defined using the same definition as is used for the special-use valuation rules of section 2032A, and thus include (1) the individual's spouse, (2) the individual's ancestors, (3) lineal descendants of the individual, of the individual's spouse, or of the individual's parents, and (4) the spouses of any such lineal descendants.

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

The value of a trade or business qualifying as a family-owned business interest is reduced to the extent the business holds passive assets or excess cash or marketable securities. Under the provision, the value of qualified family-owned business interests does not include any cash or marketable securities in excess of the reasonably expected day-to-day working capital needs of the trade or business.

Qualifying estates

A decedent's estate qualifies for the family-owned business deduction only if the decedent was a U.S. citizen or resident at the time of death, and the aggregate value of the decedent's qualified family-owned business interests that are passed to qualified heirs exceeds 50 percent of the decedent's adjusted gross estate.

Ownership and participation requirements

To qualify for the family-owned business deduction, the decedent (or a member of the decedent's family) must have owned and materially participated in the trade or business for at least five of the eight years preceding the decedent's date of death. For this purpose, "material participation" is defined as under the special-use valuation rules.

For purposes of the qualified family-owned business deduction, a "qualified heir" includes a member of the decedent's family who acquired the property from the decedent as defined in the special-use valuation rules. In addition, a "qualified heir" also includes any active

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[866] Sec. 2057(a).

employee of the trade or business to which the business relates if such employee has been employed by such trade or business for a period of at least 10 years before the date of the decedent's death.

Recapture of estate tax

Under the family-owned business deduction rules, if a disqualifying event occurs, then the estate-tax savings from this provision are recaptured. These rules are similar to those contained in the special-use valuation provisions; however, there are some differences. Recapture events, which are similar to the special-use valuation recapture events, include: (1) the failure of a qualified heir to materially participate in the operation of the trade or business, (2) a disposition of an interest in the business by a qualified heir to someone other than a member of the qualified heir's family or in a qualified conservation contribution, (3) the loss of a qualified heir's citizenship, and (4) moving the principal place of business outside the United States.[867] The additional estate tax that is imposed under the qualified family-owned business deduction provisions is equal to the difference between what the estate tax would have been if the qualified family-owned business deduction were not taken and the estate tax calculated with the qualified family-owned business deduction.

Unlike the estate tax recapture regime under the special-use valuation rules, the qualified family-owned business rules provide a gradual recapture regime, which is based on the number of years after the decedent's death in which the disqualifying event occurred. Under the provision, if the disqualifying event occurred within six years of the decedent's death, then 100 percent of the benefit of the deduction is recaptured. The remaining percentage of recapture based on the year after the decedent's death in which a disqualifying event occurs is as follows: 7 years after the decedent's death, 80 percent; 8 years after the decedent's death, 60 percent, 9 years after the decedent's death, 40 percent, and 10 years after the decedent's death, 20 percent.[868]

Additional rules

An estate is not eligible to claim the qualified family-owned business deduction if stock or debt of the entity is publicly traded or was at any time within three years of the decedent's death.[869] An estate also is not eligible for the deduction if more than 35 percent of the business' income is personal holding company income.[870]

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[867] Sec. 2057(f)(1).

[868] Sec. 2057(f)(2)(B).

[869] Sec. 2057(e)(2)(B).

[870] Sec. 2057(e)(2)(C).

Sources of Complexity

The special-use valuation and qualified family-owned business deduction rules are designed to provide certain estate tax benefits to estates of decedents whose assets consisted primarily of an interest in a farming or other trade or business. Certain rules contained in both the special-use valuation and family-owned business deduction provisions are identical. The family-owned business deduction provision contains 13 cross references in section 2057(i)(3) to the special-use valuation rules in section 2032A, which apply certain rules to both the special-use valuation and family-owned business deduction provisions. The special-use valuation and family-owned business deduction provisions also contain rules that are unique to each provision, because the policy advanced by the provision requires a specific rule.

There are, however, rules contained in both the special-use valuation and family-owned business deduction provisions that are different but may address similar principles. It may be appropriate to conform these provisions to the extent practicable. For example, under both estate tax provisions, if a disqualifying event occurs, an estate is subject to recapture of estate tax. However, the amount of recaptured tax is different under both provisions. Under the special-use valuation rules, the recaptured tax generally is equal to the entire benefit of special-use valuation if a disqualifying event occurs at any time during the 10-year recapture period. However, under the family-owned business deduction rules, the amount of recaptured tax depends upon when in the 10-year recapture period the disqualifying event occurred (i.e., a gradual recapture regime). Simplification may be achieved by having certain rules, which apply only to one provision under present law, to apply to both provisions, because taxpayers and practitioners would need only be familiar with one rule for both provisions.

Recommendation for Simplification

The Joint Committee staff recommends that the qualification and recapture rules contained in the special-use valuation and family-owned business deduction provisions should be conformed to the extent practicable.

Qualification

The special-use valuation rules require that at least 50 percent of the adjusted value of the gross estate must consist of the adjusted value of real or personal property for the estate to qualify. The family-owned business deduction requires that the adjusted value of qualified business interests must exceed 50 percent of the adjusted gross estate. Although these rules apply to different estate tax benefits, they are similar in that both rules consider the adjusted value of a decedent's gross estate. The Joint Committee recommends that both provisions should require that at least 50 percent of the adjusted gross estate should consist of the adjusted value of real or personal property (for special-use valuation purposes) or the adjusted value of qualified business interests.

Qualified heir

The definition of a "qualified heir" is similar for purposes of both the special-use valuation rules and the family-owned business deduction. Under both provisions, a qualified heir is a member of the decedent's family who acquired the property from the decedent. This

rule is incorporated by reference in the family-owned business rules. However, for purposes of the family-owned business deduction only, any active employee of the trade or business to which the business relates (if such employee was employed by such business for at least 10 years prior to the decedent's death) also is an eligible heir. The Joint Committee staff recommends that any such active employee of the trade or business to which the business relates should be eligible to receive property under the special-use valuation provisions. Thus, material participation by any qualified heir could include material participation by any active employee of the trade or business to which the business relates.

Recapture of estate tax--disqualifying events

Loss of U.S. citizenship or movement of the business outside the United States

Under both estate tax provisions, the events that cause recapture of estate tax (i.e., the disqualifying events) are similar but not identical. Under the special-use valuation rules, if an heir disposes of the property or ceases to use the property for its qualified use, the estate tax savings must be recaptured. However, under the family-owned business deduction, loss of a qualified heir's U.S. citizenship or moving the principal place of business outside the United States also is a disqualifying event. Loss of U.S. citizenship or movement of the business outside the United States during the 10-year recapture period do not cause recapture under the special-use valuation rules.[871] The Joint Committee staff recommends that the loss of a qualified heir's U.S. citizenship or movement of the principal place of business outside the United States should cause recapture under both estate tax provisions.

Qualified conservation contribution

Under the special-use valuation rules, a qualified conservation contribution is not considered a disposition that would cause recapture. The family-owned business deduction provisions do not contain this exception. The Joint Committee staff recommends that a qualified conservation contribution should not be considered a disposition that would cause recapture of estate tax under either provision.

Recapture of estate tax--calculation

If a disqualifying event occurs during the 10-year recapture period, it should be calculated similarly under both the special-use valuation rules and the family-owned business deduction. The Joint Committee staff believes that the amount of tax subject to recapture should depend upon when in the 10-year recapture period the disqualifying event occurred (i.e., a graduated recapture regime). This regime would subject an estate to tax in proportion to the number of years after the date of the decedent's death, which arguably is an appropriate and equitable way of measuring the degree of the effect of a disqualifying event.

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[871] However, at the time of the decedent's death, the decedent must have been a U.S. citizen or resident and the property must have been located within the United States. Sec. 2032A(a)(1)(A), (b)(1).

Public ownership

If, at any time within three years of the decedent's death, the business (or a related entity's) stock or securities were publicly traded, the business interest does not qualify for the family-owned business deduction. The Joint Committee staff recommends that this rule apply to real estate for which a special-use valuation election has been made. Thus, real estate owned by an entity, the stock or securities of which were publicly traded at any time within three years of the decedent's death, would not be eligible for the special-use valuation election.

Active income requirement

An interest in a trade or business generally does not qualify for the family-owned business deduction if more than 35 percent of the adjusted ordinary gross income of the business for the year of the decedent's death was personal holding company income (as defined in section 543). The Joint Committee staff recommends that this rule apply to real estate that is held in a trade or business for purposes of special-use valuation. Thus, real estate held in a trade or business would not be eligible for special-use valuation if more than 35 percent of the adjusted ordinary gross income in the year of the decedent's death was personal holding company income.

XV. EMPLOYMENT TAX PROVISIONS

A. Structural Issues Relating to Worker Classification

Present Law

In general

Significant tax consequences result from the classification of a worker as an employee or independent contractor. These consequences relate to withholding and employment tax requirements, as well as the ability to exclude certain types of compensation from income or take tax deductions for certain expenses. Some consequences favor employee status, while others favor independent contractor status. For example, an employee may exclude from gross income employer-provided benefits such as pension, health, and group-term life insurance benefits. On the other hand, an independent contractor can establish his or her own pension plan and deduct contributions to the plan. An independent contractor also has greater ability to deduct work-related expenses.

Under present law, the determination of whether a worker is an employee or an independent contractor is generally made under a facts and circumstances test that seeks to determine whether the worker is subject to the control of the service recipient, not only as to the nature of the work performed, but the circumstances under which it is performed. Under a special safe harbor rule (sec. 530 of the Revenue Act of 1978), a service recipient may treat a worker as an independent contractor for employment tax purposes even though the worker is in fact an employee if the service recipient has a reasonable basis for treating the worker as an independent contractor and certain other requirements are met. In some cases, the treatment of a worker as an employee or independent contractor is specified by statute.

Significant tax consequences also result if a worker was misclassified and is subsequently reclassified, e.g., as a result of an audit. For the service recipient, such consequences may include liability for withholding taxes for a number of years, interest and penalties, and potential disqualification of employee benefit plans. For the worker, such consequences may include liability for self-employment taxes and denial of certain business-related deductions.

Common-law test

In general, the determination of whether an employer-employee relationship exists for Federal tax purposes is made under a common-law test that has been incorporated into Treasury regulations. The regulations provide that an employer-employee relationship generally exists if the person contracting for services has the right to control not only the result of the services, but also the means by which that result is accomplished. In other words, an employer-employee relationship generally exists if the person providing the services "is subject to the will and control of the employer not only as to what shall be done but how it shall be done."[872] Under the Treasury regulations, it is not necessary that the employer actually control the manner in which

[872] Treas. Reg. sec. 31.3401(c)-(1)(b).

the services are performed, rather it is sufficient that the employer have a right to control.[873] Whether the requisite control exists is determined based on all the relevant facts and circumstances.

Over the years courts have identified on a case-by-case basis various facts or factors that are relevant in determining whether an employer-employee relationship exists. In 1987, based on an examination of cases and rulings, the IRS developed a list of 20 factors that may be examined in determining whether an employer-employee relationship exists.[874] The degree of importance of each factor varies depending on the occupation and the factual context in which the services are performed; factors other than the listed 20 factors may also be relevant.

More recently, the IRS has identified three categories of evidence that may be relevant in determining whether the requisite control exists under the common-law test and has grouped illustrative factors under these three categories: (1) behavioral control; (2) financial control; and (3) relationship of the parties.[875] The IRS emphasizes that factors in addition to the 20 factors identified in 1987 may be relevant, that the weight of the factors may vary based on the circumstances, that relevant factors may change over time, and that all facts must be examined.[876]

Among the factors cited by the courts and the IRS are whether the worker incurs unreimbursed business expenses, has a significant investment in facilities or equipment, can realize a profit or loss as a result of the performance of the services, hires his or her own assistants, makes his or her services available to the general public or must perform services exclusively for the service recipient, is subject to the instructions of the service recipient, receives training from the service recipient, and carries on regular business activity and whether the service recipient provides employee benefits to the worker and has the right to hire and fire the worker.

Generally, individuals who follow an independent trade, business, or profession in which they offer services to the public are not employees. Courts have recognized that a highly educated or skilled worker does not require close supervision; therefore, the degree of day-to-day control over the worker's performance of services is not particularly helpful in determining the worker's status. Courts have considered other factors in these cases, tending to focus on the

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[873] *Id. See also, Gierek v. Commissioner,* 66 T.C.M. 1866 (1993)(involving the classification of a stockbroker and stating that the key inquiry is whether the brokerage firm had a right to control the worker regardless of the extent to which such control was actually exercised).

[874] Rev. Rul. 87-41, 1987-1 C.B. 296.

[875] Department of the Treasury, Internal Revenue Service, *Independent Contractor or Employee? Training Materials,* Training 3320-102 (10-96) TPDS 84238I, at 2-7. This document is publicly available through the IRS website.

[876] *Id.* at 2-3 through 2-7.

individual's ability to realize a profit or suffer a loss as evidenced by business investments and expenses.

Section 530 of the Revenue Act of 1978

Section 530 of the Revenue Act of 1978 ("section 530") generally allows a taxpayer to treat a worker as not being an employee for employment tax purposes (but not income tax purposes), regardless of the worker's actual status under the common-law test, unless the taxpayer has no reasonable basis for such treatment or fails to meet certain requirements. Section 530 was initially scheduled to terminate at the end of 1979 to give Congress time to resolve the many complex issues regarding worker classification. It was extended through the end of 1980 by P.L. 96-167 and through June 30, 1982, by P.L. 96-541. The provision was extended permanently by the Tax Equity and Fiscal Responsibility Act of 1982. A number of changes to section 530 were made by the Small Business Job Protection Act of 1996.

Under section 530, a reasonable basis for treating a worker as an independent contractor is considered to exist if the taxpayer reasonably relied on (1) past IRS audit practice with respect to the taxpayer, (2) published rulings or judicial precedent, (3) long-standing recognized practice in the industry of which the taxpayer is a member, or (4) if the taxpayer has any "other reasonable basis" for treating a worker as an independent contractor. The legislative history states that section 530 is to be "construed liberally in favor of taxpayers."

