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OPTIONS TO IMPROVE TAX COMPLIANCE AND REFORM TAX EXPENDITURES

PREPARED BY THE STAFF

OF THE

JOINT COMMITTEE ON TAXATION

January 27, 2005

JCS-02-05

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INTRODUCTION AND SUMMARY

This report, prepared by the staff of the Joint Committee on Taxation ("Joint Committee staff"), presents various options to improve tax compliance and reform tax expenditures. This report is prepared at the request of Senate Finance Committee Chairman Charles Grassley and Ranking Member Max Baucus. A copy of their letter follows this Introduction and Summary. This report is an independent work-product of the Joint Committee staff and the options included in it have not received prior approval by Senator Grassley, Senator Baucus, or their staffs.

As requested by Senators Grassley and Baucus, the report describes a number of proposals that would reduce the size of the tax gap by curtailing tax shelters, closing unintended loopholes, and addressing other areas of noncompliance in present law. In addition, the report contains proposals that would reform certain tax expenditures. Each proposal includes a description of present law, reasons for change, a description of the proposed change and effective date, and a discussion of the issues raised by the proposal. The proposals are not ranked or presented in any order other than by subject-matter.

The proposals contained in the report attempt to reduce noncompliance in several different ways. Some proposals address the problem by requiring new compliance or reporting initiatives, revising aspects of the law that have proven to be a source of taxpayer noncompliance, or increasing penalties. Other proposals address the problem by simplifying the law or making it more fair.

Among the proposals contained in this report are the following. According to the National Taxpayer Advocate, noncompliance by self-employed persons accounts for the largest share of the known tax gap.[1] Prior proposals to curb such noncompliance through required withholding by the party making payments to the self-employed person have raised concerns regarding the burden placed upon the party required to withhold. This report contains a proposal to require withholding on such payments only by government entities. Because such payments represent a significant part of the economy, the proposal can be expected to improve compliance to an important extent without burdening private sector payors. The proposal exempts smaller government entities from the withholding requirement.

The report contains a proposal targeted specifically at tax shelter activity. In addition to potentially providing unintended tax relief to the participants of the shelter, such activity enlarges the tax gap by undermining overall respect for the tax system. Prior proposals to restrain such activity by codifying the "economic substance" doctrine have been criticized as either removing too much flexibility from the courts or potentially applying too broadly to many non-tax-shelter transactions. The proposal contained in this report addresses these concerns by requiring a higher level of judicial scrutiny only in the case of specific categories of uncommon transactions which have the characteristics of tax shelters.

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[1] National Taxpayer Advocate, *2003 Annual Report to Congress*, Publication 2104 (Rev. 12-2003), at iv.

Valuation issues, whether in the context of charitable contributions, transfer taxes, or other situations presented by the tax law, are a common source of noncompliance. The report contains several proposals to resolve valuation controversies in a simpler and more administrable way.

The report includes proposals to curb the mismatched taxation of income and related deductions, a common sheltering technique. In addition, there are proposals addressing the difficult compliance problem raised by mixed-use property, such as property that provides both business and personal benefits.

The report also contains several proposals that would carry out a restructuring of different tax expenditure areas. One example is a proposal that would consolidate three tax benefits relating to education into a single tax credit for education-related expenses. In general, the proposed restructurings attempt to simplify the law or permit the Congressional purpose to be achieved in a more fair or efficient manner.

Finally, the report contains a number of smaller proposals designed to improve compliance, close loopholes, reform or repeal tax expenditures, end specific tax shelters, and otherwise prevent unintended consequences.

This report contains proposals that touch on virtually every aspect of the tax law. Nevertheless, the report is not intended to be comprehensive. The Joint Committee staff explored and rejected many other ideas as being too difficult to administer or needing further analysis. As requested by Senators Grassley and Baucus, the Joint Committee staff will continue to investigate and analyze possible proposals to increase compliance and reform tax expenditures.

A table at the end of the report contains yearly revenue estimates through fiscal year 2014 of each of the proposals described in the report. With the exception of proposed restructurings of certain tax expenditures and excise taxes, which have been developed to have a revenue neutral effect, each of the proposals is estimated to raise revenue. If the proposed restructurings are viewed as achieving efficiency or other gains, their adoption may provide Congress with the opportunity to revisit the level of benefit provided or tax imposed.

The revenue estimate of each proposal is determined independent of the other proposals, and is based on the 2004 CBO baseline. In general, due to time constraints, the absence of statutory language, and in certain cases, the lack of specificity of certain aspects of some proposals, the estimates should be viewed as general guidance to the Congress regarding the likely revenue impact of the proposal. Some estimates may change significantly as a result of new information, greater specificity of the proposal, and a change to the 2005 CBO baseline. The proposals are generally assumed to be effective upon date of enactment or, in certain cases, at some point after date of enactment; for purposes of these estimates, it is assumed that the date of enactment is October 1, 2005 with no transition relief provided. If any legislation is developed based on one of these proposals, it may be appropriate to revisit the effective date as well as the availability of transition relief.

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United States Senate

COMMITTEE ON FINANCE

WASHINGTON, DC 20510–6200

FEB 26 2004

February 26, 2004

Mr. George K. Yin
Chief of Staff
Joint Committee on Taxation
1015 Longworth HOB
Washington, DC 20515

Dear Mr. Yin:

The National Taxpayer Advocate's 2003 Annual Report to Congress estimates that, in the year 2001, the amount of tax voluntarily and timely paid by taxpayers was approximately $311 billion less than the actual tax liability of taxpayers. The Report attributes the tax gap to underreporting ($249 billion), underpayment ($32 billion) and nonfiling ($30 billion). The Report indicates that the tax gap is growing and, as a consequence, law-abiding taxpayers are being asked to pay more than their fair share of taxes to make up for the resulting revenue shortfall. In addition, the Federal budget deficit is projected to be $477 billion for fiscal year 2004.

We request that the staff of the Joint Committee on Taxation issue periodic reports to the Congress containing proposals to reduce the size of the tax gap. These reports should include proposals to curtail tax shelters, close unintended loopholes, and address other areas of noncompliance in present law. In addition, we would appreciate receiving recommendations to reform tax expenditures that the Joint Committee staff believes the Congress should review from a policy standpoint.

Please provide as much detail as possible with respect to each proposal, including, to the extent practicable, descriptions of the proposals and estimates of their revenue effects. We would like the Joint Committee staff to prepare a report at least once each Congress.

Sincerely yours,

Max Baucus
Ranking Member

Charles E. Grassley
Chairman

cc: Senator Bob Graham

I. TAX PROCEDURE AND ADMINISTRATION

A. Impose Withholding on Certain Payments Made by Government Entities

Present Law

Withholding requirements

The Internal Revenue Code of 1986 (the "Code") requires employers to withhold income tax on wages paid to employees, including wages and salaries of employees or elected officials of Federal, State, and local government units.[2] Withholding rates vary depending on the amount of wages paid, the length of the payroll period, and the number of withholding allowances claimed by the employee.[3]

Certain nonwage payments also are subject to mandatory or voluntary withholding. For example:

- Employers are required to withhold FICA and Railroad Retirement taxes from wages paid to their employees. Withholding rates are generally uniform.[4]

- Payors of pensions are required to withhold from payments made to payees, unless the payee elects no withholding. Withholding from periodic payments is at variable rates, parallel to income tax withholding from wages, whereas withholding from nonperiodic payments is at a flat 10-percent rate.[5]

- A variety of payments (such as interest and dividends) are subject to backup withholding if the payee has not provided a valid taxpayer identification number (TIN). Withholding is at a flat rate based on the fourth lowest rate of tax applicable to single taxpayers.[6] This rate is 28 percent for 2005.

- Certain gambling proceeds are subject to withholding. Withholding is at a flat rate based on the third lowest rate of tax applicable to single taxpayers.[7] This rate is 25 percent for 2005.

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[2] Sec. 3401(c).

[3] Secs. 3401 and 3402.

[4] Secs. 3121 and 3231.

[5] Sec. 3405.

[6] Sec. 3406.

[7] Sec. 3402(q).

- Voluntary withholding applies to certain Federal payments, such as Social Security payments. Withholding is at rates specified by Treasury regulations.[8]

- Voluntary withholding applies to unemployment compensation benefits. Withholding is at a flat 10-percent rate.[9]

- Foreign taxpayers are generally subject to withholding on certain U.S.-source income which is not effectively connected with the conduct of a U.S. trade or business. Withholding is at a flat 30-percent rate (14-percent for certain items of income).[10]

Many payments made by government entities are not subject to withholding under present law. For example, no tax is generally withheld from payments made to workers who are not classified as employees (i.e., independent contractors).

Information reporting

Present law imposes numerous information reporting requirements that enable the Internal Revenue Service ("IRS") to verify the correctness of taxpayers' returns. For example, every person engaged in a trade or business generally is required to file information returns for each calendar year for payments of $600 or more made in the course of the payor's trade or business.[11] Special information reporting requirements exist for employers required to deduct and withhold tax from employees' income.[12] In addition, any service recipient engaged in a trade or business and paying for services is required to make a return according to regulations when the aggregate of payments is $600 or more.[13] Government entities are specifically required to make an information return, reporting payments to corporations as well as individuals.[14] Moreover, the head of every Federal executive agency that enters into certain contracts must file an information return reporting the contractor's name, address, TIN, date of contract action, amount to be paid to the contractor, and any other information required by Forms 8596 (Information Return for Federal Contracts) and 8596A (Quarterly Transmittal of Information Returns for Federal Contracts).[15]

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[8] Sec. 3402(p)(1).

[9] Sec. 3402(p)(2).

[10] Secs. 1441 and 1442.

[11] Sec. 6041(a).

[12] Sec. 6051(a).

[13] Sec. 6041A.

[14] Sec. 6041A(d)(3)(A).

[15] Sec. 6050M.

Reasons for Change

The lack of a withholding mechanism on nonwage payments leads to substantial underpayments of tax each year and has long been identified as contributing to the tax gap.[16] For example, it is estimated that tax compliance for wage earners whose income is subject to withholding is approximately 99 percent, while compliance for individuals with income not subject to withholding is significantly less.[17]

Payments made by the Federal government and State and local governments represent a significant amount of those annual payments that are not subject to withholding. Imposing withholding on nonwage payments made by the Federal government and State and local governments would improve taxpayer compliance, reduce the tax gap, and promote fairness. Requiring withholding on government payments also addresses concerns regarding the poor compliance records of Federal contractors. For example, a recent Government Accountability Office ("GAO") study of Department of Defense and IRS records showed that over 27,000 Federal contractors owed about $3 billion in unpaid taxes as of September 30, 2002.[18]

Description of Proposal

The proposal requires withholding on payments for goods and services[19] made by all branches of the Federal government and its agencies and all units of State and local governments,[20] including counties and parishes. Local governments with less than $100 million of annual expenditures are excluded from the withholding requirement.

The rate of withholding is three percent on all payments, regardless of whether the payments are for goods or services.

The proposal imposes information reporting requirements on payments that are subject to withholding under the proposal but are not subject to information reporting under present law.

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[16] The tax gap is the amount of tax that is imposed by law for a given tax year but is not paid voluntarily and timely. The estimated size of the annual net tax gap (i.e., the gross tax gap reduced by the taxes eventually collected) is about $255 billion. National Taxpayer Advocate, *2004 Annual Report to Congress*, Publication 2104 (Rev. 12-2004), at 211.

[17] For example, self-employed individuals whose income is subject to neither withholding nor to information reporting are estimated to report only 36 percent of their income. National Taxpayer Advocate, *2003 Annual Report to Congress*, Publication 2104 (Rev. 12-2003), at 265.

[18] U.S. General Accounting Office, *Financial Management: Some DOD Contractors Abuse the Federal Tax System with Little Consequence*, GAO-04-95 (February 2004).

[19] Thus, the proposal does not apply, for example, to welfare and other types of public assistance payments.

[20] Multistate agencies also would be covered by the terms of the proposal.

The proposal does not apply to payments of wages or to any other payment with respect to which mandatory (e.g., U.S.-source income of foreign taxpayers) or voluntary (e.g., unemployment benefits) withholding applies under present law.[21] The proposal also does not apply to the following: payments of interest; payments for real property; payments to tax-exempt entities or foreign governments; intragovernmental payments; and payments made pursuant to a classified or confidential contract (as defined in section 6050M(e)(3)).

Effective Date

The proposal applies to payments made after the first December 31st that is at least six months after the date of enactment.

Discussion

The withholding of tax on wages has been described as "the cornerstone of our tax compliance system for employees."[22] Employees who are subject to withholding have little opportunity to underreport income. Withholding also provides taxpayers with a gradual and systematic method to pay their taxes. Thus, taxpayers subject to withholding are less likely to face a large liability at the end of the tax year and have less motivation for underreporting their income.