The relief under section 530 is available with respect to a worker only if certain additional requirements are satisfied. The taxpayer must not have treated the worker as an employee for any period, and for periods since 1978 all Federal tax returns, including information returns, must have been filed on a basis consistent with treating such worker as an independent contractor. Further, the taxpayer (or a predecessor) must not have treated any worker holding a substantially similar position as an employee for purposes of employment taxes for any period beginning after 1977.

Under section 1706 of the Tax Reform Act of 1986, section 530 does not apply in the case of a worker who, pursuant to an arrangement between the taxpayer and another person, provides services for such other person as an engineer, designer, drafter, computer programmer, systems analyst, or other similarly skilled worker engaged in a similar line of work. Thus, the determination of whether such workers are employees or independent contractors is made in accordance with the common-law test.

Section 530 also prohibits the further issuance of Treasury regulations and revenue rulings on common-law employment status. However, taxpayers may generally obtain private letter rulings from the IRS regarding the status of particular workers as employees or independent contractors with respect to prospective employment status. Rulings with regard prior status may or may not be issued.[877]

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[877] Rev. Proc. 2001-3, 2001-1 I.R.B. 111.

Statutory employees or independent contractors

The Code contains various provisions that prescribe treatment of a worker as an employee or an independent contractor. Some of these provisions apply for Federal tax purposes generally; for example, certain real estate agents and direct sellers are treated for all tax purposes as not being employees.[878] Others apply only for specific purposes; for example, full-time life insurance salesmen are treated as employees for employee benefit purposes,[879] and certain salesmen are treated as employees for social security tax purposes.[880]

Analysis

Sources of complexity

Need to make factual determinations

A major source of complexity regarding classification of a worker as an employee or an independent contractor is that present law imposes a set of subjective standards that often do not result in clearly applicable rules.

Although the proper classification of a worker often will be clear, in close cases the law creates a significant gray area that leads to complexity and, potentially, abuse. Under the common-law test, some of the relevant factors may support employee status, while some may indicate independent contractor status. Because the determination of proper classification is factual, reasonable people may differ as to the correct result given a certain set of facts. Thus, for example, even though a taxpayer in good faith determines that a worker is an independent contractor, an IRS agent may reach a different conclusion by weighing some of the relevant factors differently than the taxpayer. Similarly, workers and service recipients may reach different conclusions as to the proper classification of a worker.

Misclassification of workers also may be deliberate. In some cases, workers and service recipients may prefer to classify workers as independent contractors, both for tax and nontax reasons. For example, the worker may wish to take advantage of the ability to contribute on a deductible basis to a pension plan or to deduct significant work-related expenses. A service recipient may wish to avoid administrative problems associated with withholding income and employment taxes. The service recipient also may wish to avoid coverage and nondiscrimination requirements applicable to qualified retirement plans by classifying lower-paid workers as independent contractors. The IRS may have an interest in classifying workers as employees, in order to obtain the benefits of withholding.

Workers sometimes argue that they prefer independent contractor status because it gives them more control over their own lives. To the extent such reasons exist in particular cases,

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[878] Sec. 3508.

[879] Sec. 7701(a)(20).

[880] Sec. 3121(d)(3)(D).

service recipients may feel compelled to classify workers as independent contractors rather than employees. In many instances, it may be very difficult to distinguish whether a misclassification was deliberate or inadvertent, largely due to the subjective nature of the applicable rules.

As discussed below, it may be difficult to address this source of complexity without affecting the fundamental policies underlying present law.

Lack of published guidance

As discussed above, since the enactment of the Revenue Act of 1978, the IRS has been prohibited from issuing general guidance relating to worker classification. The resulting lack of current guidance contributes to the lack of clarity in the law and increases the likelihood of inadvertent misclassification of workers. Previously issued guidance may not reflect current case law, statutory changes, or changes in workplace situations. Without appropriate guidance, not only are differences between taxpayers and the IRS more likely, but different IRS agents may reach different conclusions on the law as well as the relevant facts, resulting in increased inconsistent enforcement.[881]

This source of complexity under present law could be addressed by eliminating the moratorium on generally applicable guidance in this area.

Section 530 of the Revenue Act of 1978

Although section 530 was intended to reduce disputes between the IRS and taxpayers regarding classification issues, it also has been a source of disputes. Like the common-law test, some aspects of section 530 depend on the facts and circumstances and reasonable people may differ as to the correct result given a certain set of facts, i.e., whether section 530 properly is available to the taxpayer.

Another source of complexity stemming from section 530 is that it applies only to the service recipient and only for employment tax purposes. As a result of these limitations, if a worker is treated by the service recipient as an independent contractor under section 530, the worker may mistakenly believe he or she is in fact an independent contractor for Federal income tax purposes. However, because section 530 does not apply for Federal income tax purposes, the worker is still required to determine whether he or she is an independent contractor or employee under the common-law test without regard to section 530.

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[881] The IRS has made publicly available its training guide for agents on worker classification issues. Department of the Treasury, Internal Revenue Service, *Independent Contractor or Employee? Training Materials,* Training 3320-102 (10-96) TPDS 84238I. The guide may aid consistent enforcement by different agents and provide a guide to taxpayers regarding the state of the law; however, the guidelines leave substantial discretion to individual agents and do not resolve all issues. Further, the guidelines do not carry the same force of law as revenue rulings or regulations.

Section 530 causes complexity because it is not available to all taxpayers. In particular, section 530 does not apply to technical services personnel. This disparate treatment can cause confusion.

Section 530 also causes complexity because it is not codified in the Code. Thus, it may be difficult for taxpayers and tax practitioners to locate the provision and subsequent changes made to it by other laws. This source of complexity could be addressed by codifying section 530.

General effects of complexity in the law regarding worker classification

The complexities in the present-law rules relating to worker classification result in the following adverse consequences: (1) confusion among taxpayers about whether or not they may legally be classified as independent contractors or employees; (2) administrative disputes and litigation over whether individuals are appropriately classified; (3) inconsistent enforcement and application of the rules by the IRS; (4) different treatment of similarly situated taxpayers; and (5) loss of federal tax revenue because of the misclassification of workers. Such complexity can also undermine the confidence of taxpayers in the Federal tax rules, leading taxpayers to believe the law is not being applied fairly or consistently and frustrating taxpayer efforts to comply.

Effect of worker misclassification on compliance and Federal revenues

Under present law, there is revenue loss associated with lower compliance rates of independent contractors and service recipients compared to the compliance rates of employees and their employers. Tax data indicate that service recipients often fail to file requisite Forms 1099 for payments made to independent contractors, and that independent contractors often fail to report the unreported payments as income. In addition, employers must file information reports on all wages paid to employees; the requirement with respect to service recipients are not as comprehensive. Even when Forms 1099 are issued, compliance is somewhat less than when workers are classified as employees and withholding is required.

The IRS has prepared several surveys from audits of employment tax returns. Two of the most widely utilized in the analysis of employment tax issues are the 1984 Strategic Initiative to Establish a Research Project on Withholding Noncompliance[882] (the "1984 Strategic Initiative") and the Employment Tax Examination Program.

The 1984 Strategic Initiative examined 3,331 employers for tax year 1984 and found that nearly 15 percent of employers misclassified employees as independent contractors. According to the IRS, the section 530 safe harbor protected nine percent of misclassified employees from being reclassified as employees.[883] Of those returns using the section 530 safe harbor protections, nearly half relied on the prior audit provision. The 1984 Strategic Initiative survey also found that when employers classified workers as employees, more than 99 percent of wage

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[882] This survey is often referred to as SVC-1.

[883] Several changes have been made to the section 530 safe harbor since this survey that could effect the number of workers subject to the safe harbor.

and salary income was reported. However, when workers were classified as independent contractors, 77 percent of gross income was reported when a Form 1099 was filed, and only 29 percent of gross income was reported when no Form 1099 was filed.

The IRS performed 11,380 audits in the Employment Tax Examination Program from fiscal years 1988 through 1994. Employers were audited to determine employment status of personnel who often were not classified as employees for employment tax purposes. The General Accounting Office has conducted a study of audits from the program and has reported that these audits resulted in proposed tax assessments of $751 million and reclassification of 483,000 workers as employees.

In addition to these data sources, the Taxpayer Compliance Measurement Program provides information on the overall level of tax compliance of sole proprietorships. This program consists of approximately 54,000 individual income tax returns that are extensively audited. The most recent year of the Taxpayer Compliance Measurement Program is for tax year 1988. The 1988 data indicated that gross income reporting for Schedule C filers improved when a Form 1099 was issued. This data also indicated that overall compliance for gross income reporting averaged 94 percent, while net income reporting averaged only 75 percent for Schedule C (Profit or Loss from Sole Proprietorship) filers. (The voluntary compliance percentage varies by employment sector and with income.)

Discussion of general issues relating to proposals to reduce complexity in the law regarding worker classification

Introduction

In conducting this study, the staff of the Joint Committee analyzed a variety of different proposals to simplify the rules relating to the determination of worker status. Although such proposals may achieve some level of simplification, they may also add significant complexity to the Code.

In addition, the Joint Committee staff believes that the likely effects of proposals to simplify the worker classification rules raise policy issues that need to be addressed apart from simplification. Thus, the Joint Committee staff is not making a specific recommendation relating to such rules. However, a general discussion of issues arising under various different approaches to simplifying the rules relating to determination of worker status is warranted in the event that the policy issues are resolved.

General policy implications

Any modification to the worker classification rules is likely to produce different results in some cases than would present law. That is, some workers that are properly classified as employees under present law may be classified as independent contractors under modified rules (or vice versa). Depending on the specifics of any given proposal, a change to the law could result in the reclassification of significant numbers of workers, which could have a variety of consequences. For example, a change to the Federal tax rules applicable to the worker and the service recipient would require a substantial adjustment to behavior from a tax and a personal viewpoint. The eligibility of the worker for employee benefits, such as health care and pension

benefits would change. Compliance and Federal tax revenues also could be affected by the reclassifications of large numbers of workers. Further, even if a proposal were intended to be limited to the Federal tax laws, any new Federal tax rules regarding worker status would likely spill over into State tax rules, as well as Federal and State nontax rules relating to workers (e.g., various worker protection laws). Finally, how a worker views himself or herself may be affected by reclassification.

Evaluating effects on simplification

Although the degree of simplification achieved by any particular proposal will depend on the specifics of the proposal, a number of general factors are relevant under any approach, including the following: (1) whether the proposal is a replacement for present-law rules or adds an additional test or safe harbor for determining worker status; (2) whether the proposal applies for all Code purposes or only certain purposes (e.g., employment taxes); (3) the effect of the proposal on workers and their overall Federal tax responsibilities; and (4) the effect of the proposal on workers whose status is not in doubt under present law.

Some recent proposals relating to worker status take the approach of adding to the present-law rules one or more additional safe harbors under which workers are not classified as employees. Such an approach is less likely to achieve simplification than one that replaces the present-law rules with a single rule. In general, an approach that adds additional rules or safe harbors tends to increase complexity by adding to the number of rules that a taxpayer needs to understand and apply to determine which rule is best for them. In addition, by keeping the present-law rules for at least some taxpayers, such an approach would retain the complexities associated with present law.

Some proposals relating to worker status would apply for all Code purposes, while others would apply only for employment tax purposes. Proposals that are limited to employment taxes raise fewer policy issues than broader proposals, e.g., limited proposals would not affect eligibility for employee benefits. However, limited proposals may not achieve the same degree of simplification as broader proposals, because the present-law rules and complexities would still apply for some purposes. In addition, having different rules for different purposes may increase both complexity and the likelihood of inadvertent errors, because taxpayers may mistakenly believe that the same rule applies for all purposes.

If a proposal results in more workers being classified as independent contractors, the proposal may actually increase complexity for those workers. One reason for this is that employees are subject to wage withholding, whereas independent contractors are required to make quarterly estimated tax payments. In addition, workers previously classified as employees would now be required to calculate and pay self-employment taxes, rather than have FICA taxes withheld and remitted by their employer. Further, employees are generally eligible for employee benefit and pension plans, whereas independent contractors are not. Thus, for example, if an employee who was participating in an employer-sponsored retirement plan is reclassified as an independent contractor, the individual would no longer be eligible to participate in the employer plan but would be eligible to establish his or her own qualified retirement plan. Although such plans may in some cases provide greater benefits than an employer's plan, they also involve greater complexity. To the extent that workers do not realize benefits from being reclassified as

independent contractors, they may view themselves as worse off by having to deal with more complicated tax rules.

Finally, as mentioned above, the status of most workers is not in doubt under present law. Accordingly, any change to worker status may create doubt as to the status of workers with respect to whom there is no issue under present law, which may increase complexity. To some extent, this might be only a transition issue; that is, as taxpayers become more familiar with new standards, uncertainty may decrease.

Effects on compliance

As discussed above, there is revenue loss associated with lower compliance rates of independent contractors and service recipients compared to employees and their employers. Thus, compliance and tax revenues could be affected by proposals that reclassify large numbers of workers.

Effects on pension and benefit coverage

As previously mentioned, employees are eligible to participate in certain employer-sponsored benefit plans. While independent contractors generally cannot participate in the benefit plans of the service recipient, they can set up their own plan. In some cases, an independent contractor may be able to establish a plan that provides greater benefits than does a typical employer plan.

For example, an independent contractor would be able to set up his or her own profit-sharing plan and make contributions to the plan of up to $35,000 (for 2001) per year. As an employee, a worker is subject to the limits on contributions and benefits contained in the employer plan, which typically are lower than the maximum permitted contributions. Thus, an independent contractor may receive greater pension benefits under his or her own plan than under an employer plan. On the other hand, some employees who are reclassified as independent contractors may not take advantage of the opportunities available to them, thereby possibly causing a reduction in future retirement savings. In short, the effect of reclassification of a worker from an employee to an independent contractor (or vice versa) on retirement plan or other benefit coverage is unclear.