In contrast, the absence of withholding on many types of payments has been cited as contributing to the growing compliance problem.[23] Studies have consistently shown that rates of noncompliance are considerably higher for taxpayers with income not subject to withholding than for those taxpayers whose income is subject to withholding.[24] For example, the National Taxpayer Advocate concluded that the absence of a withholding mechanism on certain nonwage payments creates several problems, including contributing to the substantial tax gap and

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[21] The proposal does not exclude payments that are potentially subject to backup withholding under section 3406. If, however, payments are actually being withheld under backup withholding, withholding under the proposal does not apply. The purpose of the backup withholding system is to decrease noncompliance by ensuring taxpayers provide valid taxpayer identification numbers. Backup withholding only applies when a taxpayer has failed to furnish a taxpayer identification number and the taxpayer has either a history of underreporting or has failed to certify that backup withholding is not applicable. Thus, payments potentially subject to backup withholding, but for which amounts are not actually being withheld, are not of the type excluded from the proposal.

[22] GAO Testimony before the Committee on Small Business, House of Representatives, *Tax Administration, Improving Independent Contractor Compliance with Tax Laws*, GAO/T-GGD-94-194, August 4, 1994.

[23] See GAO Report to Congressional Requesters, *Tax Administration, Approaches for Improving Independent Contractor Compliance*, GAO/GGD-92-108, July 1992, at 4.

[24] GAO Report to the Chairman, Subcommittee on Oversight, Committee on Ways and Means, House of Representatives, *Tax Administration: Tax Compliance of Nonwage Earners, GAO/GGD*-96-165, August 1996, at 12.

"harming compliant taxpayers because they pay their correct tax liability while others do not."[25] This disparate treatment of similarly situated taxpayers undermines respect for the fairness of the tax system.

Imposing withholding on nonwage payments would increase compliance and facilitate IRS collection activities by filtering regular tax payments from large numbers of taxpayers through significantly fewer collection points. In general, the more payments to which withholding applies, the greater improvement in compliance. However, withholding requirements also impose burdens on payors. The proposal attempts to balance the goal of greater compliance with concerns regarding administrative burdens by imposing withholding only on payments made by Federal, State and most local governments, as well as agencies of these entities. Because the payments of such entities represent a significant part of the economy,[26] the proposal may be expected to appreciably improve compliance, while not burdening private sector payors. To avoid imposing a burden on small entities, local governments with less than $100 million of annual expenditures are not subject to the proposal.

Although the proposal imposes new administrative requirements on some payors, in many cases the affected parties will already have procedures in place that can be modified to accommodate the additional requirements. For example, present law imposes information reporting requirements on governmental entities. Arguably, the proposal will require only the expansion of existing information reporting procedures to satisfy the broader withholding requirement, not the creation of wholly new procedures, in such cases. Similarly, certain Federal payments to vendors of goods or services are subject to continuous levy authority under present law.[27] Thus, Federal agencies have existing procedures for deducting and remitting taxes from payments to businesses and individuals that may be tailored to the requirements of the proposal.

The proposal imposes a flat rate of three percent on all payments, other than the excluded payments discussed above, regardless of whether the payment is made for goods or services. The advantages of a flat rate of withholding are that it is simple, easy to verify, and applicable to all payees. A disadvantage of this approach, however, is that it is likely to cause either overwithholding or underwithholding for some payees. For example, sellers of goods and materials are more likely to have overwithholding and, thus, bear more of the burden of a flat rate because of the lower profit margin on such sales relative to sales of services. Similar proposals have recommended a higher rate of withholding on payments for the provision of

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[25] National Taxpayer Advocate, *2003 Annual Report to Congress*, Publication 2104 (Rev. 12-2003), p. 265; see also National Taxpayer Advocate, *2004 Annual Report to Congress*, Publication 2104 (Rev. 12-2004), at 484.

[26] The combined payments for goods and services by Federal, State, and local governments represent between six and seven percent of gross domestic product in any year, with approximately one-third of this amount attributable to purchases of goods and services by the Federal government. See Bureau of Economic Analysis, U.S. Department of Commerce, National Income and Product Accounts Tables, Tables 1.1.5 and 3.10.5 (December 22, 2004).

[27] Sec. 6331(h).

personal services (where no or minimal goods are provided) than on payments for the provision of goods only or a mix of goods and services.[28] A variable rate proposal would add additional complexity, which would have to be weighed against the benefits to be derived from a variable rate system. In addition, the rate under the proposal is set low enough not to necessitate a second rate. The conservative three-percent rate under the proposal will limit instances of overwithholding.

The proposal also addresses inefficiencies in the current Federal levy program. Under present law, the Federal government has broad authority to levy Federal payments made to vendors of goods and services, up to 100 percent of certain Federal payments.[29] Although a levy program should provide an efficient and effective method of collecting unpaid taxes, the Federal government's levy authority has not proven fully effective.[30] IRS resource constraints have limited the number of cases referred to the levy program and Federal agencies have not systematically imposed levies on cases that have been referred.[31] Because withholding, unlike a levy, is required and relatively simple, the proposal will provide a more effective means of promoting compliance than the current levy program, which requires numerous administrative steps to collect unpaid taxes.

Imposing withholding more broadly on non-wage payments throughout the economy could be expected to generate additional positive effects on compliance and IRS collection efforts.[32] However, broader withholding requirements would also involve additional administrative burdens on the private sector and on both payors and payees.

The proposal is estimated to raise approximately $6.4 billion over the fiscal years 2006 through 2014. There is a significant revenue effect in fiscal year 2007 that is largely attributable to accelerating tax receipts as a result of the withholding requirement. However, the proposal also has a significant revenue effect over the estimating period that is directly related to the expected improvement in tax compliance.

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[28] National Taxpayer Advocate, *2003 Annual Report to Congress*, Publication 2104 (Rev. 12-2003), at 265.

[29] Sec. 6331(h), as amended by Pub. L. No. 108-357 (2004).

[30] U.S. General Accounting Office, *Tax Administration: Federal Payment Levy Program Measure, Performance, and Equity Can Be Improved*, GAO-03-356 (March 6, 2003).

[31] *Id.*

[32] The National Taxpayer Advocate generally recommended withholding by all payors on non-wage payments. National Taxpayer Advocate, *2003 Annual Report to Congress*, Publication 2104 (Rev. 12-2003); see also National Taxpayer Advocate, *2004 Annual Report to Congress*, Publication 2104 (Rev. 12-2004), at 484.

B. Require Partial Payments with Submission of Offers-in-Compromise

Present Law

In general

The Federal government may compromise any civil or criminal case arising under the internal revenue laws.[33] In general, taxpayers initiate this process by making an offer-in-compromise, which is an offer by the taxpayer to settle an outstanding tax liability for less than the total amount due. Offers are generally made using Form 656. The IRS currently imposes a user fee of $150 on most offers, payable upon submission of the offer to the IRS. Taxpayers may justify their offers on the basis of doubt as to collectibility or liability or on the basis of effective tax administration. In general, enforcement action is suspended during the period that the IRS evaluates an offer. In some instances, it may take the IRS 12 to 18 months to evaluate an offer.[34] Taxpayers are permitted (but not required) to make a deposit with their offer; if the offer is rejected, the deposit is generally returned to the taxpayer. There are two general categories[35] of offers-in-compromise.

Lump-sum offers

Taxpayers making lump-sum offers propose to make one lump-sum payment of a specified dollar amount in settlement of their outstanding liability.

Periodic payment offers

Taxpayers making periodic payment offers propose to make a series of payments over time (either short-term or long-term) in settlement of their outstanding liability.

Reasons for Change

The offer-in-compromise program is a valuable collection tool; it allows the IRS to collect a portion of an outstanding tax liability in circumstances in which it may not be possible or reasonable to expect collection of the entire liability. In general, submission of an offer indicates that the taxpayer is willing and able to make a partial payment of the taxpayer's liability. Because of the lengthy review process that the IRS undertakes prior to accepting an offer, there may be a substantial period of time before the Government actually collects the amounts the taxpayer is willing to pay. Moreover, experience under present law has shown that in some cases taxpayers do not make offers in good faith (e.g., by concealing information from the IRS). Requiring partial payment with the submission of an offer-in-compromise will

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[33] Sec. 7122.

[34] *Olsen v. United States*, 326 F. Supp.2d 184 (D. Mass. June 16, 2004).

[35] The IRS categorizes payment plans with more specificity, which is generally not significant for purposes of the proposal. See Form 656, Offer-in-Compromise, page 6 of instruction booklet (revised July 2004).

preserve the offer program for those cases in which it is appropriate, and will increase fairness for those taxpayers who pay their taxes in full.

Description of Proposal

In general

The proposal requires that a taxpayer make partial payments to the government while the taxpayer's offer is being considered by the IRS. These payments are retained by the government and applied to the taxpayer's outstanding balance, even if the taxpayer's offer is rejected as inadequate.

Lump-sum offers

The proposal requires that taxpayers make a down payment of 20 percent of the amount of any lump-sum offer-in-compromise with any application for an offer. A lump-sum offer includes single payments as well as payments made in five or fewer installments. For example, if the taxpayer owes the IRS $100,000 and submits an offer-in-compromise of a single payment of $40,000 to settle this liability in full, the taxpayer must make a down payment of $8,000 when the taxpayer submits the offer-in-compromise to the IRS. If the IRS rejects an offer as inadequate and the taxpayer makes a new offer, the taxpayer must make an additional down payment so that the total of the new down payment and the previous down payment equals 20 percent of the new offer. In the previous example, if the IRS rejects that offer, the $8,000 down payment is kept by the IRS and applied to the taxpayer's account. If the taxpayer submits a new offer of $60,000, the taxpayer must make an additional down payment of $4,000 when the taxpayer submits the new offer to the IRS.

Periodic payment offers

The proposal requires the taxpayer to comply with the taxpayer's own proposed payment schedule while the offer is being considered. For example, if the taxpayer owes the IRS $100,000 and submits an offer-in-compromise of $500 per month for five years to fully settle this liability, the taxpayer would be required to pay $500 when the taxpayer submits the offer-in-compromise as well as $500 each month thereafter for as long as the IRS is considering the offer. If the IRS rejects this offer as inadequate, the taxpayer would stop making payments at that time and enforcement action is permitted. If the taxpayer then submits a higher offer of $600 per month for five years, the taxpayer would be required to pay $600 when the taxpayer submits the offer-in-compromise as well as $600 each month thereafter for as long as the IRS is considering the offer. If the taxpayer does not continue to comply with the taxpayer's own proposed payment schedule for the entire period the offer is being considered, the offer is considered to be withdrawn on the date compliance ceases and immediate enforcement action is permitted.

Rules of general applicability

Offers submitted to the IRS that do not comport with the proposed payment requirements are returned to the taxpayer as unprocessable and immediate enforcement action is permitted. The taxpayer is permitted to specify how these payments are to be applied. These payment requirements are separate from, and do not affect, any user fee imposed by the IRS with respect

to offers-in-compromise. The IRS is authorized to establish parallel rules for complex offers that have both lump-sum and periodic features. If the IRS does not make a decision to reject an offer within two years of its submission, it is considered accepted for all purposes. The ability of the IRS to make jeopardy assessments is unaffected by the proposal.

Effective Date

The proposal is effective for offers-in-compromise submitted to the IRS after 60 days after the date of enactment.

Discussion

An offer-in-compromise is a valuable tool that permits final resolution of disputes over amounts owed to the government. Agreeing on an appropriate offer may, however, be difficult, for several reasons. First, the interests of the taxpayer and the government diverge on the issue of the amount to be paid. Taxpayers prefer to pay as little as possible, whereas the government wants to maximize its receipts of outstanding liabilities. Second, the interests of the taxpayer and the government diverge on the issue of the rapidity of payment. In general, taxpayers prefer to delay payment as long as possible (especially if enforcement actions are held in abeyance), whereas the government has an interest in receiving payment as soon as possible.[36] Third, there is also likely to be an imbalance of information. The taxpayer necessarily has complete information on the taxpayer's own financial information, whereas the government has incomplete information (which is often information supplied by the taxpayer). While many taxpayers make an offer in good faith, some are abusing the offer process by concealing information from the government and by making low-ball offers.

The proposal is designed to accelerate receipts to the government while preserving the structure of the offer program. Because the proposal calculates the amount of the partial payment on the basis of the offer that the taxpayer is making, taxpayers should generally be able to comply with payment terms that they themselves propose. This has several implications. First, the proposal should not discourage most taxpayers from making offers that would be comparable to the offers they would make absent the proposal. Second, the proposal should not impede or further strain the efforts of the IRS in evaluating offers. Third, no special rules are necessary with respect to offers from low-income taxpayers.