Issues under specific proposals relating to worker classification

"Check-the-box" approach

One method for determining worker status that has been suggested is to let the parties decide by contract whether the worker is to be treated for all Federal tax purposes as an employee or independent contractor.[884] This approach would achieve simplification in the determination of worker status by providing certainty for both the worker and the service recipient as to the worker's status for all purposes of the Code. However, the proposal might also add complexity, because all workers would need to understand the consequences of deciding which status to choose.

This approach essentially shifts the basis for determining worker status from a fact-based determination to a determination grounded in which party has the greater bargaining power. As a result, this approach has the potential for producing significantly different results than the present-law rules, or other proposals that attempt to narrow the factors that are relevant to determining worker status.

Specifying the factors that are relevant to determining worker status

A number of proposals attempt to simplify the determination of worker status by limiting the number of relevant factors, either by way of an additional safe harbor or by replacing the present-law rules. Because workplace situations vary substantially, it may be difficult to develop a limited set of specific factors that are relevant in all situations.[885] On the other hand, the factors need to be drawn so that they have some effect; otherwise the proposal may in practice be a "check-the-box" approach. For example, some proposals provide that, subject to the agreement of the parties, a worker may be treated as an independent contractor if the worker has a substantial investment in training or education. Such a proposal could be interpreted to mean that any worker with a college degree could be treated as an independent contractor if the contract between the worker and the service recipient so provides.

Another potential issue with respect to proposals that specify relevant factors is that the factors themselves may give rise to factual questions of interpretation that could lead to disputes between taxpayers and the IRS, and ultimately, to litigation. For example, some proposals provide that a worker may be treated as (or is) an independent contractor if the worker has a "substantial" investment in work facilities or "substantial" unreimbursed business expenses.

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[884] Under this approach, rules would need to be developed as to the specific manner in which the decision is made, e.g., pursuant to a written contract meeting certain requirements. Rules would also be necessary to address situations in which the parties have not specified worker status by contract. For example, in the absence of a contract, a worker could be deemed to be an employee. Alternatively, in the absence of a contract, the common-law rules could be used to determine worker status. The latter alternative would involve the uncertainties of present law.

[885] It is precisely this difficulty that has let to the present-law multifactor facts and circumstances approach.

This raises the question of what "substantial" means. For example, it could be based on a flat dollar amount, or some percentage of the worker's gross receipts. What is considered "small" might be different for different occupations. Similarly, some proposals have provided that workers with "special skills" may be treated as independent contractors. To provide clarity, the proposal would need to define what is meant by "special skills." In other words, some proposals introduce new factual questions that may be as complex as present law.

Providing similar treatment of workers for all Federal tax purposes

As discussed above, a major reason that worker classification is significant is that the Federal tax treatment of employees and independent contractors varies. Some commentators have suggested that simplification could be achieved by providing similar treatment for all workers, thus making worker classification irrelevant or at least minimizing its significance.

Such an approach would involve significant changes to a variety of Federal tax laws and would raise policy issues. Major areas of the law that would require modification to achieve conformity of treatment, and some of the policy issues involved, are summarized below.

(1) Withholding and estimated tax rules.--In general, employees are subject to withholding, whereas independent contractors are required to make quarterly estimated tax payments. To provide consistent treatment, withholding would have to be extended to all taxpayers or all taxpayers would have to be required to make estimated tax payments. As mentioned above, imposing estimated taxes on all workers would add substantial complexity compared to present law, and could also have an adverse effect on compliance. A variety of issues would also need to be addressed if withholding were imposed on independent contractors. For example, the appropriate level of withholding can be difficult if the independent contractor works for multiple service providers.

(2) Eligibility for employee benefit plans.--Conformity of treatment with respect to pension and benefit plans could be achieved by providing that independent contractors must be treated as employees for purposes of employee plan coverage. Alternatively, employees could be given the same opportunity for tax-favored benefits as independent contractors (e.g., employees could be allowed to establish their own retirement plan as if they were an independent contractor). Either approach would involve significant changes to present law and significant policy issues.

(3) Deductibility of business expenses.--Independent contractors have greater ability to deduct business expenses than employees, who generally can deduct such expenses only as an itemized deduction and only to the extent all miscellaneous itemized deductions (including employee business expenses) exceed two percent of adjusted gross income. This disparate treatment would need to be addressed.[886]

[886] The Joint Committee staff has made other recommendations which, if adopted, would address the disparity of treatment of business expenses of employees and independent contractors, including repealing the individual alternative minimum tax (Section II.A. of this Part, above), repealing the overall limitation on itemized deductions (Section II.C. of this Part, above), and repealing the two-percent floor on itemized deductions (Section I.F. of this Part, above).

B. Structural Issues Relating to Determination of Individuals Subject to Self-Employment Tax

Present Law

In addition to Federal income tax, a tax is imposed on the wages of an individual received with respect to his or her employment under the Federal Insurance Contributions Act (the Social Security tax).[887] Similarly, a tax is imposed on the self-employment income of an individual under the Self-Employment Contributions Act (the self-employment tax).[888]

In the case of an individual with self-employment income, the income subject to self-employment tax is the net earnings from self-employment. This means the gross income derived by an individual from any trade or business carried on by the individual, less the deductions attributable to the trade or business that are allowed under the self-employment tax rules. If the individual is a partner in a partnership, the net earnings from self-employment generally include his distributive share (whether or not distributed) of income or loss from any trade or business carried on by the partnership. Specified types of income or loss are excluded from net earnings from self-employment of a partner, such as rentals from real estate in certain circumstances, dividends and interest, gains or loss from the sale or exchange of a capital asset or from timber, certain minerals, or other property that is neither inventory nor held primarily for sale to customers, and retirement payments from the partnership if the partner rendered no services for the partnership and certain other requirements are met.

A special rule applies for limited partners of a partnership. In determining a limited partner's net earnings from self-employment, an exclusion is provided for his or her distributive share of partnership income or loss. The exclusion does not apply with respect to guaranteed payments to the limited partner for services actually rendered to or on behalf of the partnership to the extent that those payments are established to be in the nature or remuneration for those services.

The self-employment tax rate has two components. Under the old-age, survivors, and disability insurance component, the rate of tax is 12.40 percent. Under the hospital insurance component, the rate is 2.90 percent. Self-employed individuals may deduct one-half of self-employment taxes for income tax purposes.[889]

The amount of self-employment tax under the old-age, survivors, and disability insurance component is capped at $80,400 of self-employment income (for 2001). However, the hospital insurance component is not capped. Thus, the hospital insurance component applies regardless of the amount of the individual's self-employment income.

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[887] *See* Chapter 21 of the Code.

[888] Sec. 1401.

[889] This deduction reflects the fact that the self-employment tax rates are the aggregate of the Social Security tax rates; one-half of the Social Security tax is imposed on the employer, and one half is imposed on the employee.

Limited liability companies, a relatively new form of business entity provided under State law, generally are classified as partnerships rather than as corporations, for Federal income tax purposes. The owners of a limited liability company that is classified as a partnership for tax purposes are treated as partners for Federal income tax purposes. However, under State law, limited liability company owners are not defined as either general partners or limited partners.

In 1997, the Treasury Department issued proposed regulations defining a limited partner for purposes of the self-employment tax rules.[890] These regulations provided, among other things, that an individual is not a limited partner if the individual participates in the partnership business for more than 500 hours during the taxable year. In response, in the Taxpayer Relief Act of 1997, the Congress imposed a moratorium on regulations regarding employment taxes of limited partners. The moratorium provided that any regulations relating to the definition of a limited partner for self-employment tax purposes could not be issued or effective before July 1, 1998. No regulations have been proposed or finalized.

Analysis

The reference in the self-employment tax rules to "limited partners" has given rise to interpretive issues and uncertainty, due to the increase in utilization of limited liability companies. Limited liability companies are generally treated as partnerships -- and their owners as partners -- for Federal income tax purposes. Nevertheless, limited liability company owners are neither general nor limited partners under applicable State law. Applying this provision of the tax law that refers specifically to limited partners to limited liability company owners has created difficult questions of interpretation, creating complexity for both taxpayers and tax administrators.

In the absence of regulations following the termination of the moratorium in 1998, it has been suggested that some additional clarification be provided as to the scope of the reference to limited partners in the self-employment tax rules. For example, it has been suggested that a partner's income from a partnership could be treated as labor income subject to the self-employment tax if the partner provides personal services to the partnership in excess of a certain number of hours per year.[891]

Quantifying the proper amount of compensation for personal services is an inherently factual inquiry. Voluminous litigation has resulted in a large body of case law on whether

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[890] Prop. Treas. Reg. sec. 1.1402(a)-2 (January 13, 1997).

[891] The American Institute of Certified Public Accountants has proposed this type of approach to modernize the self-employment tax reference to limited partners in section 1402(a)(13). *See* Letter of David A. Lifson, Chair, Tax Executive Committee of the American Institute of Certified Public Accountants, to the Honorable William V. Roth, Chairman, Senate Committee on Finance, dated June 22, 2000, enclosing such a recommendation originally made by letter dated July 6, 1999. The American Institute of Certified Public Accountants proposal would provide that if the partner works less than a minimum number of hours in the partnership's business, none of his income would be treated as subject to the self-employment tax.

amounts are properly characterized as compensation for personal services, or as something else, such as a dividend (income from capital). It is argued that a mechanical hours-of-service-per-year rule would be simple, at least to the extent of avoiding the complexity and litigation potential of a rule that simply refers to a reasonable amount of income from personal services. A test based on a minimum number of hours of personal service for the partnership would serve to distinguish those partners who have labor income and should be subject to self-employment tax from those partners whose income from the partnership is not in any significant part labor income from their own personal services, and therefore should not be subject to self-employment tax.

A simple hours-per-year approach could, however, be criticized as not taking into account income that is actually from capital contributed by the partner to the partnership, and not from the personal services of the partner. To address this criticism, it has been suggested that defining the income from personal services (i.e., labor income) could be accomplished by identifying what is not labor income, and defining any excess as labor income. For example, a reasonable return on capital contributed to the business by a partner could be treated as an amount that is not labor income, and any income of the partner from the partnership that exceeds this level of return could be defined as labor income.[892] This type of approach depends on how a reasonable rate of return on capital is defined. It could be based, for example, on the rate of return on a percentage or multiple of the applicable Federal rate, as defined under present law. While this approach may in some cases more accurately take account of a partner's return on capital, it may not represent the simplest and most direct approach. Inevitable factual disputes would arise in cases when the partner's actual return from capital was demonstrably different from the applicable Federal rate or other assumed rate of return. The administration of a rule carving out a presumed rate of return rather than just determining whether or not the partner worked a minimum number of hours would arguably be more complex, not simpler.

Furthermore, it could be argued that merely defining the partners who are subject to the self-employment tax leaves a gap in the rules, and does not fully address the complexity arising from present law. This complexity arises because there is not a consistent rule that applies to income from the personal services of a business owner.[893] Because the self-employment and Social Security taxes apply more broadly to income from personal services performed by sole proprietors and S corporation owners, as well as partners, some concern for consistency arguably should be taken into account in attempting to determine a simple rule for when a person has income from a business activity that is subject to self-employment tax. For example, it might be simple to apply a minimum-hours-per-year test to determine whether any individual taxpayer is subject to either self-employment or Social Security tax on income from his business (regardless

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[892] The American Institute of Certified Public Accountants proposal, *supra*, would provide that a limited liability company owner's income would be treated as subject to the self-employment tax, except for a defined rate of return on his capital in the partnership.

[893] Under present law, sole proprietors are subject to self-employment taxes on all net earnings from self employment, limited partners are subject to self-employment taxes only on guaranteed payments for personal services, and S corporation shareholder-employees are subject to Social Security taxes.

of whether he is a limited or a general partner or owns the business in some other form, such as an S corporation). This would address some of the inconsistency in present law among business owners who have personal service income with respect to the business. A broad, sweeping rule of this type, however, could be criticized as changing the self-employment and Social Security tax bases far beyond the original simplification impetus to modernize references to "limited partners" in the Code. Such a rule may represent a far greater structural change in the tax law and policy than may be merited only by simplification.

In addition, it could be argued that other approaches would much more directly eliminate the complexity of the self-employment tax rules. Increased pressure on the determination of whether a limited partner -- or indeed any business owner -- is subject to the self-employment tax was created by the elimination on the income cap on the hospital insurance component of the tax. Without the cap, more income is subject to the tax. The difficult policy and technical issues that are raised by an approach based on the number of hours worked per year could be avoided, it is argued, if the hospital insurance component of the tax were again capped so that its impact were significantly limited compared to present law. Others might argue that more dramatic simplification could be achieved by eliminating the both the self-employment and Social Security taxes altogether. The amount of tax could be recouped by increasing the rate of tax under the Federal income tax, if needed. These types of ideas represent relatively significant structural changes to the tax law that would necessitate accompanying policy determinations going beyond pure simplification. As a result, because either consistently simple rules, or comprehensive simplification, would require significant policy shifts, no recommendation is provided in this area.

XVI. COMPLIANCE AND ADMINISTRATION PROVISIONS

A. Structural Issues Relating to Alternate Return Filing Systems

Present Law

Individuals whose income exceeds specified levels must file income tax returns each year. Generally, these returns must be filed by April 15, unless the taxpayer receives an extension of time to file.

Information reports are prepared on wages, many other income items (such as interest and dividends), and some deductions (such as mortgage interest). These reports are generally required to be furnished to the taxpayer by January 31; the copy for the Internal Revenue Service (IRS) generally must be furnished by the last day of February, except that electronically filed information reports generally must be furnished by March 31.[894] The copy for the IRS generally is furnished on magnetic media.[895] The IRS generally does not begin to process these information reports until several months after it receives them.

The Secretary of the Treasury is required to develop procedures for the implementation of a return-free tax system under which appropriate individuals could comply with the requirements of the Code without filing a tax return, for taxable years beginning after 2007.[896] In addition, the Secretary must provide interim progress reports to the Congress.[897]

Analysis

In general

Some observers have advocated consideration of alternate return filing systems for individuals. There are two basic models that have been discussed. Under one model, taxpayers who meet certain criteria (relating to the complexity of their returns) would be offered the option of not filing an income tax return (hereafter referred to as the "no return" model). Instead, the IRS would prepare the return and compute the tax liability of the taxpayer. The IRS would do

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[894] Sec. 6071(b).

[895] Sec. 6011(e). For the 1998 fiscal year, the IRS received approximately 97 percent of information returns on magnetic media, diskette, or electronically; the remaining 3 percent of information returns were filed on paper. *1998 IRS Data Book*, table 32 (Pub. 55B; August 2000). Wage information is furnished to the Social Security Administration, which compiles the information and forwards it to the IRS. Approximately one-third of all wage information is given to Social Security on magnetic media.

[896] Sec. 2004 of the Internal Revenue Service Restructuring and Reform Act of 1998 (Pub. Law No. 105-206), July 22, 1998.

[897] The first report, which was required to be submitted to the Congress by June 30, 2000, has not yet been submitted.

this using wage reports[898] currently filed with the Social Security Administration and information reports[899] currently filed with the IRS. The IRS would send the taxpayer a report stating the Service's calculation of the taxpayer's tax liability. The taxpayer would be free to challenge the Service's calculation of tax. The second model would modify the tax system so that a taxpayer's ultimate tax liability is withheld from income payments so that no tax return must be filed (hereafter referred to as the "exact withholding" model). There are also a number of variants of these two basic models.

Extent of restructuring of Internal Revenue Code

"No return" model

In general, it might be possible to implement a system based on the "no return" model under the present general structure of the Internal Revenue Code. If, however, the Code were simplified by eliminating deductions and credits, a greater percentage of taxpayers would be able to participate in this system. Acceleration in the submission of information reports by businesses and in the processing of those reports by the IRS and SSA would likely be necessary.

"Exact withholding" model

Implementation of a system based on this model could require significant changes to the basic structure of the Internal Revenue Code. One issue is the taxation of wages. A large number of Americans work for more than one employer (either simultaneously or serially) during a calendar year. Unless all the wage income of an individual utilizing the "exact withholding" method is taxed at one rate (or entirely exempt from tax), the employer would have to know the employee's wages and wage withholding from the employee's other jobs in order to correctly withhold the proper amount of tax.[900] Some observers believe that taxpayers would consider this an unwarranted intrusion into their personal privacy. Accordingly, withholding on wages might need to be done at one flat rate for taxpayers participating in a system based on the "exact withholding" model. This could mean that the degree of progressivity and width of the rate brackets in the tax rate structure would need to be altered. Another issue is the treatment of other items of income, such as interest and dividends. One option would be to impose withholding on all payments of interest and dividends.[901] Another option would be to exclude

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[898] In general, these are filed on Form W-2.

[899] In general, these are filed on Form 1098 and the Form 1099 series.

[900] For example, consider a hypothetical rate structure where the first $20,000 of income is taxed at a 10 percent rate, and income above $20,000 is taxed at a 15 percent rate. If an employee has two jobs serially in the calendar year, each of which pays $15,000, employer #2 would need to know the amount of wages paid by employer #1 in order to correctly compute the amount of withholding. Computation difficulties increase if the employee holds multiple jobs simultaneously.

payments of interest and dividends from income, either entirely or up to a specified dollar threshold. Some observers might, however, view this change as moving the tax system away from a broad-based income tax and toward a more narrowly-based tax on wages.

Taxpayers eligible to participate

In general

Alternate return filing systems, in general, would be available only for individuals. Other taxpayers, such as corporations, estates, and trusts, would not be able to participate because the information reporting sources available to the IRS are not sufficiently comprehensive to inform the IRS of the information on most lines of those returns. In addition, only certain categories of individuals with relatively simple returns would be eligible to participate; individuals who are self-employed would generally not be eligible to participate. The precise characteristics of those individuals are dependent upon the system chosen.

"No return" model

Implementation of a system based on the "no return" model is dependent upon the IRS having the information necessary to compute the taxpayer's correct tax. Under present law, the information reporting system requires third parties (such as employers and banks) to provide information to the IRS[902] on a number of types of payments. That system is not, however, comprehensive. With respect to income, coverage is broad. Accordingly, wages, interest, and dividends are generally reported, whereas coverage is not as broad for capital gains items[903] or the income of independent contractors. With respect to deductions, there are significant areas, such as charitable contributions, where no information reporting is required.[904] Thus, for example, taxpayers claiming deductions for charitable contributions would not be eligible for full participation in a system based on the "no return" model. Very generally, employees with

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[901] Withholding at a rate of 10 percent was imposed on interest and dividend payments by secs. 301-308 of the Tax Equity and Fiscal Responsibility Act of 1982 (Pub. Law No. 97-248, Sept. 3, 1982), but was repealed prior to being fully implemented (sec. 102 of the Interest and Dividend Tax Compliance Act of 1983, Pub. Law No. 98-67, Aug. 5, 1983).

[902] In fiscal year 1998, 1.153 billion information return documents were submitted to the IRS. *1998 IRS Data Book*, table 32 (Pub. 55B; August 2000).

[903] Sec. 6045 requires gross proceeds reporting on many items of capital gain income, but does not require the reporting of tax basis. Accordingly, the IRS can check that transactions are reported but cannot automatically compute the amount of gain or loss of each transaction.

[904] No deduction is allowed for any contribution of $250 or more unless the taxpayer substantiates the contribution by a contemporaneous written acknowledgment of the contribution by the donee organization. Sec. 170(f)(8). These receipts do not constitute information reports, however, in that they are not automatically provided by the donee organization directly to the IRS; instead, they are furnished to the donor, who must provide them to the IRS upon request.

interest and dividend income but no other types of income would be eligible to participate, whereas others would not (absent a widespread expansion of the information reporting system).

In general, the simpler the taxpayer's return, the more easily that taxpayer could participate in a system based on the "no return" model. Under the present Internal Revenue Code, taxpayers who file Form 1040EZ, the simplest form, would generally be able to participate. Additionally, many taxpayers who file Form 1040A would be able to participate.

Many taxpayers filing Form 1040 would not be able to participate, particularly if they used, for example, Schedule A (Itemized deductions), Schedule C (Profit or loss from a business or profession), Schedule D (Capital Gains and losses), Schedule E (Supplemental Income and loss), or Schedule F (Farm income and expenses). A taxpayer who filed Form 1040 solely because interest or dividends exceeded $400[905] would, however, be able to participate in a system based on the "no return" model. For fiscal year 1998, 21 million Forms 1040EZ were filed, 22.7 million Forms 1040A were filed, and 71.2 million Forms 1040 were filed.[906]

"Exact withholding" model

In general, employees with wage income who do not itemize their deductions could participate in a system based on the "exact withholding" model. Whether participants could also have other items of income, such as interest and dividends, would be dependent upon the policy decisions made in implementing the system (see discussion above).

Administrative issues

"No return" model

For a system based on the "no return" model to be acceptable to taxpayers, the IRS generally would need to inform taxpayers of their tax liability by April 15, and pay refunds soon thereafter. To accomplish this, the IRS would need to process information returns and the Social Security Administration would need to process wage reports early in the calendar year (prior to April 15). This would be significantly earlier in the year than these reports are currently processed.

The IRS generally would need to process every information return and the Social Security Administration would need to process every wage report early in the calendar year, despite the fact that not all taxpayers would be eligible to participate in this system. Every report would need to be processed before the IRS was certain that it had all the information necessary to implement this system for those taxpayers participating, even though this would mean that reports relating to taxpayers not participating in this system would be processed more rapidly

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[905] This is done on Schedule B.

[906] *1998 IRS Data Book*, table 2 (Pub. 55B; August 2000).

than might be otherwise necessary.[907] This processing would need to be done at the same time that the IRS is receiving and processing tax returns from taxpayers not participating in this system. It would appear that the IRS and the Social Security Administration would need significant additional computer capacity in order to implement this system. Because of the rapidity with which this information would need to be processed, it might be desirable or necessary for IRS to process wage reports and compile the information for Social Security, rather than the reverse, which occurs presently.

The most significant costs of implementing this type of system would generally be the costs of additional computer capacity and programming. Thus, these costs would generally be fixed, regardless of the percentage of taxpayers who could participate. Consequently, this system would be more cost-effective if more taxpayers could participate. As a result, it may not be advantageous to implement this type of system unless a certain minimum percentage of taxpayers are eligible to participate.

"Exact withholding" model

Issues may arise as to how the IRS will verify the correctness of information underlying the computation of tax. Consider, for example, exemptions for dependents. Under present law, taxpayers must provide the TIN of each dependent in order to claim an exemption for that dependent. The IRS utilizes this information to ensure that claims for dependents are not improperly made. Under an "exact withholding" model (assuming that the deduction for dependents is preserved), the employee would provide that information to the employer. Mechanisms to transmit that information to the IRS for verification and to ensure that the employee is not claiming the same dependents with multiple employers would have to be developed.

The "exact withholding" model requires that the entity doing the withholding (generally, the employer) know sufficient information about the taxpayer in order to correctly compute the amount to be withheld, such as information about marital status and dependents. Some observers believe that requiring employees to provide this information to employers could be viewed by potential participants as an unwarranted intrusion into their privacy, which could affect the willingness of individuals to participate in the system.

The "exact withholding" model would require significant changes in the wage withholding system. For example, Form W-4 would need to include more detail than is currently provided, such as information on dependents. In addition, changes to information currently provided (such as marital status) would need to be made immediately (which is often not necessary under present law). These changes would generally impose additional responsibilities on employers. The "exact withholding" model can be viewed as shifting some of the burdens and costs of complying with the tax system away from individuals and onto employers. Some observers believe that any shifting of this burden onto employers is inappropriate.

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[907] More rapid processing of this information could also facilitate the examination and audit of returns of under this system. This could be an ancillary compliance benefit of this system.

B. Structural Issues Relating to Judicial Proceedings in Federal Tax Cases

Present Law

Federal tax jurisdiction--in general

Taxpayers who disagree with an IRS determination in a tax controversy have three different courts (the U.S. Tax Court, a U.S. district court, or the U.S. Court of Federal Claims) in which to resolve their dispute. The particular court in which a taxpayer may file a claim varies depending on whether the taxpayer has paid the tax in dispute and filed a claim for refund. In addition, special rules apply to particular types of actions.

If a taxpayer receives a notice of deficiency in which the IRS asserts that the taxpayer's tax is greater than the amount shown on the tax return, the taxpayer can file a petition in the U.S. Tax Court[908] without paying the deficiency asserted by the IRS.[909] If a taxpayer has paid a tax and has been denied a claim for refund, a suit for refund of the tax can be commenced in either an appropriate U.S. district court[910] or the U.S. Court of Federal Claims. A jury trial is available in a U.S. district court, but not in the U.S. Tax Court or the U.S. Court of Federal Claims.[911]

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[908] The U.S. Tax Court is the successor to the Tax Court of the United States and the Board of Tax Appeals (the Board of Tax Appeals was an agency within the Executive Branch). Since the Board's creation, it has developed into a court under Article I of the U.S. Constitution.

[909] The U.S. Tax Court generally has jurisdiction to redetermine the amount of a deficiency to income, estate, gift, generation-skipping transfer, and certain excise taxes. The U.S. Tax Court also has jurisdiction to determine overpayments and order refunds in proceedings to redetermine a notice of deficiency. Sec. 6512(b). In the U.S. Tax Court, if a case is filed for a redetermination of a deficiency and neither the amount in dispute nor the amount of any claimed overpayment exceeds $50,000 for any one taxable year, then the taxpayer has the option of having the case conducted under the small tax case procedures. The small tax case procedures are designed to simplify litigation of tax cases and reduce the costs associated with litigation. Decisions in such cases may not be appealed, and may not be treated as precedent for any other case. (Sec. 7463.)

The U.S. Tax Court also has jurisdiction to redetermine employment tax status and the proper amount of employment tax under such determination. (Sec. 7436.)

[910] A refund action may be brought: (1) in a district where the plaintiff resides, or (2) if a corporation, in the district in which is found the corporation's principal place of business. If the corporation has no principal place of business, then such action may be brought in the district where the return was filed. If no return was filed, then such action may be brought in the U.S. District Court for the District of Columbia. 28 U.S.C. sec. 1402(a).

[911] 28 U.S.C. secs. 1331, 1340, and 1491. The judges of the U.S. Court of Federal Claims shall hold hearings, if convenient, in the counties where the witnesses reside. 28 U.S.C. sec. 2503(c).

The regional U.S. courts of appeals[912] have exclusive jurisdiction to review decisions of the U.S. Tax Court to the same extent as such courts have jurisdiction to review decisions of the U.S. district courts in civil actions tried without a jury.[913] Venue for purposes of determining in which court to appeal a U.S. Tax Court decision generally is determined based on the residence of the petitioner.[914]

The regional U.S. courts of appeals also have jurisdiction to review decisions of the U.S. district courts. Appeals from district courts generally are taken to the U.S. court of appeals for the circuit in which the district is located.[915] The U.S. Court of Appeals for the Federal Circuit has exclusive jurisdiction over an appeal from a final decision of the U.S. Court of Federal Claims.[916]

The judgment of a U.S. court of appeals is subject to review by the Supreme Court of the United States, upon certiorari.[917] A Federal tax case may not be brought in a State court, because State courts do not have jurisdiction to hear a claim arising under the Federal tax laws.[918]

Partnership proceedings

Prior to payment of tax, the U.S. Tax Court has jurisdiction to review a notice of final partnership administrative adjustment. A petition in such a case may be filed by the tax matters partner within 90 days of the date of the notice of final partnership administrative adjustment or by other partners within the next 60 days.[919] Such a case may be brought in a U.S. district court

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[912] Reference to regional U.S. courts of appeals includes the U.S. Court of Appeals for the First through Eleventh circuits and U.S. Court of Appeals for the District of Columbia Circuit.