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[36] While the government has an interest in receiving payment as soon as possible, it also has an interest in receiving the maximum appropriate amount, and these two interests conflict. Reviewing an offer (to establish that the government is receiving the maximum appropriate amount) generally takes a significant period of time. Most offers are made because of doubt as to collectibility; in other words, the taxpayer asserts that its resources are inadequate to pay the government in full. To evaluate the veracity of the taxpayer's assertions, the IRS must in many instances consider in detail the resources available to the taxpayer. This requires a very fact-intensive process, which can require significant time to complete. In addition, the evaluation of how those resources should be deployed to satisfy the taxpayer's obligation to the government (as well as the taxpayer's other obligations) requires both time and sound judgment.

The proposal is also designed to increase collections with respect to offers that the IRS either rejects or returns. The Taxpayer Advocate's most recent report states: "The IRS collected nothing from individual taxpayers in 21 percent of the [offers-in-compromise] that it rejected and in 37 percent of the [offers-in-compromise] that it returned after acceptance for processing. The IRS collected nothing from business taxpayers in 46 percent of the [offers-in-compromise] that it rejected and in 60 percent of the [offers-in-compromise] that it returned after acceptance for processing."[37]

[37] National Taxpayer Advocate, *2004 Annual Report to Congress* (December 31, 2004), at 311, citing a recent IRS study.

C. Clarify Standards of Scrutiny for Certain Transactions with Characteristics of Tax Shelters

Present Law

In general

The Code provides specific rules regarding the determination of tax liability, including the amount, timing, source, and character of items of income, gain, loss and deduction. These rules are designed to provide taxpayers with a degree of certainty as to what their tax liability will be if they undertake a particular course of action. They also tend to ensure that different taxpayers will be treated equally, and encounter the same tax liability, if they carry out the same transaction. From the government's perspective, specific rules generally avoid the need for time-consuming, case-by-case determinations of tax liability after particular transactions have been undertaken. In addition to the statutory provisions, courts have developed several doctrines that can be applied to deny the tax benefits of tax motivated transactions, notwithstanding that the transaction may satisfy the literal requirements of a specific tax provision. The common-law doctrines are not entirely distinguishable, and their application to a given set of facts is often blurred by the courts and the IRS. Although these doctrines serve an important role in the administration of the tax system, invocation of these doctrines can be seen as at odds with an objective, "rule-based" system of taxation. Nonetheless, courts have applied the doctrines to deny tax benefits arising from certain transactions.[38]

Economic substance doctrine

In general

A common-law doctrine applied with increasing frequency is the "economic substance" doctrine. In general, this doctrine denies tax benefits arising from transactions that do not result in a meaningful change to the taxpayer's economic position other than a purported reduction in Federal income tax.[39]

Courts generally deny claimed tax benefits if the transaction that gives rise to those benefits lacks economic substance independent of tax considerations -- notwithstanding that the purported activity actually occurred. The Tax Court has described the doctrine as follows:

> The tax law . . . requires that the intended transactions have economic substance separate and distinct from economic benefit achieved solely by tax reduction. The doctrine of economic substance becomes applicable, and a judicial remedy is

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[38] See, e.g., *ACM Partnership v. Commissioner*, 157 F.3d 231 (3d Cir. 1998), *aff'g* 73 T.C.M. (CCH) 2189 (1997), *cert. denied* 526 U.S. 1017 (1999).

[39] Closely related doctrines also applied by the courts (sometimes interchangeable with the economic substance doctrine) include the "sham transaction doctrine" and the "business purpose doctrine." See, e.g., *Knetsch v. United States*, 364 U.S. 361 (1960) (denying interest deductions on a "sham transaction" the only purpose of which was to create the deductions).

warranted, where a taxpayer seeks to claim tax benefits, unintended by Congress, by means of transactions that serve no economic purpose other than tax savings.[40]

Business purpose doctrine

Another common law doctrine that overlays and is often considered together with (if not part and parcel of) the economic substance doctrine is the business purpose doctrine. The business purpose test is a subjective inquiry into the motives of the taxpayer -- that is, whether the taxpayer intended the transaction to serve some useful nontax purpose. In making this determination, some courts have bifurcated a transaction in which independent activities with nontax objectives have been combined with an unrelated item having only tax-avoidance objectives in order to disallow the tax benefits of the overall transaction.[41]

Application of the doctrine

There is a lack of uniformity regarding the proper application of the economic substance doctrine.[42] Some courts apply a conjunctive test that requires a taxpayer to establish the presence of *both* economic substance (i.e., the objective component that there be a meaningful change in the taxpayer's position) *and* business purpose (i.e., the subjective component that there be a useful non-tax purpose for the taxpayer's course of action) in order for the transaction to survive judicial scrutiny.[43] A narrower approach is to conclude that *either* a business purpose *or* economic substance is sufficient.[44] A third approach regards economic substance and business

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[40] *ACM Partnership v. Commissioner*, 73 T.C.M. at 2215.

[41] *ACM Partnership v. Commissioner*, 157 F.3d at 256 n.48.

[42] "The casebooks are glutted with [economic substance] tests. Many such tests proliferate because they give the comforting illusion of consistency and precision. They often obscure rather than clarify." *Collins v. Commissioner*, 857 F.2d 1383, 1386 (9th Cir. 1988).

[43] See, e.g., *Pasternak v. Commissioner*, 990 F.2d 893, 898 (6th Cir. 1993) ("The threshold question is whether the transaction has economic substance. If the answer is yes, the question becomes whether the taxpayer was motivated by profit to participate in the transaction").

[44] See, e.g., *Rice's Toyota World v. Commissioner*, 752 F.2d 89, 91-92 (4th Cir. 1985) ("To treat a transaction as a sham, the court must find that the taxpayer was motivated by no business purposes other than obtaining tax benefits in entering the transaction, and, second, that the transaction has no economic substance because no reasonable possibility of a profit exists."). As noted earlier, the economic substance doctrine and the sham transaction doctrine are similar and sometimes are applied interchangeably. For a more detailed discussion of the sham transaction doctrine, see, 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) at 182.

purpose as "simply more precise factors to consider" in determining whether a transaction has any practical economic effects other than the creation of tax benefits.[45]

Recently, the Court of Federal Claims questioned the continuing viability of the doctrine.[46] The court also stated that "the use of the 'economic substance' doctrine to trump 'mere compliance with the Code' would violate the separation of powers."[47]

Nontax economic benefits

There also is a lack of uniformity regarding the type of non-tax economic benefit a taxpayer must establish in order to satisfy economic substance. Several courts have denied tax benefits on the grounds that the subject transactions lacked profit potential.[48] In addition, some courts have applied the economic substance doctrine to disallow tax benefits in transactions in which a taxpayer was exposed to risk and the transaction had a profit potential, but the court concluded that the economic risks and profit potential were insignificant when compared to the tax benefits.[49] Under this analysis, the taxpayer's profit potential must be more than nominal. Conversely, other courts view the application of the economic substance doctrine as requiring an objective determination of whether a "reasonable possibility of profit" from the transaction existed apart from the tax benefits.[50] In these cases, in assessing whether a reasonable possibility of profit exists, it is sufficient if there is a nominal amount of pre-tax profit as measured against expected net tax benefits.

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[45] See, e.g., *ACM Partnership v. Commissioner,* 157 F.3d at 247; *Sacks v. Commissioner,* 69 F.3d 982, 985 (9th Cir. 1995) ("Instead, the consideration of business purpose and economic substance are simply more precise factors to consider . . . . We have repeatedly and carefully noted that this formulation cannot be used as a 'rigid two-step analysis'").

[46] *Coltec Industries, Inc. v. United States*, 62 Fed. Cl. 716 (2004) (slip opinion at 123-124). The court also found, however, that the doctrine was satisfied in that case. *Id.* at 128.

[47] *Id.* at 128.

[48] See, e.g., *Knetsch*, 364 U.S. at 361; *Goldstein v. Commissioner*, 364 F.2d 734 (2d Cir. 1966) (holding that an unprofitable, leveraged acquisition of Treasury bills, and accompanying prepaid interest deduction, lacked economic substance).

[49] See, e.g., *Goldstein v. Commissioner*, 364 F.2d at 739-40 (disallowing deduction even though taxpayer had a possibility of small gain or loss by owning Treasury bills); *Sheldon v. Commissioner*, 94 T.C. 738, 768 (1990) (stating that "potential for gain . . . is infinitesimally nominal and vastly insignificant when considered in comparison with the claimed deductions").

[50] See, e.g., *Rice's Toyota World v. Commissioner*, 752 F.2d at 94 (the economic substance inquiry requires an objective determination of whether a reasonable possibility of profit from the transaction existed apart from tax benefits); *Compaq Computer Corp. v. Commissioner*, 277 F.3d at 781 (applied the same test, citing *Rice's Toyota World*); *IES Industries v. United States*, 253 F.3d 350, 354 (8th Cir. 2001).

Financial accounting benefits

In determining whether a taxpayer had a valid business purpose for entering into a transaction, at least one court has concluded that financial accounting benefits arising from tax savings do not qualify as a non-tax business purpose.[51] However, based on court decisions that recognize the importance of financial accounting treatment, taxpayers have asserted that financial accounting benefits arising from tax savings can satisfy the business purpose test.[52]

Reporting and penalty regimes

As enacted in the American Jobs Creation Act of 2004 ("AJCA"), present law provides new and strengthened accuracy related penalties with respect to "reportable transactions" and "listed transactions," a subset of reportable transactions that includes transactions the IRS views as tax avoidance transactions.

If listed transactions or other reportable transactions with a significant tax avoidance purpose are adequately disclosed on the tax return, the accuracy related penalties do not apply if there was reasonable cause for the understatement and the taxpayer acted in good faith.[53] In the case of a nondisclosed "listed transaction," the accuracy related penalty is a "strict liability" penalty that is imposed notwithstanding the fact that a taxpayer may have had an otherwise permissible opinion of counsel stating that the taxpayer is believed to be "more likely than not" to prevail if the matter is litigated.[54]

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[51] See, *American Electric Power, Inc. v. U.S.*, 136 F. Supp. 2d 762, 791-92 (S.D. Ohio 2001).

[52] See, e.g., Joint Committee on Taxation, *Report of Investigation of Enron Corporation and Related Entities Regarding Federal Tax and Compensation Issues, and Policy Recommendations* (JSC-3-03) February, 2003 ("Enron Report"), Volume III at C-93, 289. Enron Corporation relied on *Frank Lyon Co. v. United States*, 435 U.S. 561, 577-78 (1978), and *Newman v. Commissioner*, 902 F.2d 159, 163 (2d Cir. 1990) to argue that financial accounting benefits arising from tax savings constitutes a good business purpose.

[53] In order to satisfy these requirements there must have been substantial authority for the taxpayer's position and the taxpayer must have reasonably believed that the claimed treatment was more likely than not the proper treatment. A taxpayer may not rely on a tax opinion that is issued by a "disqualified advisor" (in general, an advisor with certain relationships to the transaction) and may not rely on any tax opinion that is a "disqualified opinion" that does not meet certain standards. Sec. 6662A.

[54] Sec. 6662A. In the case of a nondisclosed reportable transaction that is not listed but that has a significant purpose of evading or avoiding Federal income tax, the IRS may waive the accuracy related penalty only if the Commissioner determines that such waiver will enhance compliance and tax administration.

The terms "reportable transaction" and "listed transaction" are defined as transactions identified by the Treasury department pursuant to regulations.[55] At the present time, "reportable transactions" include certain transactions in which the taxpayer claims a tax credit and has held property for less than 45 days and certain transactions that produce a book-tax difference, as well as several other categories of transactions. Those other categories are certain transactions involving confidentiality requirements, certain transactions involving a fee contingent upon the taxpayers achieving certain tax benefits, certain transactions producing large losses, and any listed transaction.

Reasons for Change

Recent tax avoidance transactions have relied upon the interaction of highly technical tax law provisions to produce tax consequences not contemplated by the Congress. When successful, taxpayers who engage in these transactions enlarge the tax gap by gaining unintended tax relief and by undermining overall respect for the tax system.

A strictly rule-based tax system cannot efficiently prescribe the appropriate outcome of every conceivable transaction that might be devised and is, as a result, incapable of preventing all unintended consequences. Thus, many courts have long recognized the need to supplement tax rules with anti-tax avoidance standards, such as the economic substance doctrine, in order to assure the Congressional purpose is achieved. Application of this doctrine to certain categories of transactions having the characteristics of tax shelters should be clarified and strengthened in order to improve its effectiveness at deterring unintended consequences and to promote greater uniformity.

Description of Proposal

In general

The proposal clarifies and enhances the application of the economic substance doctrine to certain "applicable transactions." For transactions that are not "applicable transactions," the proposal does not change present law.

The proposal only applies to cases in which a court determines that the economic substance doctrine is relevant. The proposal is not intended to change current law standards used by the courts in determining when to utilize an economic substance analysis, and does not require a court to make such a determination merely because of the presence of an applicable transaction. The proposal does not apply to cases in which the taxpayer establishes that the outcome of the transaction is clearly consistent with all applicable provisions of the Code and the purposes of such provisions.