[913] Sec. 7482.

[914] It is unclear under present law where an estate should properly file an appeal from a decision of the U.S. Tax Court. See sec. 7482(b); *Estate of Clack v. Commissioner*, 106 T.C. 131 (1996) (unclear if appellate venue of an estate tax case is based, for example, on the residence of the decedent or the residence of the estate's representative).

[915] 28 U.S.C. sec. 1294(1).

[916] 28 U.S.C. sec. 1295(a)(3).

[917] Sec. 7482(a)(1); 28 U.S.C. 1254.

[918] 28 U.S.C. sec. 1340 (U.S. district courts have original jurisdiction of claims arising under the Internal Revenue Code); see also secs. 7441-7475 for the jurisdiction of the U.S. Tax Court.

[919] Sec. 6226.

or the U.S. Court of Federal Claims only if an amount equal to the proposed adjustment is deposited.[920]

If tax has already been paid, the U.S. Tax Court, U.S. district courts, and U.S. Court of Federal Claims each have jurisdiction to review any part of an administrative adjustment request that has been denied by the IRS. Such a case must be brought by the tax matters partner.[921]

Prior to payment of tax, the U.S. Tax Court has jurisdiction to review a notice of partnership adjustment. Such a case must be brought by the partnership.[922] Such a case may be brought by the partnership in a U.S. district court or the U.S. Court of Federal Claims only if the partnership deposits (or attempts to deposit) the amount of the asserted tax liability, as a prerequisite to the court's jurisdiction.[923]

If tax has already been paid, the U.S. Tax Court, U.S. district courts, and U.S. Court of Federal Claims each have jurisdiction to review any part of an administrative adjustment request that has been denied by the IRS. Such a case must be brought by the partnership.[924]

Declaratory judgment proceedings

Declaratory judgments may be sought in a number of cases, most of which must be brought in the U.S. Tax Court.[925] The U.S. district courts and U.S. court of Federal Claims has jurisdiction concurrent with the U.S. Tax Court to issue declaratory judgments in Federal tax cases if there is an adverse determination or no determination regarding the initial or continuing status of an organization exempt from tax under sections 501(c)(3), private foundations under section 509(a), or private operating foundations under section 4942(j)(3).

Disclosure actions

After exhausting administrative remedies, a person may file a petition in the U.S. Tax Court or a complaint in the U.S. District Court for the District of Columbia for an order requiring

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[920] Sec. 6226(e)(1); 28 U.S.C. sec. 1346(e).

[921] Sec. 6228(a)(1)(A), (B), and (C); 28 U.S.C. secs. 1346(e), 1508.

[922] Sec. 6247(a)(1).

[923] Sec. 6247(a)(1) and (b).

[924] Sec. 6252(a)(1) and (2).

[925] These include cases to consider non-partnership items of an oversheltered return (sec. 6243); if there is an adverse determination or no determination regarding the initial or continuing qualification of certain retirement plans (sec. 7476); if there is a controversy regarding the value of a gift (sec. 7477); if there is a controversy regarding the status of a governmental obligation (sec. 7478); and to determine whether an estate qualifies for making installment payments of estate tax under sec. 6166 (sec. 7479).

the disclosure of the identity of any person who made a contact to the IRS before the issuance of a written determination.[926] A person who is the subject of an IRS written determination or who has a direct interest in such determination may, after exhausting administrative remedies, file a petition in the U.S. Tax Court for an order restraining disclosure of certain information contained in a determination.[927] There is no jurisdiction in such a case in a U.S. district court. Finally, after exhausting administrative remedies, a person who seeks additional disclosure may file a petition in the U.S. Tax Court or a complaint in the U.S. District Court for the District of Columbia for an order requiring additional disclosure.[928]

There is no jurisdiction over disclosure actions in the U.S. Court of Federal Claims.

Civil actions brought by the United States

The U.S. district courts have jurisdiction over the following cases brought by the United States: (1) if a U.S. officer or employee is injured while discharging his or her duties under the Code;[929] (2) if title is claimed by the United States to property from the enforcement of a lien under the Code;[930] (3) to enforce a lien, regardless of whether a levy has been made, when a taxpayer refuses to pay tax;[931] (4) to collect estate taxes (in a U.S. district court having jurisdiction over the property of the decedent) if an estate tax remains unpaid;[932] (5) to recover an erroneous refund if an erroneous refund has been made;[933] (6) to enjoin a preparer who has engaged in certain prohibited conduct;[934] (7) to enjoin promoters of abusive tax shelters;[935] and (8) to enjoin an organization exempt from tax under section 501(c)(3) from making flagrant political expenditures.[936]

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[926] Sec. 6110(d)(3). Such third-party contact may concern a request for written determination, the determination itself, or any other issue related to a determination.

[927] Sec. 6110(f)(3)(A).

[928] Sec. 6110(f)(4).

[929] Sec. 7402(c).

[930] Sec. 7402(e).

[931] Sec. 7403.

[932] Sec. 7404.

[933] Sec. 7405.

[934] Sec. 7407.

[935] Sec. 7408(a).

[936] Sec. 7409(a)(1).

Neither the U.S. Tax Court nor the U.S. Court of Federal Claims has jurisdiction over such civil actions brought by the United States.

Actions for damages brought by taxpayers

The U.S. district courts have jurisdiction over the following actions for damages brought by taxpayers: (1) if the IRS discloses taxpayer information in violation of section 6103;[937] (2) if the IRS knowingly or negligently fails to release a lien;[938] (3) an action for wrongful collection by the government;[939] (4) against any U.S. employee who intentionally compromises tax in exchange for information conveyed by the taxpayer to the representative employee;[940] and (5) against any person who willfully files a fraudulent information return with respect to payments purportedly made by such taxpayer.[941]

Neither the U.S. Tax Court nor the U.S. Court of Federal Claims has jurisdiction over such actions for damages brought by taxpayers.

Other collection actions

The U.S. district courts have jurisdiction over civil actions brought by persons other than the taxpayer. For example, an injunction or refund action may be sought by third parties in a U.S. district court in wrongful levy actions, surplus proceeds actions, actions for substituted sale proceeds, and actions for determinations of whether the government's interest is less than the value determined by the IRS.[942] There is no jurisdiction over such cases in the U.S. Tax Court or the U.S. Court of Federal Claims.

A taxpayer may bring an action for review of jeopardy assessment or levy procedures. Such an action generally must be brought in a U.S. district court; however, if there is a case pending in the U.S. Tax Court, then the U.S. Tax Court may review the related jeopardy assessment levy procedures.[943] There is no jurisdiction over such cases in the U.S. Court of Federal Claims.

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[937] Sec. 7431.

[938] Sec. 7432.

[939] Sec. 7433.

[940] Sec. 7435.

[941] Sec. 7434.

[942] 28 U.S.C. 1346(e).

[943] Sec. 7429(b)(2)(A) and (B).

Analysis

In general

The Joint Committee staff has not recommended modifying the present-law rules regarding court jurisdiction over Federal tax cases because the balancing of the relative advantages and disadvantages of the present-law rules involves basic policy choices as to how taxpayers can litigate against the Government that have implications beyond the Federal tax system.

The choices available to taxpayers under present law have developed over more than two centuries. The U.S. district courts were created shortly after ratification of the U.S. Constitution to provide a uniform, nationwide judicial body. The U.S. Tax Court was created in the twentieth century, developing from an administrative body into a court, to provide taxpayers with a pre-payment opportunity to resolve their disputes with the IRS. The Court of Federal Claims was created to resolve monetary claims against the Federal government; a claim for refund of taxes paid is treated no differently than other monetary claims against the Federal government.

Complexities presented by overlapping jurisdiction

Forum shopping

The present system of Federal court jurisdiction over Federal tax cases may promote "forum shopping," which is the selection of a court based on the possible outcome or more favorable procedural rules in that particular court.[944] In the Federal tax case context, "forum shopping" is a taxpayer's ability to have a case heard in the U.S. Tax Court, a U.S. district court, or the U.S. Court of Federal Claims based solely on where the taxpayer believes the case will fare best. For example, if a taxpayer finds favorable authority in the U.S. Court of Federal Claims or U.S. Court of Appeals for the Federal Circuit, then the taxpayer will ensure that the case is heard in the first instance in the U.S. Court of Federal Claims by first paying the tax, filing a claim for refund with the IRS (which would be denied), and filing a claim in the U.S. Court of Federal Claims.

Cases that originate in either the U.S. Tax Court or a U.S. district court, however, generally would be heard by the taxpayer's regional home U.S. court of appeals. Thus, taxpayers choosing between the U.S. Tax Court and a U.S. district court generally have limited ability to forum shop, because, ultimately, the same U.S. court of appeals would hear any appeal of the case.[945]

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[944] For a discussion of "forum shopping," *see, e.g., Hanna v. Plumer,* 380 U.S. 460, 467 (1965).

[945] Appellate jurisdiction of cases that originate in the U.S. Tax Court or a U.S. district court can differ. For example, in an in rem action to enforce a Federal tax lien, venue may be proper in a district in which the taxpayer's property can be found. The taxpayer may reside in one district and his or her property may be in another district, both of which may be in difference appellate circuits. However, U.S. district court venue in a refund action generally is where the

In addition to the limited ability to choose the underlying substantive law of a particular lower court or court of appeals, different procedural rules of the various courts may influence a taxpayer's choice of court to hear a potential case. A taxpayer may consider many procedural factors in selecting a forum, which include the pleading, discovery, and evidence rules of each court. In addition, the opposing party may differ depending on the court: the IRS is represented by IRS counsel in the U.S. Tax Court, whereas the government is represented by the U.S. Department of Justice in a district court or the U.S. Court of Federal Claims. Taxpayers also may be able to select or avoid particular judges by choosing one forum over another.

Forum shopping can create complexity in the administration and substantive interpretation of Federal tax laws. By providing a choice of forum to taxpayers, outcomes of Federal tax cases can vary depending on the court that has heard a case. For example, if a taxpayer has chosen a particular forum solely based on favorable substantive rulings of such forum, then the decision in the case may have been different because of that selection of forum. Moreover, if a taxpayer wants a jury to hear the case, that also may affect the outcome of the case. Furthermore, if the rules of a particular court favor a taxpayer's litigation strategy, then the application of such rules could ultimately affect the outcome of a case.

Substantive differences

Taxpayers and the government may have to consider authority from several different courts when evaluating their cases. This occurs when, for example, the substantive law in one forum is different from the substantive law of another forum with respect an issue or issues in a particular case. To the extent a taxpayer cannot choose the substantive law of a particular forum prior to the start of litigation (because, e.g., the taxpayer may not reside in a particular circuit's region), such taxpayer may be subject to unfavorable law solely because of geographic location. Moreover, under the *Golsen* rule, the U.S. Tax Court will apply the law as decided by the U.S. court of appeals with jurisdiction over a potential appeal if that court of appeals has previously issued an opinion which is considered on point, notwithstanding the U.S. Tax Court's prior holdings or what the U.S. Tax Court otherwise may have decided absent the precedent of the particular U.S. court of appeals.[946] When this rule is invoked, substantive tax law may, in effect, not be applied uniformly within the U.S. Tax Court, depending on the location of the taxpayer. The government, likewise, may be advantaged or disadvantaged based on the substantive law of

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plaintiff resided, and appellate venue generally is with the U.S. court of appeals embracing the U.S. district court. (28 U.S.C. secs. 1294(1) and 1402(a).) Likewise, appellate venue in a U.S. Tax Court case generally is based on where the taxpayer resided. (Sec. 7483(b)(1)(A).)

For corporate taxpayers, U.S. district court venue (and, consequently, appellate court venue) generally is based on the taxpayer's principal place of business. (28 U.S.C. secs. 1294(1) and 1402(a).) Appellate venue in a U.S. Tax Court case likewise is generally based on the taxpayer's principal place of business. (Sec. 7482(b)(1)(B).) Thus, it would be difficult to forum shop between U.S. courts of appeals based on the underlying substantive tax claim, because, in most instances, the appellate venue would be the same.

[946] *See Golsen v. Commissioner,* 54 T.C. 742 (1970), *affd.* 445 F.2d 985 (10th Cir. 1971).

a particular forum. This may affect the government's position in a particular case or the development of rulings and guidance in general.

Advantages created by overlapping jurisdiction

Despite the complexity involved in determining which court should take a Federal tax case, it can be argued that such a system is useful in the determination of Federal tax controversies. When substantive law is considered by several different courts, the courts can bring different perspectives to their determinations, which can help in the development of the law. For example, the U.S. Court of Federal Claims and U.S. Court of Appeals for the Federal Circuit provides a national point of view with respect to the cases that those courts hear, as does the U.S. Tax Court (subject to the *Golsen* rule). By contrast, the U.S. district courts provide a local forum. The U.S. district courts also provide judges who are generalists, in contrast to the more specialized judges of the U.S. Tax Court or U.S. Court of Federal Claims. It can be argued that the availability of Federal tax jurisdiction in these courts can foster the shaping of Federal tax law by providing a broad range of views from Federal courts.

Proponents of the present-law regime for Federal tax court jurisdiction also may assert that the fact that taxpayers and practitioners need to be familiar with the rules of the several courts with Federal tax jurisdiction is a practical consequence of having a choice of where to litigate a case, rather than a burden on the system of Federal tax litigation in general.

Finally, it may be undesirable or impossible to consolidate all Federal tax litigation in one court. For example, many taxpayers prefer to have a pre-payment opportunity to litigate their Federal tax disputes, but there may be serious impediments to permitting that in either the U.S. district courts or the U.S. Court of Federal Claims. Similarly, there may be serious impediments to litigating criminal tax cases in a court other than the U.S. district court.[947] In addition, where the taxpayer's property is at issue in a Federal tax case, it may be more appropriate for a local U.S. district court (where the property is located), rather than a national court, to hear the case.