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[55] Sec. 6707A(c). Reportable transactions are described at Treasury Regulation section 1.6011-4(b). See also Notice 2004-80, 2004-50 I.R.B. 963, modifying the definitions of reportable transactions. Listed transactions are described in Notice 2004-67, 2004-41 I.R.B. 600.

Except with respect to the economic substance doctrine as it is applied to applicable transactions, the provision is not intended to alter or supplant any other common law doctrine, and is to be considered additive to any such other doctrine.

Draft statutory language of the proposal is set forth following the discussion.

Application of economic substance doctrine to applicable transactions

Under the proposal, in any case in which a court determines that the economic substance doctrine is relevant to an "applicable transaction," such transaction has economic substance (and thus satisfies the economic substance doctrine) only if the taxpayer establishes that (1) the transaction changes in a meaningful way (apart from Federal income tax consequences) the taxpayer's economic position, and (2) the taxpayer has a substantial nontax purpose for entering into such transaction. The proposal does not alter the court's ability to aggregate, disaggregate or otherwise recharacterize a transaction when applying the economic substance doctrine. The proposal provides a uniform definition of economic substance for applicable transactions, but does not alter the flexibility of the courts in other respects.

Applicable transactions

The proposal applies the enhanced economic substance doctrine to the following six basic categories of "applicable transactions":

(1) A transaction in which (a) the taxpayer holds offsetting positions which substantially reduce the risk of loss, and (b) tax benefits would result from differing tax treatment of the positions;

(2) A transaction which is structured to result in a disparity between basis and fair market value which creates or increases a loss or reduces a gain;

(3) A transaction which is structured to create or increase a gain in an asset any portion of which would not be recognized for Federal income tax purposes if the asset were sold at fair market value by the taxpayer (or a related person);

(4) A transaction which is structured to result in income for Federal income tax purposes to a tax-indifferent party for any period which is materially in excess of any economic income to such party with respect to the transaction for such period;

(5) A transaction in which the taxpayer disposes of property (other than inventory, receivables, or stock or securities regularly traded on an established securities market) which the taxpayer held for a period less than 45 days; [56]

[56] The rules of section 246(c)(3) and 246(c)(4), regarding the computation of holding period, apply for this purpose.

(6) A transaction which is structured to result in a deduction or loss which is otherwise allowable under the Code and which is not allowed for financial reporting purposes.

Under regulations, the Secretary would have the authority to add or exempt transactions from the definition of an applicable transaction. A transaction would include a series of transactions.

Other common law doctrines not affected

Except as specifically provided, the proposal is not to be construed as altering or supplanting the economic substance doctrine or any other rule of law, and the requirements of the provision shall be construed as being in addition to such doctrine or any other rule of law.

Effective Date

The proposal applies to transactions entered into on or after the date of enactment of the proposal.

Discussion

In general

Recent tax avoidance transactions have relied on the interaction of highly technical tax rules to produce results not intended by the Congress. For example, one such transaction, described at a recent Senate hearing, involved an attempt to combine the S corporation rules and those applicable to a special class of tax-exempt entities in order to shelter ordinary business income from taxation.[57] It is not possible to set forth in advance an appropriate outcome for every conceivable transaction or uncommon combination of steps that might be devised, nor would it be efficient for the government to try to do so. For this reason, most courts have long recognized the need for anti-tax avoidance standards, such as the economic substance doctrine, to ensure that Congressional objectives are appropriately achieved.

Under current law, the application of the economic substance doctrine among the courts varies considerably, with one recent court even questioning the viability of the doctrine altogether. The lack of clarity undermines the prophylactic effect of the doctrine and produces unfairness. The potential unfairness is compounded by the recent increase in penalties in the event the IRS finds and challenges a tax shelter transaction and the taxpayer loses in court.

Legislative intrusion into this domain largely dominated by the courts has at least two potential disadvantages. First, the legislative rule might inadvertently restrict the flexibility of the courts in resolving disputes on a case-by-case basis. Second, the rule might apply too

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[57] See description of "SC2" transaction, Appendix B of the report, "U.S. Tax Shelter Industry: The Role of Accounts, Lawyers, and Financial Professionals," Minority Staff of the Permanent Subcommittee on Investigations, Senate Committee on Government Affairs (released in conjunction with Hearings on November 18 and 20, 2003).

broadly, and cause a court (or the IRS) to raise an "economic substance" inquiry in common situations not previously involving the issue.

The proposal attempts to respond to such concerns by limiting its application only to certain types of transactions having the characteristics of tax shelters, and only if a court determines the economic substance doctrine is relevant. For these transactions, the proposal provides that the doctrine requires a conjunctive analysis inquiring into both the nontax economic effects of the transaction and the taxpayer's purpose for undertaking it. The proposal is not intended to modify the judicial determination of when to apply the doctrine, and does not apply to cases in which the taxpayer establishes the outcome of a transaction is clearly consistent with all applicable rules and Congressional purposes. The proposal does, however, constitute a legislative determination that the economic substance doctrine has an appropriate role to play in the tax system.

Proposed clarification of economic substance doctrine for applicable transactions

Conjunctive analysis

Under the proposal, an applicable transaction must satisfy both the objective and subjective prongs of the economic substance doctrine -- i.e., it must change in a meaningful way (apart from Federal income tax consequences) the taxpayer's economic position, and the taxpayer must have a substantial non-tax purpose for entering into such transaction -- in order to satisfy that doctrine. This clarification eliminates the disparity that exists among the circuits regarding the application of the doctrine to applicable transactions.

Nontax business purpose

The proposal provides that a taxpayer's non-tax purpose for entering into an applicable transaction must be "substantial." It is intended that the nontax purpose for the transaction must bear a reasonable relationship to the taxpayer's normal business operations or investment activities.[58]

In determining whether a taxpayer has a substantial nontax business purpose, a purpose of achieving a financial accounting benefit shall not be taken into account if the origin of such

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[58] See, e.g., Treas. Reg. sec. 1.269-2(b) (stating that a distortion of tax liability indicating the principal purpose of tax evasion or avoidance might be evidenced by the fact that "the transaction was not undertaken for reasons germane to the conduct of the business of the taxpayer"). Similarly, in *ACM Partnership v. Commissioner*, 73 T.C.M. (CCH) 2189 (1997), the court stated:

> Key to [the determination of whether a transaction has economic substance] is that the transaction must be rationally related to a useful nontax purpose that is plausible in light of the taxpayer's conduct and useful in light of the taxpayer's economic situation and intentions. Both the utility of the stated purpose and the rationality of the means chosen to effectuate it must be evaluated in accordance with commercial practices in the relevant industry.

benefit is a reduction of income tax. Under this rule, a transaction that is expected to increase financial accounting income as a result of generating tax deductions or losses without a corresponding financial accounting charge (i.e., a permanent book-tax difference)[59] would not be considered to have a substantial non-tax purpose unless such a purpose exists apart from the financial accounting benefits.[60]

The proposal retains the present-law ability of the courts to bifurcate a transaction in which independent activities with nontax objectives are combined with an unrelated item having only tax-avoidance objectives in order to disallow the tax benefits of the overall transaction.[61]

Meaningful change in the taxpayer's economic position

The proposal requires a meaningful change in the taxpayer's economic position in order to satisfy a requirement of economic substance. As one example, a transaction is suspect under this standard if money (or any other asset or liability) moves in a circular manner, such that the taxpayer's or another party's apparent financial outlay is largely protected from risk and is reasonably expected to be returned to that party or a related party when the transaction is complete.

Definitions of applicable transactions

The following illustrates the categories of applicable transactions and is not intended to be an exhaustive description.

Offsetting positions which substantially reduce the risk of loss

The first type of applicable transaction is one in which the taxpayer holds offsetting positions which substantially reduce the risk of loss, and tax benefits would result from differing tax treatment of the positions.

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[59] The tax deductions or losses need not arise in the year the financial accounting benefit is recognized but may, for example, be expected to occur in some future year. Statement of Financial Accounting Standards No. 109 ("FAS 109") in some cases permits the recognition of financial accounting benefits prior to the period in which the tax benefits are recognized for income tax purposes.

[60] Claiming that a financial accounting benefit constitutes a substantial non-tax business purpose fails to consider the origin of the accounting benefit (i.e., reduction of taxes) and significantly diminishes the purpose for having a substantial non-tax purpose requirement. See, e.g., *American Electric Power, Inc. v. U.S.*, 136 F. Supp. 2d 762, 791-92 (S.D. Ohio, 2001) ("AEP's intended use of the cash flows generated by the [corporate-owned life insurance] plan is irrelevant to the subjective prong of the economic substance analysis. If a legitimate business purpose for the use of the tax savings 'were sufficient to breathe substance into a transaction whose only purpose was to reduce taxes, [then] every sham tax-shelter device might succeed...'" citing *Winn-Dixie v. Commissioner*, 113 T.C. 254, 287 (1999)).

[61] See, e.g., *ACM Partnership v. Commissioner*, 157 F.3d at 256, n.48.

Many of the earlier economic substance decisions involved these types of transactions. Examples include borrowing to purchase a deferred annuity,[62] borrowing to purchase Treasury obligations,[63] and commodity straddles.[64] This category generally includes transactions in which a taxpayer enters into offsetting positions and recognizes a loss without recognizing the offsetting gain in the same period.[65]

Structured to result in a disparity between basis and fair market value which creates or increases a loss or reduces a gain

The second type of applicable transaction is one that is structured to result in a disparity between basis and fair market value which creates or increases a loss or reduces a gain.[66]

One example of this type of transaction is one in which an income interest is separated from property ("income stripping") and the taxpayer's basis in the property is not reduced by the resulting diminution in the property's fair market value. For example, suppose a taxpayer pays $100 to acquire income-producing property. That price, which acts as the taxpayer's basis for purposes of determining gain or loss on a subsequent disposition of the property, represents the fair market value of the property including its expected income stream. The taxpayer then enters a transaction or series of transactions in which it splits the right to receive all or part of the future income stream from the basic property right. In one structure, a taxpayer might retain all or much of the right to the future income (worth $95) and dispose of whatever remains of the initial "property" rights (worth only $5). If the taxpayer can allocate all of its $100 basis to the disposed-of remainder rights, after largely stripping out the income rights, and if this basis allocation is respected, then the taxpayer will recognize an immediate $95 "loss" on the disposition even though its economic position is unchanged. Although the taxpayer may have $95x of income in the future from the stream of future income, the time value of the immediate loss that may be used to shelter other income in the year of sale exceeds the deferred future income tax on the future income stream.

Some provisions of the Code specifically attempt to prevent this type of result.[67] However, other similar transactions purport to accomplish similar results in areas outside the

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[62] See, e.g., *Knetsch v. United States*, 364 U.S. 361 (1960).

[63] See, e.g., *Goldstein v. Commissioner*, 364 F.2d 734 (2d Cir. 1966); *Sheldon v. Commissioner*, 94 T.C. 738 (1990).

[64] See, e.g., *Yosha v. Commissioner*, 861 F.2d 494 (7th Cir. 1988).

[65] See, e.g., Rev. Rul. 2000-12, 2000-1 C.B. 744 (bull/bear); Notice 2002-65, 2002-2 C.B. 690 (pass-through entity straddle).

[66] The mere fact that a purchased asset loses value with a resulting disparity between basis and fair market value would not be covered since, without more, this alone is not a transaction "structured to result" in a disparity between basis and fair market value.

[67] For example, section 1232B (the predecessor of current Code section 1286) was enacted in 1982 to address "coupon stripping" transactions with debt instruments. See H.R.

scope of these particular Code provisions.[68] The proposal is intended to clarify that the taxpayer should not obtain benefits of basis shifting in this type of situation if the enhanced economic substance test is not satisfied. Such transactions are applicable transactions under the provision.

This category also includes transactions structured to duplicate a built-in loss,[69] transactions in which a distribution to a taxpayer in effect represents a return of the taxpayer's investment,[70] and transactions in which basis does not adequately account for the party expected to pay a liability or obligation of any kind.[71]

> Structured to create or increase a gain in any asset any portion of which would not be recognized if the asset were sold at fair market value by the taxpayer or a related person

The third type of applicable transaction is one that is structured to create or increase a gain in any asset any portion of which would not be recognized if the asset were sold at fair market value by the taxpayer or a related person.

Conf. Rep. No. 97-760, 97th Cong., 2d Sess. 554-555(1982); S. Rep. No. 97-494, 97th Cong., 2d Sess. 215-18 (1982). Section 305(e) applies to analogous transactions that involve stripping dividends from preferred stock. These sections were further expanded in the American Jobs Creation Act of 2004, 108th Cong. Sec. 831 (2004), to apply to certain stripped interests in bond and preferred stock funds. Secs. 1286(f) and 305(e)(7).

[68] For example, similar techniques have been used with rent payments on long-term leases. In many situations, unlike the case with stripped bonds or stripped preferred stock, the future value of the stripped property is uncertain. For this reason, the particular preventive approach of section 1286 would be more difficult to apply. As another example, see Notice 2003-55, 2003-34 I.R.B. 35 (lease stripping).

[69] See, e.g., Notice 2001-17, 2001-1 C.B. 730 (contingent liabilities); see also the Tanya and Valor transactions described in the Enron Report; Vol. I, at 118-135, *Black & Decker Corporation v. United States*, 340 F. Supp. 2d 621 (D. Md. 2004); and *Coltec Industries, Inc. v. United States,* 62 Fed. Cl. 716 (2004). The enactment of Section 358(h) has addressed similar transactions. However, any other transactions not covered by section 358(h) but structured to duplicate losses would also be applicable transactions. The American Jobs Creation Act of 2004, 108th Cong. Secs. 833 and 836 (2004), also added certain explicit statutory limitations on the ability to import or duplicate certain built-in losses.

[70] See, e.g., Notice 2000-60, 2000-2 C.B. 568 (stock compensation transfers) and *Castle Harbour v. United States*, 342 F. Supp. 2d 94 (D.Conn. 2004). See also Notice 97-21, 1997-1 C.B. 407 (step-down preferred). The "step-down" preferred investment transaction described in that notice has since been addressed in Treasury Regulations section 1.7701(l)-3. However, these and other transactions involving recovery of investment would be applicable transactions.

[71] See, e.g., Notice 2002-21, 2002-1 C.B. 730 (inflated basis); Notice 2001-17, 2001-1 C.B. 730 (contingent liability); Notice 2000-44, 2000-2 C.B. 255 (son of boss); Notice 99-59, 1999-2 C.B. 761 (boss).

For example, this category includes transactions in which the taxpayer recognizes a loss or deduction (or a reduced amount of income or gain) that was or is reasonably expected to be offset by the taxpayer (or a related person) enjoying a corresponding amount of income or gain that has not been or will not be recognized under section 1032 or that can be eliminated prior to sale by a liquidation under section 332 that eliminates stock basis, or under any similar provision that can eliminate gain potential.

Certain transactions described in the Enron Report, including the Tomas and Condor transactions,[72] would be included in this category. In the Tomas transaction, the taxpayer contributed low basis but high value depreciable assets, as well as all the stock of another corporation to a partnership. The other partners (affiliates of Banker's Trust) contributed cash. The partnership assumed debt and the corporation that the taxpayers contributed received notes receivable from a Banker's Trust affiliate. Upon the later distribution of the stock out of the partnership in liquation of the taxpayer's partnership interest, the basis of the distributed stock was reduced under the tax law to the low basis of the taxpayer's partnership interest. The partnership made a section 754 election to increase the basis of the depreciable assets it retained. Although the stock was thus stripped of its basis, the distributee could avoid recognition of any built-in gain on that stock by liquidating the subsidiary in a tax-free transaction under section 332, with no step down in the basis of the subsidiary's assets under the law at the time of the transaction. If this transaction were respected, then it would allow permanent avoidance of gain on the low basis depreciable assets contributed to the partnership.[73] In the Condor transaction, Enron formed a partnership with the objective of shifting basis from certain Enron stock held by the partnership to certain depreciable assets. One strategy devised by the taxpayers to avoid any potential gain recognition in the Enron stock was to utilize section 1032.

Transactions with tax-indifferent parties

The fourth type of applicable transaction is a transaction structured to result in income to a tax indifferent party for any period, which income is materially in excess of economic income to such party for such period.

For this purpose, a tax-indifferent party means any person not subject to Federal income tax, or any person to whom an item would have no substantial impact on its income tax liability.

Examples of persons not subject to Federal income tax include non-U.S. persons, tax-exempt organizations, or governmental entities (unless they are in fact subject to tax with respect to the income because, for example, the income is subject to withholding tax at the full statutory rate, is effectively connected with a U.S. trade or business, or is unrelated business taxable income). Under appropriate circumstances, a person to whom an item would have no substantial

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[72] See Enron Report, Vol. I, at 189-221. See also the Tammy I and Tammy II transactions, Enron Report, Vol. I, at 221-41.

[73] The subsequent enactment of section 732(f) shut down the specific Tomas structure of transaction. However, that transaction and any similar transactions not affected by that section would be applicable transactions.

impact on its income tax liability may also include a person who generally is subject to income tax, but does not have a tax liability from a transaction because of deductions or credits unrelated to the transaction (e.g., net operating losses from an unrelated activity).[74] Another example of a tax-indifferent party would be a person who is generally subject to tax but engages in a transaction structured to result in that person's realizing taxable income and offsetting such income with a loss resulting from an increase in basis above fair market value as a result of such income realization.

One example of this type of applicable transaction would be a financing or other transaction if the present value of the income inclusions of a tax-indifferent party is substantially in excess of the anticipated economic returns to that party because the income inclusion is in effect recovery of the tax-indifferent party's basis.[75] This category also includes transactions that result in a shifting of basis on account of overstating the income or gain of the tax-indifferent party, whether because the transaction is in effect a recovery of basis or for other reasons.[76]

Another example is a transaction structured through an entity (such as a pass-through entity that is an S corporation or real estate investment trust), where income is allocated (but not distributed) to a tax-indifferent party in excess of the economic gain ultimately provided to such party. If successful, the remaining investors might obtain economic gain with little or no tax liability.[77]

This category also would include, for example, the series of transactions in *ACM Partnership v. Commissioner*, 157 F.3d 231 (3d Cir. 1998). In that case ACM Partnership ("ACM") purchased Citibank notes and, three weeks later, sold a portion of those notes for cash and LIBOR notes. Using the ratable basis recovery rules under contingent payment sale provisions of Temporary Treasury Regulation section 15a.453-1(c), ACM claimed only a portion

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[74] Other examples could include situations where any reduction in a tax loss or tax credit carryover would not be expected to have a substantial impact on tax liability, due to the amount and timing of such reduction and the taxpayer's otherwise reasonably expected use of such loss or credit carryover.

[75] See, e.g., Notice 97-21, 1997-1 C.B. 407 (step-down preferred). The Apache transaction described in the Enron Report, Vol. I, at 242-60 is also an applicable transaction under this category, as is the transaction in *Castle Harbour v. United States,* 342 F. Supp. 2d 94 (D.Conn. 2004).

[76] See, e.g., Notice 2001-45, 2001-2 C.B. 129 (basis shifting).

[77] See description of "SC2" transaction, Appendix B of the report entitled "U.S. Tax Shelter Industry: The Role of Accountants, Lawyers, and Financial Professionals," Minority Staff of the Permanent Subcommittee on Investigations, Senate Committee on Government Affairs, (released in conjunction with Hearings on November 18 and 20, 2003). Or the remaining investors might attempt to use a loss remaining in the entity. See, e.g., Notice 2002-65, 2002-2 C.B. 690. Similar transactions have also been addressed in Rev. Rul. 2004-4, 2004-6 I.R.B. 414 and Temp. Reg. sec. 1.409(p) – IT.

of its basis in the sale and allocated the resulting gain to a foreign partner who was not subject to U.S. tax. Subsequently, ACM redeemed the foreign partner's interest and sold the LIBOR notes at a loss. ACM allocated the loss to its remaining U.S. partners. Because this series of transactions resulted in an allocation of gain to a tax-indifferent party (the foreign partner) in excess of that party's economic gain, the series of transactions in *ACM Partnership* would be treated as an applicable transaction under the provision.

Less than 45-day holding period

The fifth category of applicable transaction is one in which the taxpayer disposes of property (other than inventory, receivables, or stock or securities that are regularly traded on an established securities market) having held such property for less than 45 days. The holding period is reduced for periods in which the taxpayer's risk of loss is diminished (e.g. by purchasing a put option or entering into a short sale with respect to the property).[78]

Present law contains certain specific restrictions relating to a 45-day holding period for purposes of the dividends received deduction and for the foreign tax credit.[79] The proposal adopts a similar test to categorize transactions as applicable transactions even though tax benefits may not otherwise be denied under the specific existing 45-day holding period rules.

Permanent book-tax difference

The sixth category of applicable transaction is one which is structured to result in a deduction or loss which is otherwise allowable under the Code and which is not allowed for financial reporting purposes.

Thus, a transaction in which certain amounts are deducted from taxable income for Federal tax purposes but not for financial accounting purposes is covered by this category.[80] One example of such a transaction is one in which contingent liabilities are contributed to a subsidiary corporation, a separate class of high basis stock is created reflecting all or most of the loss associated with such liabilities, and such stock is sold at a loss while the contributed liabilities also are expected to produce a second deduction to the taxpayer's consolidated group when paid.[81]

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[78] The rules of section 246(c)(3) and (4) apply in determining holding period.

[79] Secs. 246(c)(1)(A) and 901(k)(3).

[80] It is intended that the Treasury Department will identify and except from this category certain transactions producing a permanent book-tax difference, such as the claiming by a corporation of a tax deduction upon the exercise of nonqualified stock options granted by the corporation, absent factors indicating that the transaction was a sham or used in conjunction with other technical provisions to obtain an inappropriate result.

[81] See, e.g., Notice 2001-17, 2001-1 C.B. 730, and see Tanya and Valor transactions described in the Enron Report, Vol. I, at 118-135.

Other examples are the Steele, Condor, and Teresa transactions described in the Enron Report, which Enron treated as giving rise to permanent book-tax differences. The Steele transaction involved another party's transfer of assets (including REMIC residual interests) with a basis in excess of value to an entity structured as a subsidiary in the Enron affiliated group, and the creation of a special class of stock for the contributing party, whose basis reflected the loss inherent in the assets. The transaction was intended to duplicate the loss of the transferor and allow the duplicate loss also to be taken by the Enron group. The transaction was treated as generating tax deductions and financial earnings.[82]

In the Condor transaction previously described, Enron's accountants concluded that the transaction would produce tax deductions without any corresponding financial expense, and that the tax deductions would therefore generate after-tax financial statement income.[83]

The Teresa transaction involved the creation of a partnership and the transfer of assets with a low basis and high value. The transaction was structured with the purpose of creating dividend income that would not be fully taxed, due to the dividends received deduction, but that would increase partnership basis. The partnership basis ultimately was to be shifted to the appreciated asset, producing greater depreciation deductions in the future. The transaction was treated as generating financial statement income.[84]

Treasury Regulations

The proposal provides the Treasury with authority to add or exempt transactions from the definition of an applicable transaction.

No inference regarding present law

No inference is intended regarding the application of the economic substance doctrine under present law.

Estimating assumptions

For revenue estimating purposes, the proposal assumes that reporting requirements will apply to applicable transactions, as well as a strict liability penalty (i.e, reliance on an opinion of counsel would not protect the taxpayer from penalties if the taxpayer loses in court with respect to the economic substance doctrine as applied to an applicable transaction).

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[82] See Enron Report, Vol. I, at 135-46. See also the Cochise transaction, Enron Report, Vol. I, at 147-164.

[83] See Enron Report, Vol. I, at 208-21.

[84] See Enron Report, Vol. I, at 165-80.

Statutory draft of proposed new code section

Clarification of Scrutiny for Certain Transactions

(a) IN GENERAL.--Section 7701 is amended by redesignating subsection (n) as subsection (o) and by inserting after subsection (m) the following subsection:

"(n) CLARIFICATION OF SCRUTINY FOR CERTAIN TRANSACTIONS.--

"(1) IN GENERAL.--In any case in which a court determines that the economic substance doctrine is relevant for purposes of applying this title to an applicable transaction, such transaction shall have economic substance only if --

"(A) the transaction changes in a meaningful way (apart from Federal tax effects) the taxpayer's economic position, and

"(B) the taxpayer has a substantial nontax purpose for entering into the transaction.

"(2) APPLICABLE TRANSACTION.--For purposes of paragraph (1), the term 'applicable transaction' means a transaction--

"(A) in which--

"(i) the taxpayer holds offsetting positions which substantially reduce the risk of loss, and

"(ii) tax benefits would result from differing tax treatment of the positions,

"(B) which is structured to result in a disparity between basis and fair market value which creates or increases a loss or reduces a gain,

"(C) which is structured to create or increase a gain in an asset any portion of which would not be recognized for Federal income tax purposes if the asset were sold at fair market value by the taxpayer (or a related person),

"(D) which is structured to result in income for Federal income tax purposes to a tax-indifferent party for any period which is materially in excess of any economic income to such party with respect to the transaction for such period,

"(E) in which the taxpayer disposes of property (other than inventory, receivables, or stock or securities regularly traded on an established securities market) which the taxpayer held for a period less than 45 days. The rules of section 246(c)(3) and (4) shall apply in determining holding period for this purpose.