[947] For example, a jury is available in the U.S. district courts, but not in the U.S. Tax Court or U.S. Court of Federal Claims.

C. Penalties and Interest

Below is the executive summary of the recommendations of the Joint Committee staff with respect to penalties and interest that were published in its 1999 study.[948] Because the purpose of that set of recommendations was not exclusively simplification, some of the recommendations summarized do not relate to simplification. Nevertheless, for completeness, all of the recommendations of the 1999 study are summarized below.

Provisions of general applicability

- Provide one interest rate for both individual and corporate taxpayers. The rate, which would apply to both underpayments and overpayments of tax, would be the applicable Federal rate ("AFR") plus five percent.

- Exclude interest paid by the IRS from the income of individual taxpayers.

- Convert the present-law penalty for failure to pay estimated tax into an interest provision, increase the threshold at which taxpayers are subject to an interest charge for underpayment of estimated tax from $1,000 to $2,000, and allow both tax withheld and certain estimated tax paid throughout the year to be considered in determining whether the threshold has been met.

- Repeal the present-law penalty for failure to pay tax. If a taxpayer has not entered into an installment agreement with the IRS by the fourth month after assessment, then an annual 5-percent late payment service charge would apply. For those taxpayers who agree to an automated withdrawal of each installment payment directly from their bank account, the present-law $43 fee on installment agreements would be waived.

Interest

In addition to the recommendation to apply one interest rate contained in the provisions of general applicability, the Joint Committee staff recommends the following:

- Allow abatement of interest if gross injustice would otherwise result.

- Expand the circumstances in which interest may be abated to include periods attributable to any unreasonable IRS error or delay.

- Allow abatement of interest if the taxpayer is repaying an erroneous refund based on IRS calculations without regard to the size of the refund.

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[948] Joint Committee on Taxation, *Study of Present-Law Penalty and Interest Provisions as Required by Section 3801 of the Internal Revenue Service Restructuring and Reform Act of 1998 (Including Provisions Relating to Corporate Tax Shelters)* (JCS-3-99), July 22, 1999. The recommendations relating to corporate tax shelters are not reproduced here.

- Allow abatement of interest to the extent interest is attributable to the taxpayer's reliance on written statements by the IRS.

- Allow taxpayers to deposit amounts in a "dispute reserve account," a special interest-bearing account within the U.S. Treasury, which would stop the running of interest on tax underpayments and allow taxpayers to earn interest generally to the extent that a taxpayer's deposit is not applied to a tax underpayment.

Estimated tax

In addition to the recommendations to convert the present-law penalty for failure to pay estimated tax into an interest provision and to increase the threshold from $1,000 to $2,000, taking into account certain estimated tax payments, the Joint Committee staff recommends the following:

- Repeal the modified safe harbor that applies to individuals with adjusted gross income in the preceding taxable year in excess of $150,000. All taxpayers would be subject to the same safe harbor, which would require that estimated payments be made based on either 90 percent of current year's tax or 100 percent of prior year's tax.

- Provide only one interest rate per underpayment period.

- Change the definition of "underpayment" to allow existing underpayment balances to be used in underpayment calculations for succeeding estimated tax payment periods.

- Require taxpayers to use a 365-day year for all estimated tax underpayment calculations, regardless of whether the taxable year is a leap year.

Accuracy-related penalties

- Raise the minimum standards for undisclosed positions for both taxpayers and tax preparers such that, for each undisclosed position on a tax return, the taxpayer or tax preparer must reasonably believe that the tax treatment is "more likely than not" the correct tax treatment under the Code. Under present law, to avoid a penalty, taxpayers must have substantial authority for an undisclosed position, and, for tax preparers, the undisclosed position must have a realistic possibility of being sustained on the merits.

- Raise the minimum standards for disclosed positions for both taxpayers and tax preparers such that, for each disclosed position on a tax return, there must be at least substantial authority. Under present law, to avoid a penalty, taxpayers must have a reasonable basis for a return position and disclose the position (and it must not relate

to a tax shelter item), and, for tax preparers, the disclosed position must not have been frivolous (applies to tax shelter and non-tax shelter items).

- Change the preparer penalty from a flat $250 per occurrence to $250 or 50 percent of the tax preparer's fee, whichever is greater, for first-tier violations (i.e., preparation of a return with a position that does not meet the above-described recommended minimum preparer standards), and change the preparer penalty from a flat $1,000 per occurrence to $1,000 or 100 percent of the preparer's fee, whichever is greater, for second-tier violations (i.e., understatements that result from willful or reckless disregard of rules or regulations).

Pension penalty provisions

- Consolidate the Internal Revenue Code and ERISA penalties for failure to file Form 5500 series annual return/report, designate the IRS as the agency responsible for enforcement of reporting requirements, and reduce from three to one the number of government agencies authorized to assess, waive, and reduce penalties for failure to file Form 5500.

- Repeal the separate penalties for failure to file Schedules SSA and B and for failure to provide notification of plan status change; any such failure would constitute a failure to file a complete Form 5500.

Tax-exempt organization penalty provisions

- Clarify that the penalty imposed under section 6652(c)(2)(A), for failure to file annual trust information returns under section 6034, applies to a trust's failure to file Form 5227. Increase the penalty under section 6652(c)(2)(A), as applied to a trust's failure to file Form 5227, to that imposed by section 6652(c)(1)(A), which is $20 each day the failure continues, not to exceed the lesser of $10,000 or 5 percent of the organization's gross receipts.

- Recommend that the Congress consider whether it is appropriate to increase the penalty imposed under section 6652(c)(2)(A) for failure to file returns under section 6034 generally.

General administrative provisions

- Apply a higher standard of behavior to conduct by the IRS, similar to that which would be imposed on practitioners by the Joint Committee staff recommendations made elsewhere in the study.

- Require the IRS to publish, annually, statistics concerning the number of payments made and total amount paid out under section 7430 for taxpayers' reasonable administrative and litigation costs, as well as a summary of the administrative issues raised with respect to these payments and how these issues were resolved by the IRS.

- Require the IRS to improve the supervisory review of the imposition of penalties as well as their abatement in order to provide greater uniformity in penalty and interest administration and application.

- Require the IRS to develop better information systems in order to provide better statistical information on abatements and the reasons and criteria for abatements.

- Require the IRS to shorten significantly the current 45-day processing time for address changes.

- Require the IRS to establish administrative systems that assure that the proper representative of a taxpayer receives the proper notice directly from the IRS.

- Require the IRS to consider whether recent technological advances, such as e-mail and facsimile transmissions, permit the utilization of alternative means of communicating with taxpayers.

D. Disclosure of Returns and Return Information

Section 3802 of the Internal Revenue Service Restructuring and Reform Act of 1998 (the "IRS Reform Act") required the Joint Committee and the Department of the Treasury to conduct separate studies of the scope and use of provisions regarding taxpayer confidentiality and to report the findings of their studies, together with such recommendations as they deem appropriate, to the Congress not later than January 22, 2000. The studies were to examine: (1) the present protections for taxpayer privacy; (2) any need for third parties to use tax return information; (3) whether greater levels of voluntary compliance may be achieved by allowing the public to know who is legally required to file tax returns, but does not file tax returns; (4) the interrelationship of the taxpayer confidentiality provisions in the Code with such provisions in other Federal law, including section 552a of Title 5 of the United States Code (commonly referred to as the "Freedom of Information Act"); (5) the impact on taxpayer privacy of the sharing of income tax return information for purposes of enforcement of State and local tax laws other than income tax laws, including the impact on taxpayer privacy intended to be protected at the Federal, State, and local levels under the Taxpayer Browsing Protection Act of 1997;[949] and (6) whether the public interest would be served by greater disclosure of information relating to tax-exempt organizations described in section 501 of the Code.

The Joint Committee staff issued its report on January 28, 2000.[950] The Department of the Treasury issued its report regarding items one through five on October 2, 2000.[951] The following is a summary taken from the executive summaries of the Joint Committee staff's report. Recommendations that have been enacted since the publication of the Joint Committee staff report are so noted.

The purpose of the Joint Committee report was not exclusively simplification of the tax law relating to disclosure of returns and return information. As a result, some of the

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[949] Pub. Law No. 105-35 (1997).

[950] The Joint Committee staff issued a three-volume report. Joint Committee on Taxation, *Study of Present-Law Taxpayer Confidentiality and Disclosure Provisions as Required by Section 3802 of the Internal Revenue Service Restructuring And Reform Act of 1998, Volume I: Study of General Disclosure Provisions* (JCS-1-00), January 28, 2000. Joint Committee on Taxation, *Study of Present-Law Taxpayer Confidentiality and Disclosure Provisions as Required by Section 3802 of the Internal Revenue Service Restructuring And Reform Act of 1998, Volume II: Study of Disclosure Provisions Relating to Tax-Exempt Organizations* (JCS-1-00), January 28, 2000. Joint Committee on Taxation, *Study of Present-Law Taxpayer Confidentiality and Disclosure Provisions as Required by Section 3802 of the Internal Revenue Service Restructuring And Reform Act of 1998, Volume III: Public Comments and General Accounting Office Reports* (JCS-1-00), January 28, 2000.

[951] Department of the Treasury, *Report to Congress on Scope and Use of Taxpayer Confidentiality and Disclosure Provisions, Volume I: Study of General Provisions* (October 2, 2000).

recommendations summarized do not relate to simplification. Nevertheless, for completeness, all of the recommendations of that report are summarized below. Some of these recommendations can be considered to promote simplification by clarifying the application of Federal law to disclosure of returns and return information and improving the administration of the Federal tax system.

General Recommendations Relating to Section 6103

General recommendations relating to exceptions to section 6103

- The Joint Committee staff recommends that new access to returns and return information should not be provided unless the requesting agency can establish a compelling need for the disclosure that clearly outweighs the privacy interests of the taxpayer.

- The Joint Committee staff also recommends that the IRS continue to monitor disclosures under present law to ensure that the information provided is tailored to the needs of the recipient.

Coordination of section 6103 with other disclosure provisions

- The Joint Committee staff recommends that all provisions authorizing access to returns and return information should be contained in the Code.

Matters made part of the public record

- The Joint Committee staff recommends that returns and return information properly made a part of public records (i.e., court records and lien filings) pursuant to Federal tax administration activities should not be protected by section 6103.

Access to working law of the IRS

- The Joint Committee staff recommends that all final written legal interpretations issued to IRS employees should be made publicly available to the extent that such interpretations: (1) affect a member of the public; and (2) are issued by the IRS or the IRS Chief Counsel.

Application of the FOIA to returns and return information

- The Joint Committee staff recommends that it be should be clarified that 6103 preempts the FOIA as to returns and return information. Thus, section 6103 would be the sole means by which returns and return information can be requested. The Joint Committee staff further recommends that the FOIA administrative provisions and opportunity for de novo judicial review should be incorporated into section 6103.

Tax treaties and tax information exchange agreements

- For tax information that is not return information under section 6103, the Joint Committee staff recommends that it should be clarified that tax treaties qualify under exemption 3 of the FOIA and under section 6110(c)(3). Similarly, the Joint Committee staff recommends that it should be clarified that tax information exchange agreements, as authorized by the Code, qualify under exemption 3 of the FOIA and under section 6110(c)(3). Thus, information exchanged pursuant to tax treaties and

tax information exchange agreements would be protected from disclosure under the FOIA and section 6110 to the extent provided in such agreements. This recommendation was enacted as part of the Community Renewal Tax Relief Act of 2000.[952]

Application of the Privacy Act to returns and return information

- The Joint Committee staff recommends that it should be clarified that sections 6103 and 7431 preempt the Privacy Act with respect to the disclosure of returns and return information and the remedy for unauthorized disclosure.

Reforms of Current Exceptions Under Section 6103

Disclosure of collection activities with respect to a joint return

- The Joint Committee staff recommends amending section 6103(e)(8) to permit the IRS to honor oral requests from a former spouse (or an authorized representative of the former spouse) regarding joint return collection activities.

Clarification of the scope of section 6103(h)(1): investigation of taxpayer representatives

- The Joint Committee staff recommends clarifying that an IRS employee's official duties do not include determining whether a taxpayer's representative is current in his or her tax filing obligations merely because the taxpayer is under audit.

Disclosure of criminal investigation

- The Joint Committee staff recommends that IRS special agents should be required to identify themselves and the nature of their investigation when interviewing third parties.

Disclosure in judicial and administrative tax proceedings

- The Joint Committee staff recommends that when nonparty taxpayer returns and return information are to be disclosed pursuant to section 6103(h)(4)(A)-(C), the taxpayer should be given notice prior to the disclosure. The Joint Committee staff further recommends that only the portions of a nonparty return or return information that directly relate to the resolution of an issue in the proceeding should be disclosed in such proceeding. Finally, the Joint Committee staff recommends that the nonparty taxpayer should be given an opportunity to participate in the reduction process.

Investigative disclosure authority

- The Joint Committee staff recommends that section 6103(k)(6), regarding investigative disclosure authority, should be clarified to include personnel of the Office of the Treasury Inspector General for Tax Administration. This recommendation was enacted as part of the Community Renewal Tax Relief Act of 2000.[953]

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[952] Pub. Law No. 106-554, H.R. 5662 sec. 304 (2000).

[953] Pub. Law No. 106-554, H.R. 5662 sec. 313 (2000).

Information related to offers in compromise

- The Joint Committee staff recommends that the IRS should not disclose the taxpayer identification number and street address of taxpayers who are parties to accepted offers in compromise.

Refund offset disclosures

- The Joint Committee staff recommends the repeal of section 6103(m)(2), relating to the Federal debt collection refund offset program, as the usefulness of this provision has been superceded by the Treasury Offset Program.

Disclosure to contractors

- The Joint Committee staff recommends that States receiving returns and return information should be required to: (1) conduct annual on-site safeguard reviews of all their contractors (if the duration of the contract is less than one year, a review would be conducted mid-way through the duration of the contract); and (2) submit the findings of such reviews to the IRS as part of their annual safeguard activity report, along with a certification that their contractors are in compliance with all safeguard restrictions. The certification should include the name of each contractor, a description of their contract responsibility, and the duration of the contract.

- The Joint Committee staff recommends that the present-law disclosure rules for using contractors for nontax administration purposes should not be expanded.

Consent to authorize disclosure to third parties

- The Joint Committee staff recommends that the Code should prohibit a third party from requesting the execution of a consent that does not designate a recipient. The Joint Committee staff also recommends that the Code should prohibit a third party from requesting a taxpayer to execute a consent that will not be dated by the taxpayer at the time of execution.

- The Joint Committee staff recommends that all third parties, governmental or otherwise, receiving returns and return information under section 6103(c) should be required to: (1) ensure that the information received will be kept confidential; (2) use the information only for the purpose for which it was requested; and (3) not further disclose the information except to accomplish that purpose, unless a separate consent from the taxpayer is obtained.

Statistical disclosure authority for the Federal Trade Commission

- The Joint Committee staff recommends the repeal of the provision authorizing disclosures to the Federal Trade Commission for statistical purposes, as this information is no longer needed.

Unauthorized disclosure

- The Joint Committee staff recommends that the IRS notify the taxpayer at the time the Treasury Inspector General for Tax Administration administratively determines that the taxpayer's returns or return information have been unlawfully accessed or

disclosed (rather than at the time of criminal indictment). In addition, the Joint Committee staff recommends that the IRS should provide, as part of its present-law public annual report to the Joint Committee, information regarding unauthorized disclosure and inspection of returns and return information. This information should include the number, status, and results of: (1) administrative investigations; (2) civil lawsuits brought under section 7431 (including settlement amounts or damages awarded); and (3) criminal prosecutions.

Public disclosure of nonfilers

- The Joint Committee staff does not recommend the publication of the identities of nonfilers by the Federal government at this time. In addition, the Joint Committee staff recommends that States provide updated information to the Congress on their programs to publicize delinquent taxpayers.

Recommendations relating to undelivered refunds

- The Joint Committee staff recommends that it be clarified that the IRS is able to notify taxpayers of undelivered refunds via any means of mass communication, including the Internet.

Joint Committee Staff Disclosure Recommendations Regarding Tax-Exempt Organizations

Disclosure of IRS materials

- The Joint Committee staff recommends that all written determinations (and background file documents) involving tax-exempt organizations should be publicly disclosed. In general, the Joint Committee staff recommends that such disclosure should be made without redactions.

- The Joint Committee staff recommends that the IRS disclose the results of audits of tax-exempt organizations. In addition, the Joint Committee staff recommends that all closing agreements with tax-exempt organizations should be disclosed. In general, the Joint Committee staff recommends that such disclosures should be made without redaction.

- The Joint Committee staff recommends that applications for exempt status (and supporting documents) should be disclosed when the application is made. In addition, the Joint Committee staff recommends that any action taken on the application should be disclosed.

- The Joint Committee staff recommends that rules similar to the disclosure rules that apply to third party communications under section 6110 should be applied to third party communications relating to written determinations and exemption applications subject to disclosure under section 6104.

- The Joint Committee staff recommends that the taxpayer identification number of tax-exempt organizations should not be subject to disclosure.

Form 990 and related forms

- The Joint Committee staff recommends that the Form 990 and related forms: (1) should be accepted by the IRS for electronic filing for returns filed after 2002; and (2) should be revised to ensure that the forms provide relevant and comprehensible information to the public as well as the IRS.

- The Joint Committee staff recommends that the scope of section 6104 should be expanded to require the disclosure of all Forms 990-T and any returns filed by affiliated organizations of tax-exempt organizations.

- The Joint Committee staff recommends that the scope of section 6104 should be expanded to require the disclosure of the annual return filed by political organizations described in section 527, that section 527 organizations should be required to file an annual return even if they have no taxable income, and that the annual return for such organizations should be revised to include more information concerning the activities of such organizations.

- The Joint Committee staff recommends that tax-exempt organizations should be required to provide both their legal name and the name under which they do business on the Form 990.

- The Joint Committee staff recommends that the IRS notify taxpayers in instructions and publications that Form 990 is publicly available.

- The Joint Committee staff recommends that the address of the site on the World Wide Web, if any, of a tax-exempt organization should be included on Form 990 and that the IRS be required to publish such addresses.

- The Joint Committee staff recommends that the Form 990 report more information concerning the transfer of funds among various tax-exempt organizations so that the public and the IRS can better assess whether contributions to tax-exempt organizations are being used to fund political activities.

- The Joint Committee staff recommends that tax-exempt entities (other than churches) that are below the filing threshold for the Form 990-EZ should be required to file annually a brief notification of their status with the IRS.

- The Joint Committee staff recommends that private foundations reporting capital gains and losses on Form 990-PF should be permitted to disclose a summary of those capital transactions. A full listing of capital transactions would be required to be filed with the IRS and to be provided to the public upon request.

- The Joint Committee staff recommends that the present-law tax penalty imposed on tax return preparers should be expanded to apply to any omission or

misrepresentation on a Form 990 that either was known or reasonably should have been known to the preparer.

- The Joint Committee staff recommends that the present-law tax penalty imposed on tax return preparers should be expanded to apply to willful or reckless misrepresentation or disregard of rules and regulations with respect to Form 990.

Disclosure of returns and return information of tax-exempt organizations to nontax State officials or agencies

- The Joint Committee staff recommends that the IRS should be permitted to disclose to Attorneys General and other nontax State officials or agencies audit and examination information concerning tax-exempt organizations with respect to whom the State officials have jurisdiction and have made a specific referral of such organization to the IRS prior to a final determination with respect to the denial or revocation of tax exemption. In addition, the Joint Committee staff recommends that the IRS should be permitted to share audit and examination information concerning tax-exempt organizations with nontax State officials and agencies with jurisdiction over the activities of such organizations and who regularly share information with the IRS when the IRS determines that such disclosure may facilitate the resolution of cases.

Lobbying expenditures

- The Joint Committee staff recommends that public charities (both electing and nonelecting charities) should be required to provide a general description of their lobbying activities on Schedule A to Form 990.

- The Joint Committee staff recommends that public charities should be required to disclose expenditures for self-defense lobbying.

- The Joint Committee staff recommends that public charities should be required to disclose expenditures for nonpartisan study, analysis, and research if such study, analysis, or research includes a limited "call to action."

XVII. DEADWOOD PROVISIONS

Sources of Complexity

The Joint Committee staff found that there were numerous out of date and obsolete provisions ("deadwood provisions") in the Code. Although the vast majority of taxpayers are unaffected by the existence of deadwood provisions, these provisions contribute to overall complexity of the Federal tax system. For example, taxpayers and tax professionals must determine whether any particular provision has any continuing applicability.

There is a general perception that the Code is complicated and difficult for taxpayers to understand. The existence of deadwood provisions lends credence to this perception by forcing taxpayers to read and understand inoperative provisions.

Recommendation

The Joint Committee staff recommends that out of date and obsolete provisions in the Code should be eliminated. The Joint Committee staff has identified the following provisions as deadwood provisions.

1. Adjustments in tax tables so that inflation will not result in tax increases

Paragraph (7) of section 1(f) is amended to read as follows:

"(7) Special rule for certain brackets.--In prescribing tables under paragraph (1) which apply to taxable years beginning in a calendar year after 1994, the cost-of-living adjustment used in making adjustments to the dollar amounts at which the 36 percent bracket begins or at which the 39.6 rate bracket begins shall be determined under paragraph (3) by substituting '1993' for '1992'."

2. Reduced capital gain rates for qualified 5-year gain

Paragraph (2) of section 1(h) is amended by striking "In the case of taxable years beginning after December 31, 2000, the" and inserting "The".

3. Transitional rule for maximum capital gains rate

Paragraph (13) of section 1(h) is repealed.

4. Child tax credit

Subsection (a) of section 24 is amended by striking "($400 in the case of taxable years beginning in 1998)".

5. Credit for producing fuel from nonconventional source

Section 29 is amended by striking subsection (e).

6. Earned income credit

Paragraph (1) of section 32(b) is amended by striking subparagraphs (B) and (C) and by striking "(A) In General. In the case of taxable years beginning after 1995:".

7. Supplemental child credit

Section 32 is amended by striking subsection (n).

Clause (ii) of section 24(d)(1)(B) is amended by striking "(determined without regard to subsection (n))".

8. General business credits

Subsection (d) of section 38 is amended by striking paragraph (3).

9. Carryback and carryforward of unused credits

Section 39 is amended by striking subsection (d).

10. Adjustments to net operating loss computation

Paragraph (2) of section 56(d) is amended to read as follows:

"(2) Adjustments to net operating loss computations.--The net operating loss for any taxable year under section 172(c) shall--

"(A) be determined with the adjustments provided in this section and section 58, and

"(B) be reduced by the items of tax preference determined under section 57 for such year.

An item of tax preference shall be taken into account under subparagraph (B) only to the extent such item increased the amount of the net operating loss for the taxable year under section 172(c)."

11. Adjustments based on adjusted current earnings

Clause (ii) of section 56(g)(4)(E) is amended by striking "In the case of any taxable year beginning after December 31, 1992, clause" and inserting "Clause".

12. Items of tax preference; Depletion

Paragraph (1) of section 57(a) is amended by striking "Effective with respect to taxable years beginning after December 31, 1992, this" and inserting "This".

13. Intangible drilling costs

Clause (i) of section 57(a)(2)(E) is amended by striking "In the case of any taxable year beginning after December 31, 1992, this" and inserting "This".

Clause (ii) of section 57(a)(2)(E) is amended by striking "(30 percent in the case of taxable years beginning in 1993)".

14. Annuities; certain proceeds of endowment and life insurance contracts

Paragraph (4) of section 72(c) is amended by striking "under the contract" and all that follows and inserting "under the contract."

Paragraph (3) of section 72(g) is amended by striking "January 1, 1954, or".

15. Accident and health plans

Section 105(f) is amended by striking "or (d)".

16. Flexible spending arrangements

Section 106(c)(1) is amended by striking "Effective on and after January 1, 1997, gross" and inserting "Gross".

17. Certain combat zone compensation of members of the Armed Forces

Subsection (c) of section 112 is amended by striking "(after June 24, 1950)" in paragraph (2), and striking "such zone;" and all that follows in paragraph (3) and inserting "such zone."

18. Principal residence

Section 121(b)(3) is amended be striking subparagraph (B).

19. Certain reduced uniformed services retirement pay

Section 122(b)(1) is amended by striking "after December 31, 1965,".

20. Great plains conservation program

Section 126(a) is amended by striking paragraph (6).

21. Treble damage payments under the antitrust law

Section 162(g) is amended by striking the last sentence.

22. State legislators' travel expenses away from home

Paragraph (4) of section 162(h) is amended by striking "For taxable years beginning after December 31, 1980, this" and inserting "This".

23. Interest

Section 163 is amended by striking paragraph (6) of subsection (d) and paragraph (5) of subsection (h).

Section 56(b)(1)(C) is amended by striking clause (ii) and by redesignating clauses clauses (iii) and (iv) as clauses (ii) and (iii) respectively.

24. Charitable, etc., contributions and gifts

Section 170 is amended by striking subsection (k).

25. Amortizable bond premium

Subparagraph (B) of section 171(b)(1) is amended to read as follows:

"(B)(i) in the case of a bond described in subsection (a)(2), with reference to the amount payable on maturity or earlier call date, and

"(ii) in the case of a bond described in subsection (a)(1), with reference to the amount payable on maturity (or if it results in a smaller amortizable bond premium attributable to the period to earlier call date, with reference to the amount payable on earlier call date), and"

26. Net operating loss carrybacks and carryovers

Section 172 is amended by striking subparagraph (D) of subsection (b)(1), subsection (g), and subparagraph (F) of paragraph (h)(2).

27. Research and experimental expenditures

Subparagraph (A) of section 174(a)(2) is amended to read as follows:

"(A) Without consent.--A taxpayer may, without the consent of the Secretary, adopt the method provided in this subsection for his first taxable year for which expenditures described in paragraph (1) are paid or incurred."

28. Amortization of certain research and experimental expenditures

Paragraph (2) of section 174(b)(2) is amended by striking "beginning after December 31, 1953".

29. Soil and water conservation expenditures

Paragraph (1) of section 175(d) is amended to read as follows:

"(1) Without consent.--A taxpayer may, without the consent of the Secretary, adopt the method provided in this section for his first taxable year for which expenditures described in subsection (a) are paid or incurred."

30. Activities not engaged in for profit

Section 183(e)(1) is amended by striking the last sentence.

31. Dividends received on certain preferred stock; and Dividends paid on certain preferred stock of public utilities

Sections 244 and 247 are repealed.

Paragraph (5) of section 172(d) is amended to read as follows:

"(5) Computation of deduction for dividends received. The deductions allowed by section 243 and 245 shall be computed without regard to section 246(b) (relating to limitation on aggregate amount of deductions)."

Paragraph (1) of section 243(c) is amended to read as follows:

"(1) In General.--In the case of any dividend received from a 20-percent owned corporation, subsection (a)(1) shall be applied by substituting '80 percent' for '70 percent'."

Section 243(d) is amended by striking paragraph (4).

Section 246 is amended--

(i) by striking ",244," in subsection (a)(1),

(ii) by striking "sections 243(a)(1), and 244(a)," the first place it appears in subsection (b)(1) and inserting "section 243(a)(1)," and by striking "244(a)," the second place it appears therein, and

(iii) by striking in subsection (c)(1).

Section 246A is amended by striking "244" in subsections (a) and (e).