"(F) which is structured to result in a deduction or loss which is otherwise allowable under this title and which is not allowed for financial reporting purposes, or

"(G) which is specified in regulations prescribed by the Secretary.

The Secretary may by regulations exempt any transaction from the application of subparagraphs (A) through (F).

"(3) DEFINITIONS AND SPECIAL RULES.--For purposes of this subsection--

"(A) TRANSACTION.--The term 'transaction' includes a series of transactions.

"(B) EXCEPTION.--Paragraph (1) shall not apply to any transaction if the taxpayer establishes that the transaction is clearly consistent with all applicable provisions of this title and the purposes of such provisions.

"(C) NONTAX PURPOSE.-- If a transaction has a purpose of achieving a financial accounting benefit, such purpose shall not be taken into account in determining whether the transaction has substantial nontax purpose if the origin of such benefit is a reduction of income tax.

"(D) COMMON LAW DOCTRINE NOT AFFECTED.--Except as specifically provided in this subsection, the provisions of this subsection shall not be construed as altering or supplanting any rule of law, and the requirements of this subsection shall be construed as being in addition to such rule of the law.

"(E) TAX-INDIFFERENT PARTY.--The term 'tax-indifferent party' means any person or entity not subject to tax imposed by subtitle A. A person shall be treated as a tax-indifferent party with respect to a transaction if the items taken into account with respect to a transaction have no substantial impact on such person's liability under subtitle A."

(b) EFFECTIVE DATE.--The amendments made by this section shall apply to transactions entered into on or after the date of the enactment of this Act.

II. INDIVIDUAL INCOME TAX

A. Provide Uniform Treatment for Dependent Care Benefits (secs. 21 and 129)

Present Law

In general

Present law contains two tax benefits for dependent care expenses: the dependent care credit and the exclusion for employer-provided dependent care expenses. While both provisions provide tax benefits for similar expenses, the tax benefit available differs under the two provisions.

Dependent care credit[85]

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 35 percent of a limited amount of employment-related dependent care expenses. Eligible employment-related expenses are limited to $3,000 if there is one qualifying individual or $6,000 if there are two or more qualifying individuals. Thus, the maximum credit is $1,050 if there is one qualifying individual and $2,100 if there are two or more qualifying individuals.[86] The applicable dollar limit is reduced by any amount excluded from income under an employer-provided dependent care assistance plan. The 35-percent credit rate is reduced, but not below 20 percent, by one percentage point for each $2,000 (or fraction thereof) of adjusted gross income above $15,000. Thus, for taxpayers with adjusted gross income of $45,000 or above, the credit rate is 20 percent.

Generally, a qualifying individual is (1) a qualifying child of the taxpayer under the age of 13 for whom the taxpayer may claim a dependency exemption,[87] or (2) a dependent or spouse of the taxpayer if the dependent or spouse is physically or mentally incapacitated, and shares the

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[85] Sec. 21.

[86] The expenses cannot exceed the earned income of the taxpayer (or, in the case of married taxpayers, the earned income of the spouse with the lowest earned income).

[87] A qualifying child is determined by reference to the uniform definition of qualifying child enacted by Congress in 2004, effective for taxable years beginning after December 31, 2004. Secs. 21(b)(1)(A) and 152(a)(1) (as amended by The Working Families Tax Relief Act of 2004, Pub. L. No. 108-311, secs. 201 and 203). In general, a qualifying child means, with respect to a taxpayer for a taxable year, an individual who: (1) is a son, daughter, stepson, stepdaughter, adopted child, eligible foster child, brother, sister, stepbrother, or stepsister of the taxpayer, or a descendant of any such individual; (2) shares the same principal place of abode as the taxpayer for more than half the taxable year; (3) meets certain age requirements or is permanently and totally disabled; and (4) has not provided over one half of his or her own support during the year. Sec. 152(c) (as amended by the Act).

same principal place of abode with the taxpayer for over one half the year. Married taxpayers must file a joint return in order to claim the credit. For purposes of the credit, taxpayers who are legally separated are not considered married. In addition, a taxpayer is not considered married if he or she files a separate return from his or her spouse, maintains a household which constitutes the principal place of abode of a qualifying individual for at least half the year, and the taxpayer's spouse is not a member of such household during the last six months of the year.

For taxable years beginning in 2004 and 2005, the dependent care credit offsets the alternative minimum tax. For taxable years thereafter, the dependent care credit does not offset the alternative minimum tax.

Exclusion for employer-provided dependent care[88]

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 for employment tax purposes 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. The definition of dependent care expenses eligible for the exclusion is the same as the expenses eligible for the dependent care credit.

The dependent care exclusion is limited to $5,000 per year (regardless of the number of qualifying individuals) 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.

Reasons for Change

The differing tax provisions for dependent care expenses create inequity in the operation of the tax laws. While the exclusion generally provides more favorable tax benefits than does the credit, it is not available to all taxpayers. Thus, individuals not covered by an employer's dependent care assistance plan may receive a lower tax benefit for the same expenses than an individual who is covered by such a plan. The differing benefits also add to complexity in the tax laws for taxpayers who may be eligible for both provisions.

Description of Proposal

The proposal repeals the exclusion for employer-provided dependent care. Thus, under the proposal, the dependent care credit is the exclusive means for receiving tax benefits for dependent care expenses.[89]

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[88] Secs. 129 and 3121(a)(18).

[89] The value of dependent care provided by an employer (e.g., day care provided on-site by an employer to employees without charge) is includible in gross income and wages under the proposal. The amount of employer-provided dependent care included in gross income is eligible for the credit.

Effective Date

The proposal is effective with respect to taxable years beginning after date of enactment.

Discussion

The proposal has two primary policy objectives: equity and simplification.

The proposal provides greater equity among similarly situated taxpayers by providing the same tax benefit for persons with dependent care expenses. Under present law, taxpayers who are covered under an employer's dependent care plan generally receive greater tax benefits than other individuals with dependent care expenses.

There are several significant differences between the dependent care credit and the exclusion for employer-provided dependent care, including the following: (1) the amount of the tax benefit provided by the exclusion, but not the credit, depends on the tax bracket (income plus payroll tax rate) of the taxpayer; (2) the amount of benefit provided by the credit, but not the exclusion, depends on whether the taxpayer has one or two qualifying individuals; (3) the credit is reduced for persons with incomes above certain levels, whereas the exclusion is not limited based on income; (4) the credit is not available to married taxpayers who file separate returns, whereas one-half the maximum exclusion is available to such taxpayers[90]; (5) the availability of the exclusion depends on the compensation arrangements of employers; and (6) for taxable years beginning after 2005, the exclusion will continue to apply in determining alternative minimum taxable income, but the credit will not offset alternative minimum tax liability of individuals.

The proposal retains the present-law nonrefundable credit approach as the means of providing a tax benefit for dependent care expenses. A credit is broadly available, treats similarly situated taxpayers equally, and the value of the benefit is independent of the taxpayer's rate bracket. Other means of providing tax benefits for dependent care expenses are possible. For example, an above-the-line deduction would provide similar tax benefits to the exclusion; like the exclusion, an above-the-line deduction would provide a benefit that varies with the individual's tax rate and would not affect the taxpayer's eligibility for other tax benefits that vary based on adjusted gross income. From a theoretical perspective, a deduction may be more appropriate if dependent care expenses are viewed as affecting taxpayers' overall ability to pay taxes or as expenses for the production of income. A credit may be more appropriate if a goal of the tax benefit is to make dependent care expenses more affordable, or to target the benefit more toward certain taxpayers. If the primary objective of the credit is to lower the price of dependent care regardless of whether the individual has tax liability, that may suggest that the credit should be refundable. Refundable credits, however, are administratively complex and potentially more subject to fraudulent claims that are difficult to recoup.

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[90] Denying the credit to married individuals filing separate returns serves as a way to prevent avoidance of the income phaseout of the credit by splitting income between the spouses.

The proposal also reduces complexity by applying a single set of existing rules for dependent care expenses.[91]

Taxpayers who currently claim the exclusion for employer-provided dependent care benefits may face increased tax liability as a result of the proposal. Overall, the greatest tax impact of the proposal would be on taxpayers who are subject to the alternative minimum tax; most of the revenue increase from the proposal is attributable to the impact of the alternative minimum tax beginning in 2006, when the credit will no longer offset minimum tax liability.

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[91] As part of the 2001 simplification report, the Joint Committee staff previously noted that, in general, the exclusion is less complex than the credit. In that report, the Joint Committee staff generally recommended conforming the credit to the exclusion by having a single dollar amount of expenses that can be taken into account that does not depend on the number of children, eliminating the income phasedown of the credit, and allowing married taxpayers filing a separate return to claim one half the credit. 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, at 67-8. Other considerations in addition to simplification have resulted in a different proposal here. The current proposal also achieves simplification by eliminating the primary source of the complexity, the existence of two provisions with similar policy goals yet differing requirements.

B. Combine Hope and Lifetime Learning Credits and the Above-the-Line Deduction for Higher Education Expenses (secs. 25A and 222)

Present Law

Hope credit

The Hope credit is a nonrefundable credit of 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.[92] 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 Hope credit that a taxpayer may otherwise claim is phased out ratably for taxpayers with modified adjusted gross income between $43,000 and $53,000 ($87,000 and $107,000 for married taxpayers filing a joint return) for 2005.[93] The first adjustment to these amounts as a result of inflation is expected in 2006. Thus, for example, an eligible student who incurs $1,000 of qualified tuition and related expenses is eligible (subject to the adjusted gross income phaseout) for a $1,000 Hope credit. If an eligible student incurs $2,000 or more of qualified tuition and related expenses, then he or she is eligible for a $1,500 Hope credit.

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 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 (e.g., in cases in which the student is the taxpayer's child) only if the taxpayer claims the student as a dependent for the taxable year for which the credit is claimed. If a student is claimed as a dependent, 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

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[92] Sec. 25A. The Hope credit generally may not be claimed against a taxpayer's alternative minimum tax liability. However, the credit may be claimed against a taxpayer's alternative minimum tax liability for taxable years beginning prior to January 1, 2006.

[93] The adjusted gross income phase-out ranges are indexed for inflation. Also, each of the $1,000 amounts of qualified tuition and related expenses to which the 100-percent credit rate and 50 percent credit rate apply are indexed for inflation, with the amount rounded down to the next lowest multiple of $100.

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, the Lifetime Learning credit (described below), or the section 222 deduction for qualified tuition and related expenses (described below) with respect to an eligible student.

The Hope credit is available for "qualified tuition and related expenses," which include tuition and fees (excluding nonacademic 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.

Effective for taxable years beginning after December 31, 2010, the changes to the Hope credit made by EGTRRA no longer apply. The EGTRRA change scheduled to expire is the change that permitted a taxpayer to claim a Hope credit in the same year that he or she claimed an exclusion from an education savings account. Thus, after 2010, a taxpayer cannot claim a Hope credit in the same year he or she claims an exclusion from an education savings account.

Lifetime Learning credit

Individual taxpayers are allowed to claim a nonrefundable credit, the Lifetime Learning credit, 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.[94] Up to $10,000 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 $2,000). In contrast with the Hope credit, the maximum credit amount is not indexed for inflation.

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 $43,000 and $53,000 ($87,000 and $107,000 for married taxpayers filing a joint return) for 2005. These phaseout ranges are the same as those for the Hope credit, and are similarly indexed for inflation.

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. As with the Hope credit, repayment of a loan is not a qualified tuition expense.

As with the Hope credit, a taxpayer may claim the Lifetime Learning credit with respect to a student who is not the taxpayer or the taxpayer's spouse (e.g., in cases in which the student is the taxpayer's child) only if the taxpayer claims the student as a dependent for the taxable year for which the credit is claimed. If a student is claimed as a dependent by the parent or other taxpayer, the 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 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). As with the Hope credit, a taxpayer may not claim the Lifetime Learning credit and also claim the section 222 deduction for qualified tuition and related expenses (described below).

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[94] Sec. 25A. The Lifetime Learning credit generally may not be claimed against a taxpayer's alternative minimum tax liability. However, the credit may be claimed against a taxpayer's alternative minimum tax liability for taxable years beginning prior to January 1, 2006.

As with the Hope credit, the Lifetime Learning credit is available for "qualified tuition and related expenses," which include tuition and fees (excluding nonacademic fees) required to be paid to an eligible educational institution as a condition of enrollment or attendance of a student at the institution. Eligible higher education institutions are defined in the same manner for purposes of both the Hope and Lifetime Learning credits. 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, or the education is undertaken to acquire or improve the job skills of the student.

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 courses.[95] Additionally, in contrast to the Hope credit, the eligibility of a student for the Lifetime Learning credit does not depend on whether the student has been convicted of a Federal or State felony consisting of the possession or distribution of a controlled substance.

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 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 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.

Effective for taxable years beginning after December 31, 2010, the changes to the Lifetime Learning credit made by EGTRRA no longer apply. The EGTRRA change scheduled to expire is the change that permitted a taxpayer to claim a Lifetime Learning credit in the same year that he or she claimed an exclusion from an education savings account. Thus, after 2010, taxpayers cannot claim a Lifetime Learning credit in the same year he or she claims an exclusion from an education savings account.

Above-the-line deduction for certain higher education expenses

An individual is allowed an above-the-line deduction for qualified tuition and related expenses for higher education paid by the individual during the taxable year.[96] Qualified tuition and related expenses are defined in the same manner as for the Hope and Lifetime Learning credits, and includes 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 may claim a personal exemption, at an eligible institution of higher education for courses of

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[95] As explained above, the Hope credit is available only with respect to the first two years of a student's undergraduate education.

[96] Sec. 222.

instruction of such individual at such institution.[97] The expenses must be in connection with enrollment at an institution of higher education during the taxable year, or with an academic term beginning during the taxable year or during the first three months of the next taxable year. The deduction is not available for tuition and related expenses paid for elementary or secondary education.

For taxable years beginning in 2004 or 2005, the maximum deduction is $4,000 for an individual whose adjusted gross income for the taxable year does not exceed $65,000 ($130,000 in the case of a joint return), or $2,000 for other individuals whose adjusted gross income does not exceed $80,000 ($160,000 in the case of a joint return). No deduction is allowed for an individual whose adjusted gross income exceeds the relevant adjusted gross income limitations, for a married individual who does not file a joint return, or for an individual with respect to whom a personal exemption deduction may be claimed by another taxpayer for the taxable year. The deduction is not available for taxable years beginning after December 31, 2005.

The amount of qualified tuition and related expenses must be reduced by certain scholarships, educational assistance allowances, and other amounts paid for the benefit of such individual,[98] and by the amount of such expenses taken into account for purposes of determining any exclusion from gross income of: (1) income from certain United States Savings Bonds used to pay higher education tuition and fees; and (2) income from a Coverdell education savings account.[99] Additionally, such expenses must be reduced by the earnings portion (but not the return of principal) of distributions from a qualified tuition program if an exclusion under section 529 is claimed with respect to expenses eligible for exclusion under section 222. No deduction is allowed for any expense for which a deduction is otherwise allowed or with respect to an individual for whom a Hope credit or Lifetime Learning credit is elected for such taxable year.

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[97] The deduction generally is not available for expenses with respect to a course or education involving sports, games, or hobbies, and is not available for student activity fees, athletic fees, insurance expenses, or other expenses unrelated to an individual's academic course of instruction.

[98] Secs. 222(d)(1) and 25A(g)(2).

[99] Sec. 222(c). These reductions are the same as those that apply to the Hope and Lifetime Learning credits.

Table 1.–Comparison of Certain Education Tax Incentives Available to Individuals Under Present Law

Provision	Tax Benefit	Dollar Limits on Amount Eligible for Tax Benefit	Eligible Claimants	Eligible Beneficiaries	Qualified Education Expenses	Coordination with Other Education Provisions
1. Hope credit (sec. 25A)	Nonrefundable credit 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. The credit is phased out ratably for taxpayers with modified adjusted gross income between $43,000 and $53,000 ($87,000 and $107,000 for married taxpayers filing a joint return) for 2005.	Credit may be claimed by student or by another taxpayer if the taxpayer claims the student as a dependent.	Eligible student must be enrolled on at least a half-time basis and must not have been convicted of a Federal or State felony involving possession or distribution of a controlled substance.	(1) Tuition, except that tuition is a qualified expense with respect to any course or other education involving sports, games, or hobbies, only if such course or other education is part of the individual's degree program. (2) Required fees, except that required fees with respect to any course or other education involving sports, games, or hobbies is included only if such course or other education is part of the individual's degree program. Nonacademic fees are not included.	Hope credit cannot be claimed with respect to a student if either the Lifetime Learning credit or the above-the-line deduction for higher education expenses is claimed for such student in the same year. No credit is allowed for any expense for which a deduction is allowed under any other provision of the Code.
2. Lifetime Learning Credit ("LLC") (sec. 25A)	Nonrefundable credit for qualified tuition and related expenses for undergraduate or graduate courses. Unlike Hope credit, LLC is available for	Credit rate is 20% of up to $10,000 of qualified expenses. Unlike Hope credit, LLC is computed on family-wide basis, rather than per-student	Same as Hope credit.	No restrictions.	Same as Hope credit, except that Lifetime Learning credit also applies to expenses for courses related to sports, games and hobbies if the course	Lifetime Learning credit cannot be claimed with respect to a student if either the Hope credit or the above the line deduction

Provision	Tax Benefit	Dollar Limits on Amount Eligible for Tax Benefit	Eligible Claimants	Eligible Beneficiaries	Qualified Education Expenses	Coordination with Other Education Provisions
	an unlimited number of years.	basis. The credit is phased out ratably for taxpayers with modified adjusted gross income between $43,000 and $53,000 ($87,000 and $107,000 for married taxpayers filing a joint return) for 2005.			is taken to acquire or improve the job skills of the student.	for higher education expenses is claimed for such student in the same year. No credit is allowed for any expense for which a deduction is allowed under any other provision of the Code.
3. Above-the-line deduction for certain higher education expenses (sec. 222)	Above-the-line deduction for qualified tuition and related expenses for undergraduate or graduate courses.	For 2004 or 2005, the maximum deduction is: (1) $4,000 for an individual whose adjusted gross income for the taxable year does not exceed $65,000 ($130,000 in the case of a joint return); (2) $2,000 for other individuals whose adjusted gross income does not exceed $80,000 ($160,000 in the case of a joint return); and (3) zero for all other individuals. The deduction is not available in 2006 and thereafter.	Same as Hope credit.	No restrictions.	Same as Hope credit.	Above-the-line deduction cannot be claimed with respect to a student if either the Hope credit or the Lifetime Learning credit is claimed for such student in the same year. No deduction is allowed for any expense for which a deduction is allowed under any other provision of the Code.

Reasons for Change

Combining the Hope and Lifetime Learning credits and the deduction for higher education expenses into a single credit for higher education expenses would promote simplicity in delivering education tax benefits.[100] Additionally, providing such benefits on a per-student basis, rather than a per tax return basis, would promote greater fairness by allowing the credit to vary more directly with the number of students in a family.

Description of Proposal

The proposal combines the Hope and Lifetime Learning credits and the above-the-line deduction for qualified higher education expenses into a single credit. The credit applies on a per-student basis, as under the Hope credit, and, as under the Lifetime Learning credit, applies to qualified education expenses for both graduate and undergraduate education without regard to enrollment status (i.e., halftime or otherwise). The credit equals 25 percent of the first $10,000 dollars of qualified expenses per student. The otherwise allowable aggregate credit per tax return is phased out by $50 for each $1,000 that adjusted gross income exceeds $70,000 ($140,000 if married filing a joint return). The credit is allowed against the alternative minimum tax.

The credit rate, expense limitation, and phaseout ranges were chosen to create an approximately revenue neutral proposal over the period 2006-2014[101] under the assumption that the baseline includes permanent extension of the above-the-line deduction and extension of provisions allowing nonrefundable personal credits against the alternative minimum tax. These assumptions were made for purposes of illustrating a possible credit that provides benefits comparable to those based on the law in effect for 2005. A revenue estimate of this proposal, which would be determined relative to present law (and therefore would incorporate the expiration of all expiring provisions), would not be revenue neutral. In particular, the proposal does not completely reflect the revenue loss attributable to allowing the credit against the alternative minimum tax or allowing the credit for those taxpayers phased out of the present-law Hope and Lifetime Learning Credits, but otherwise eligible for the above-the-line deduction for higher education expense if the deduction were extended.

The $10,000 expense limit and the phaseout thresholds are the 2006 levels. The expense limit and the phaseout thresholds are indexed for inflation.

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[100] The complexity of the present-law rules was previously noted by the staff of the Joint Committee on Taxation in the 2001 simplification study. The proposal here is similar to the recommendation in the simplification study. 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, at 122, 126-30.

[101] The proposal is not revenue neutral on a year-by-year basis.

Effective Date

The proposal is effective with respect to taxable years beginning after the date of enactment.

Discussion

The proposal embodies two principal policy objectives. The first is simplification. The three present-law benefits are substantially similar in their objectives; combining them into a single benefit can achieve the same general policy in a less complicated manner.[102] The second policy objective is to achieve a more equitable benefit by making the benefit apply on a per student basis rather than a per tax-return basis.

The credit structure (as opposed to a deduction) is adopted, and an income-based phaseout of the benefit is retained, on the grounds that educational expenses do not warrant a reduced tax liability as a result of ability-to-pay principles. Rather, the primary function of the educational benefit is to lower the price of education (accomplished via the credit) to a particular group in order to encourage pursuit of higher education. The rationale for the credit approach rather than the deduction suggests that the credit should be refundable, because the rationale for subsidizing the price of education does not depend on having a tax liability. Nevertheless, refundable credits are administratively complex and potentially more subject to fraudulent claims that are difficult to recoup. Additionally, there are Federal programs, such as the Pell Grant program, that provide direct grants for education to a population that is generally similar to the population that would be eligible for a refundable credit. Thus, a mechanism already exists to assist this demographic group, which could be expanded by Congress as necessary.

The proposal does not provide for refundability because Congress has not in the past permitted refundability with respect to education benefits. The credit structure would readily permit refundability should Congress desire to provide for it.

The proposal does not include a half-time or greater enrollment requirement on the grounds that many students from lower-income families cannot afford to attend school on a half-time or greater basis, either as a result of the expenses of half-time or greater enrollment or as a result of the greater foregone earnings from reduced employment of the student that a half-time or greater enrollment requirement would likely entail.

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[102] Further simplification could be achieved across other tax benefits for education. For example, separately, the President's Fiscal Year 2005 budget proposal and the staff of the Joint Committee on Taxation have recommended that the definition of qualified education expenses be conformed more generally across provisions of the Code. See Office of Management and Budget, *Budget of the United States Government, Fiscal Year 2005*; and, 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, at 122-26.

C. Repeal Exclusion for Qualified Tuition Reductions (sec. 117(d))

Present Law

Qualified tuition reductions

Present law provides an exclusion from gross income and wages for amounts received as a qualified tuition reduction.[103] In general, a qualified tuition reduction is the amount of any reduction in tuition provided to employees of qualifying educational organizations for the education below the graduate level (including primary and secondary school) of the employee (and the employee's spouse and dependents)[104] at such organizations or other qualifying educational organizations. A graduate student at a qualifying educational organization who is engaged in teaching or research activities at the organization may exclude from gross income and wages any amount received as a qualified tuition reduction even if the education provided is not below the graduate level.

For a tuition reduction to qualify for the exclusion, the organization must be an educational organization which normally maintains a regular faculty and curriculum and normally has a regularly-enrolled body of pupils or students in attendance at the place where its educational activities are regularly carried on.

A qualified tuition reduction which is provided with respect to a highly compensated employee qualifies for the exclusion only if it meets certain nondiscrimination rules. Specifically, the exclusion must be offered on substantially the same terms to each member of a group of employees which is defined under a reasonable classification established by the employer which does not discriminate in favor of highly compensated employees. For this purpose, the term "highly compensated employee" means any employee who (1) was a five-percent owner of the employer at any time during the year or (2) for the preceding year, had compensation from the employer in excess of $95,000 (for 2005) and if the employer elects, was in the top-paid group of employees for such year.[105]

The exclusion for qualified tuition reductions generally does not apply to any amount received by a student that represents payment for teaching, research, or other services by the student required as a condition for receiving the tuition reduction. Payments for such services are includible in gross income and wages.

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[103] Secs. 117(d) and 3121(a)(20).

[104] Certain other individuals may also be treated as employees for purposes of this rule, including retired and disabled employees and surviving spouses of employees. Sec. 117(d)(2)(B).

[105] Sec. 414(q). This is the same definition used for purpose of the nondiscrimination rules applicable to qualified retirement plans.

Other tax benefits for education expenses

Present law provides a variety of other tax benefits relating to education. These include: the Hope tax credit; the Lifetime Learning credit; an above-the-line deduction of up to $4,000 of higher education expenses; an exclusion of up to $5,250 annually for employer-provided education assistance; qualified scholarships; section 529 qualified tuition programs; Coverdell education savings accounts; an exclusion of earnings on education savings bonds; a deduction for student loan interest; and an exclusion of income for student loan forgiveness.[106]

Reasons for Change

The exclusion for qualified tuition reductions raises fairness concerns because it is available only to a limited group of taxpayers, as compared to other present-law provisions which provide tax benefits relating to education much more broadly. Repeal of the provision would simplify the law and remove a potential source of noncompliance.