Sections 277(a), 301(e), 469(e)(4), 512(a)(3)(A), subparagraphs (A), (C), and (D) of section 805(a)(4), 805(b)(5), 812(e)(2)(A), 832(b)(5), 833(b)(3)(E), 1059(b)(2)(B), and 1244(c)(2)(C) are each amended by striking ", 244," each place it appears.

Section 805(a)(4)(B) is amended by striking ", 244(a)," each place it appears.

Section 810(c)(2) is amended by striking "244 (relating to dividends on certain preferred stock of public utilities),".

32. Organization expenses

Section 248(c) is amended by striking "beginning after December 31, 1953," and by striking the last sentence.

33. Bond repurchase premium

Section 249(b)(1) is amended by striking ", in the case of bonds or other evidences of indebtedness issued after February 28, 1913,".

34. Amount of gain where loss previously disallowed

Section 267(d) is amended by striking "(or by reason of section 24(b) of the Internal Revenue Code of 1939)" in paragraph (1), by striking "after December 31, 1953," in paragraph (2), by striking the second sentence, and by striking "or by reason of section 118 of the Internal Revenue Code of 1939" in the last sentence.

35. Acquisitions made to evade or avoid income tax

Paragraphs (1) and (2) of section 269 are each amended by striking "or acquired on or after October 8, 1940,".

36. Interest on indebtedness incurred by corporations to acquire stock or assets of another corporation

Section 279 is amended--

(A) by striking "after December 31, 1967," in subsection (a)(2),

(B) by striking "after October 9, 1969," in subsections (b),

(C) by striking "after October 9, 1969, and", and

(D) by striking subsection (i) and redesignating subsection (j) as subsection (i).

37. Special rules relating to corporate preference items

Paragraph (4) of section 291(a) is amended by striking "In the case of taxable years beginning after December 31, 1984, section" and inserting "Section".

38. Distributions of property

Section 301(c)(3) is amended to read as follows:

"(3) Amounts in excess of basis.--That portion of the distribution which is not a dividend, to the extent that it exceeds the adjusted basis of the stock, shall be treated as gain from the sale or exchange of property."

39. Effect on earnings and profits

Subsection (d) of section 312 is amended by striking paragraph (2) and redesignating paragraph (3) as paragraph (2).

40. Basis to corporations

Section 362 is amended by striking "on or after June 22, 1954," in subsection (a) and by striking ", on or after June 22, 1954," each place it appears in subsection (c).

41. Qualifications for tax credit employee stock ownership plan

Section 409 is amended by striking subsections (a), (g), and (p).

42. Funding standards

Section 412(m)(4) is amended by striking "the applicable percentage" in subparagraph (A) and by inserting "25 percent", and by striking subparagraph (C).

43. Retiree health accounts

Section 420 is amended by striking subsections (b)(4) and (c)(2)(B).

44. Employee stock purchase plans

Section 423(a) is amended by striking "after December 31, 1963,".

45. Limitation on deductions for certain farming

Section 464 is amended by striking "any farming syndicate (as defined in subsection (c))" in subsections (a) and (b) and inserting "any taxpayer to whom subsection (f) applies", and by striking subsections (c) and (g).

46. Deductions limited to amount at risk

Paragraph (3) of section 465(c)(3) is amended by striking "In the case of taxable years beginning after December 31, 1978, this" and inserting "This".

Paragraph (2) of section 465(e)(2)(A) is amended by striking "beginning after December 31, 1978".

47. Nuclear decommissioning costs

Section 468A(e)(2) is amended by striking "at the rate set forth in subparagraph (B)" in subparagraph (A) and inserting "at a rate of 20 percent", and by striking subparagraph (B).

48. Passive activity losses and credits limited

Section 469 is amended by striking subsection (m).

Subsection (b) of section 58 is amended by adding "and" at the end of paragraph (1), by striking paragraph (2), and by redesignating paragraph (3) as paragraph (2).

49. Adjustments required by changes in method of accounting

Section 481(b)(3) is amended by striking subparagraph (C).

50. Exemption from tax on corporations, certain trusts, etc.

Section 501 is amended by striking subsection (p).

51. Requirements for exemption

Section 503(a)(1) is amended to read as follows:

"(1) General rule.--An organization described in paragraph (17) or (18) of section 501(a) or described in section 401(a) and referred to in section 4975(g)(2) or (3) shall not be exempt from taxation under section 501(a) if it has engaged in a prohibited transaction."

Paragraph (2) of section 503(a) is amended by striking "described in section 501(c)(17) or (18) or paragraph (a)(1)(B)" and inserting "described in paragraph (1)".

Subsection (c) of section 503 is amended by striking "described in section 501(c)(17) or (18) or subsection (a)(1)(B)" and inserting "described in subsection (a)(1)".

52. Reduction in permitted contributions to education IRAs based on adjusted gross income

Section 530 is amended by striking subsection (c).

53. Accumulated taxable income

Paragraph (1) of section 535(b), paragraph (1) of section 545(b), and paragraph (1) of section 556(b) are each amended by striking "section 531" and all that follows and inserting "section 531, or the personal holding company tax imposed by section 541."

54. Definition of foreign personal holding company

Paragraph (1) of section 552(a) is amended by striking "ending after August 26,1937,".

55. Special rules as to operating mineral interest in oil and gas wells or geothermal deposits

Subsection 614(b) of section 614 is amended by striking paragraphs (3)(C) and (5) and by striking "whichever of the following taxable years is the later: The first taxable year beginning after December 31, 1963, or" in paragraph (4).

56. Amounts received by surviving annuitant under joint and survivor annuity contract

Subparagraph (A) of section 691(d)(1) is amended by striking "after December 31, 1953, and".

57. Income taxes of members of Armed Forces on death

Section 692(a)(1) is amended by striking "after June 24, 1950".

58. Special rules for computing reserves

Section 807(e)(7) is amended by striking subparagraph (B) and redesignating subparagraph (C) as subparagraph (B).

59. Transitional rule for certain high surplus mutual life insurance companies

Section 809 is amended by striking subsection (i).

60. Insurance company taxable income

Section 832(e)(1) is amended by striking "of taxable years beginning after December 31, 1966,"

Section 832(e)(6) is amended by striking "In the case of any taxable year beginning after December 31, 1970, the" and by inserting "The".

61. Capitalization of certain policy acquisition expenses

Section 848 is amended by striking subsection (j).

62. Tax on nonresident alien individuals

Subparagraph (B) of section 871(a)(1) is amended to read as follows:

"(B) gains described in section 631(b) or (c),".

63. Limitation on credit

Paragraph (2) of section 904(d) is amended by striking subparagraph (I).

64. Basis of property acquired from a decedent

Section 1014(b) is amended by striking paragraphs (7) and (8).

65. Adjustments to basis

Section 1016(a) is amended by striking paragraphs (4) and (12).

66. Property on which lessee has made improvements

Section 1019 is amended by striking the last sentence.

67. Involuntary conversion

Section 1033 is amended by striking subsection (j).

68. Property acquired during affiliation

Section 1051 is repealed.

69. Section 1081: Nonrecognition of gain or loss on exchanges or distributions in obedience to orders of S.E.C.

Part VI of subchapter O of chapter 1 (relating to exchanges in obedience to S.E.C. orders) is repealed.

Paragraph (3) of section 1223 is repealed.

Paragraph (5) of section 1245(b) is repealed.

Paragraph (5) of section 1250(d) is repealed.

70. Redeemable ground rents

Subsection (b) of section 1055 is repealed.

71. Holding period of property

Paragraphs (5) of section 1223 is amended by striking "(or under so much of section 1052(c) as refers to section 113(a)(23) of the Internal Revenue Code of 1939)".

Paragraph (7) of section 1223 is amended by striking the last sentence.

Paragraph (9) of section 1223 is repealed.

72. Property used in the trade or business and involuntary conversions

Paragraph (2) of section 1231(c) is amended by striking "beginning after December 31, 1981".

73. Sale or exchange of patents

Section 1235 is amended by striking subsection (c) and redesignating subsections (d) and (e) as (c) and (d) respectively.

74. Dealers in securities

Subsection (b) of section 1236 is amended by striking "after November 19, 1951,".

75. Sale of patents

Subsection (a) of section 1249 is amended by striking "after December 31, 1962,".

76. Gain from disposition of farm land

Subparagraph (a) of section 1252 is amended by striking "after December 31, 1969,".

77. Treatment of amounts received on retirement or sale or exchange of debt instruments

Subsection (c) of section 1271 is amended by striking paragraph (1).

78. Amount and method of adjustment

Section 1314 is amended by striking subsection (d).

79. Computation of tax where taxpayer restores substantial amount held under claim of right

Paragraph (5) of section 1341(a) is amended by striking the last sentence.

80. Election; revocation; termination

Clause (iii) of section 1362(d)(3) is amended by striking "unless" and all that follows and inserting "unless the corporation was an S corporation for such taxable year."

81. Old-age, survivors, and disability insurance

Subsection (a) of section 1401 is amended by striking "the following percent" and all that follows and inserting "12.4 percent of the amount of the self-employment income for such taxable year."

82. Hospital insurance

Subsection (b) of section 1401 is amended by striking "the following percent" and all that follows and inserting "2.9 percent of the amount of the self-employment income for such taxable year."

83. Ministers, members of religious orders, and Christian Science practioners

Paragraph (3) of section 1402(e) is amended by striking ""whichever of the following dates is later: (A)" and by striking "; or (B)" and all that follows and by inserting a period.

84. Withholding of tax on nonresident aliens

The first sentence of subsection (b) of section 1441 and the first sentence of paragraph (5) of section 1441(c) are each amended by striking the "gains subject to tax " and all that follows through "October 4, 1966" and inserting "and gains subject to tax under section 871(a)(1)(D)"

85. Affiliated group defined

Subparagraph (A) of section 1504(a)(3) is amended by striking "for a taxable year which includes any period after December 31, 1984" in clause (i) and by striking "in a taxable year beginning after December 31, 1984" in clause (ii).

86. Disallowance of the benefits of the graduated corporate rates and accumulated earnings credit

Subsection (a) of section 1551 is amended--

(1) by striking paragraph (1) and designating paragraphs (2) and (3) as (1) and (2) respectively, and

(2) by striking "(2) or (3)" and inserting "(1) or (2)".

Subsection (b) of section 1551 is amended by striking "or (2)".

87. Property within the United States

Subsection (c) of section 2104 is amended by striking "With respect to estates of decedents dying after December 31, 1969, deposits" and inserting "Deposits".

88. Powers of appointment

Section 2514 is amended by striking subsection (f).

89. Definition of wages

Section 3121(b) is amended by striking paragraph (17).

90. Credits against tax

Section 3302(f) is amended by striking paragraphs (4)(B) and (5)(D).

91. Domestic service employment taxes

Section 3510(b) is amended by striking paragraph (4).

92. Tax on fuel used in commercial transportation on inland waterways

Section 4042(b)(2)(A) is amended to read as follows:

"(A) The Inland Waterways Trust Fund financing rate is 20 cents per gallon."

93. Transportation by air

Section 4261(e) is amended by striking paragraphs (1)(C) and (5).

94. Taxes on failure to distribute income

Section 4942 is amended--

(1) by striking subsection (f)(2)(D),

(2) by striking "For all taxable years beginning on or after January 1, 1975, subject" and inserting "Subject" in subsection (g)(2)(A),

(3) by striking subsection (g)(4), and

(4) by striking "after December 31, 1969, and" in subsection (i)(2).

95. Taxes on taxable expenditures

Section 4945(f) is amended by striking "(excluding therefrom any preceding taxable year which begins before January 1, 1970)".

96. Returns

Subsection (a) of section 6039D is amended by striking "beginning after December 31, 1984,".

97. Information returns

Subsection (c) of section 6060 is amended by striking "year" and all that follows and inserting "year.".

98. Abatements

Section 6404(f) is amended by striking paragraph (3).

99. Failure by corporation to pay estimated income tax

Clause (i) of section 6655(g)(4)(A) is amended by striking "(or the corresponding provisions of prior law)".

100. Retirement

Section 7447(i)(3)(B)(ii) is amended by striking "at 4 percent per annum to December 31, 1947, and at 3 percent per annum thereafter", and inserting "at 3 percent per annum".

101. Annuities to surviving spouses and dependent children of judges

Paragraph (2) of section 7448(a) is amended by striking "or under section 1106 of the Internal Revenue Code of 1939" and by striking "or pursuant to section 1106(d) of the Internal Revenue Code of 1939".

Subsection (g) of section 7448 is amended by striking "or other than pursuant to section 1106 of the Internal Revenue Code of 1939".

Subsection (j)(1)(B) and (j)(2) of section 7448 are each amended by striking "at 4 percent per annum to December 31, 1947, and at 3 percent per annum thereafter" and inserting "at 3 percent per annum".

102. Merchant Marine capital construction funds

Paragraph (4) of section 7518(g) is amended by striking "any nonqualified withdrawal" and all that follows through "shall be determined" and inserting "any nonqualified withdrawal shall be determined".

103. Valuation tables

Paragraph (3) of section 7520(c) is amended by striking "Not later than December 31, 1989, the" and inserting "The".

104. Administration and collection of taxes in possessions

Section 7651 is amended by striking paragraph (4).

105. Definition of employee

Section 7701(a)(20) is amended by striking "chapter 21" and all that follows and inserting "chapter 21.".

Effective Date.--

General Rule.--Except as otherwise provided in this part, the amendments made by this part shall take effect of the date of enactment of this Act.

Savings Provision.--If

(1) any provision amended or repealed by this part applied to--

(a) any transaction occurring before the date of the enactment of this Act,

(b) any property acquired before such date of enactment, or

(c) any item of income, loss, deduction, or credit taken into account before such date of enactment, and

(2) the treatment of such transaction, property, or item under such provision would (without regard to the amendments made by this part) affect the liability for tax for periods ending after such date of enactment,

nothing in the amendments made by this part shall be construed to affect the treatment of such transaction, property, or item for purposes of determining liability for tax for periods ending after such date of enactment.