Description of Proposal

The proposal repeals the exclusion for qualified tuition reductions. Under the proposal, such benefits are included in gross income and are treated as wages for employment tax purposes.[107] Tuition reductions that are includible in income under the proposal would be eligible for the present-law tax benefits for education expenses, provided the requirements for such benefits are otherwise satisfied.

Effective Date

The proposal is effective with respect to taxable years beginning after date of enactment.

Discussion

The exclusion for qualified tuition reductions is available only to a limited group of taxpayers. It is not available to individuals working in fields other than education and, within the education field, may be available primarily to those working for educational institutions which have the greatest resources and by employees of the most resource-rich schools within such

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[106] Some of these provisions apply to higher education, while others also apply to elementary and secondary education. For example, the Coverdell education savings accounts may be used to provide for primary and secondary education on a tax-favored basis. A proposal to combine the above-the-line deduction, the Hope credit and the Lifetime Learning credit is described in Part II.B., of the report.

[107] Tuition reductions are also excludable from income and wages if they qualify: (1) as a working condition fringe benefit (sec. 132(d)), i.e., if the cost of the education would be deductible as a business expense paid by the employee; or (2) for the exclusion for employer-provided education assistance (sec. 127). In many cases, the section 127 exclusion will not apply, because that exclusion applies to education provided to the employee, but not to the employee's spouse or dependents.

institutions because such institutions and schools may be in the best financial position to provide such benefits.

Although the nondiscrimination rules for qualified tuition reductions require that the benefits not discriminate in favor of highly compensated employees, these rules may not adequately prevent the award of these benefits in favor of the more highly compensated, depending upon how a "reasonable classification" of employees is defined.[108] Moreover, the nondiscrimination rules do not address the limited scope of the provision to benefit only employees of certain educational organizations.

By comparison to qualified tuition reductions, other provisions under present law provide tax benefits for education to a much broader segment of taxpayers. If the proposal were adopted, current beneficiaries of qualified tuition reductions would be entitled to claim benefits under any of these provisions if they are otherwise eligible.

Qualified tuition reductions are sometimes viewed as a means to promote loyalty on the part of employees of educational organizations. For example, under present law, such organizations may subsidize in a tax-free manner the education of an employee's dependents at the same institution where the employee works. But this rationale may not fully justify the present-law rules for qualified tuition reductions because these rules also permit a tax-free subsidy even if the employee's dependent is educated at any other qualifying institution.

The proposal simplifies the law and removes a potential source of noncompliance. For example, repeal of the provision eliminates the need to determine the appropriate classification of employees for purposes of applying the nondiscrimination requirement. Repeal also eliminates the potential confusion of distinguishing between a tax-free tuition reduction received by a student and taxable compensation received by such student for teaching, research, or other services.

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[108] Reasonable classification is a concept that also applies with respect to the nondiscrimination rules applicable to qualified retirement plans. The IRS has noted that the reasonable classification rule applies differently to qualified tuition reductions than to qualified retirement plans. See, e.g., Priv. Ltr. Ruls. 200137041 (June 20, 2001) and 9710022 (December 6, 1996).

D. Deny Refundable Child Credit When Section 911 Exclusion is Elected (sec. 24)

Present Law

Child credit

In general

An individual may claim a $1,000 tax credit for each qualifying child under the age of 17.[109]

The child tax credit is phased-out for individuals with income over certain thresholds. Specifically, the otherwise allowable child tax credit is reduced by $50 for each $1,000 (or fraction thereof) of modified adjusted gross income over $75,000 for single individuals or heads of households, $110,000 for married individuals filing joint returns, and $55,000 for married individuals filing separate returns.[110] The length of the phase-out range depends on the number of qualifying children. For example, the phase-out range for a single individual with one qualifying child is between $75,000 and $95,000 of modified adjusted gross income. The phase-out range for a single individual with two qualifying children is between $75,000 and $115,000.

The amount of the tax credit and the phase-out ranges are not adjusted annually for inflation.

Refundability

For 2005, the child credit is refundable to the extent of 15 percent of the taxpayer's earned income in excess of $10,900.[111] Families with three or more children are allowed a

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[109] Sec. 24. The credit reverts to $500 in taxable years beginning after December 31, 2010, under the sunset provision of EGTRRA. A qualifying child is determined by reference to the uniform definition of qualifying child enacted by Congress in 2004, effective for taxable years beginning after December 31, 2004. Secs. 21(b)(1)(A) and 152(a)(1) (as amended by The Working Families Tax Relief Act of 2004, Pub. L. No. 108-311, secs. 201 and 203). In general, a qualifying child means, with respect to a taxpayer for a taxable year, an individual who: (1) is a son, daughter, stepson, stepdaughter, adopted child, eligible foster child, brother, sister, stepbrother, or stepsister of the taxpayer, or a descendant of any such individual; (2) shares the same principal place of abode as the taxpayer for more than half the taxable year; (3) meets certain age requirements or is permanently and totally disabled; and (4) has not provided over one half of his or her own support during the year. Sec. 152(c) (as amended by the Act).

[110] Modified adjusted gross income is the taxpayer's total gross income plus certain amounts excluded from gross income (e.g., excluded income of U.S. citizens or residents living abroad (sec. 911); residents of American Samoa and the Northern Mariana Islands (sec. 931); and residents of Puerto Rico (sec. 933)).

[111] The $10,900 amount is indexed for inflation.

refundable credit for the amount by which the taxpayer's social security taxes exceed the taxpayer's earned income credit, if that amount is greater than the refundable credit based on the taxpayer's earned income in excess of $10,900 (for 2005). The refundable portion of the child credit does not constitute income and is not treated as resources for purposes of determining eligibility or the amount or nature of benefits or assistance under any Federal program or any State or local program financed with Federal funds. For taxable years beginning after December 31, 2010, the sunset provision of EGTRRA applies to the rule allowing refundable child credits based on earned income in excess of the threshold.

The definition of "earned income" for purposes of the refundable child credit generally follows that for the earned income credit, which includes (1) wages, salaries, tips and other employee compensation to the extent includible in gross income, plus (2) net earnings from self-employment. For purposes of the refundable child credit, earned income also must be taken into account in computing taxable income in order to be considered earned income for calculating the refundable child credit.

Earned income credit

In general

Low and moderate-income workers may be eligible for the refundable earned income credit ("EIC").[112] Eligibility for the EIC is based on earned income, adjusted gross income, investment income, filing status, and immigration and work status in the United States. The amount of the EIC is based on the presence and number of qualifying children in the worker's family, as well as on adjusted gross income and earned income.

The earned income credit generally equals a specified percentage of wages up to a maximum dollar amount. The maximum amount applies over a certain income range and then diminishes to zero over a specified phaseout range. For taxpayers with earned income (or adjusted gross income ("AGI"), if greater) in excess of the beginning of the phaseout range, the maximum EIC amount is reduced by the phaseout rate multiplied by the amount of earned income (or AGI, if greater) in excess of the beginning of the phaseout range. For taxpayers with earned income (or AGI, if greater) in excess of the end of the phaseout range, no credit is allowed.

An individual is not eligible for the EIC if the aggregate amount of disqualified income of the taxpayer for the taxable year exceeds $2,700 (for 2005). This threshold is indexed. Disqualified income is the sum of: (1) interest (taxable and tax exempt); (2) dividends; (3) net rent and royalty income (if greater than zero); (4) capital gains net income; and (5) net passive income (if greater than zero) that is not self-employment income.

The EIC is a refundable credit, meaning that if the amount of the credit exceeds the taxpayer's Federal income tax liability, the excess is payable to the taxpayer as a direct transfer payment. Under an advance payment system, eligible taxpayers may elect to receive the credit

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[112] Sec. 32.

in their paychecks, rather than waiting to claim a refund on their tax return filed by April 15 of the following year.

Section 911

An individual electing to exclude foreign earned income under the provisions of section 911 is not eligible for the EIC.

Foreign earned income exclusion (section 911)

In general

U.S. citizens generally are subject to U.S. income tax on all their income, whether derived in the United States or elsewhere. U.S. citizens living abroad may be eligible to elect to exclude from their income for U.S. tax purposes certain foreign earned income and foreign housing costs, in which case no residual U.S. tax is imposed to the extent of such exclusion.[113] In order to qualify for these exclusions, an individual must be either: (1) a U.S. citizen who is a bona fide resident of a foreign country for an uninterrupted period that includes an entire taxable year;[114] or (2) a U.S. citizen or resident present overseas for 330 days out of any 12-consecutive-month period. In addition, the taxpayer must have his or her tax home in a foreign country.

Exclusion for compensation

The foreign earned income exclusion generally applies to income earned from sources outside the United States as compensation for personal services rendered by the taxpayer. The maximum exclusion amount for foreign earned income is $80,000 per taxable year for 2005 and thereafter. For taxable years beginning after 2007, the maximum exclusion amount is indexed for inflation.

Reasons for Change

Present law permits certain high-income taxpayers to receive the refundable child credit, which is intended for low-income taxpayers.

Description of Proposal

The proposal denies a refundable child credit to anyone claiming the section 911 exclusion.

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[113] Sec. 911.

[114] Only U.S. citizens may qualify under the bona fide residence test. However, resident aliens of the United States who are citizens of foreign countries that have a treaty with the United States may qualify for section 911 exclusions under the bona fide residence test by application of a nondiscrimination provision.

Effective Date

The proposal is effective with respect to taxable years beginning after the date of enactment.

Discussion

The refundable child credit is generally intended to apply to working families of sufficiently low economic income. Under present law, however, because earned income must be included in gross income in order to be considered earned income for purposes of the EIC and the refundable child credit, taxpayers working abroad and claiming an exclusion under section 911 are potentially eligible for a refundable child credit if their income is sufficiently high. Specifically, the refundable credit becomes payable for taxpayers working abroad, and electing the section 911 exclusion, once the taxpayer's earned income exceeds $90,900 (section 911 exclusion of $80,000 plus the refundable child credit earned income threshold of $10,900 for 2005).

Example 1.–A married U.S. taxpayer with two children who lives and works in a foreign country with $100,000 of foreign earned income has gross income of only $20,000 as a result of the $80,000 foreign earned income (section 911) exclusion. The taxpayer is potentially eligible for up to $2,000 of child credits as a result of having two eligible children. Because the phaseout of the child credit starts at $110,000 of modified AGI for a married taxpayer filing jointly, the child credit is not reduced by the phaseout.[115] As a result of other provisions of U.S. tax law such as the personal exemptions and the standard deduction which collectively exceed $20,000,[116] taxpayer has no taxable income and thus no U.S. income tax liability to apply the $2,000 credit towards. However, because the refundable child credit is based on only the portion of earned income that is included in taxable income, the taxpayer is eligible for a refundable credit of up to 15 percent of the amount by which such income (in this case $20,000) exceeds $10,900, or $9,100, for a refundable credit of $1,365 (15 percent of $9,100). Since the taxpayer was eligible for up to $2,000 in child credits, the taxpayer is able to claim the full refundable amount of $1,365.[117]

Example 2.–The facts are the same as example 1 except that the taxpayer has $60,000 of foreign earned income, or $40,000 less income than the taxpayer of example 1. The taxpayer thus has no gross income for U.S. tax purposes as a result of the $80,000 foreign earned income (section 911) exclusion. The taxpayer is potentially eligible for up to $2,000 of child credits as a

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[115] The phaseout of the child credit applies regardless of whether the child credit is used to offset regular tax liability or is a refundable child credit.

[116] The taxpayer would have two personal exemptions and two dependent exemptions at $3,200 each for a total of $12,800, and a standard deduction of $10,000, for total exemptions and deductions of $22,800.

[117] If the taxpayer had only one child, the calculation for the refundable credit would still yield a potentially refundable credit of $1,365, but the actual refundable credit would have been limited to $1,000 as that is the maximum credit allowable for a taxpayer with one child.

result of having two eligible children. Because the phaseout of the child credit starts at $110,000 of modified AGI for a married taxpayer filing jointly, the child credit is not reduced by the phaseout. As a result of having no gross income, the taxpayer has no taxable income and thus no U.S. income tax liability to apply the $2,000 credit towards. Because the refundable child credit is based on only the portion of earned income that is included in taxable income for a taxpayer with fewer than three children, the taxpayer is not eligible for a refundable credit because none of the earned income is included in taxable income.

Thus, the taxpayer with the lower income is denied the refundable credit, while the taxpayer with higher income receives a refundable credit. Most observers would agree that present law, in providing a refundable credit to certain high-income taxpayers, while denying it to certain lower-income taxpayers, violates generally held principles of equitable tax policy. Hence, the proposal adopts the EIC rule and prohibits claiming a refundable credit when the section 911 exclusion is taken.

E. Repeal the Deduction for Interest on Home Equity Indebtedness (sec. 163)

Present Law

In general

In general, an individual may not deduct personal interest.[118] Personal interest is any interest other than interest incurred or continued in connection with the conduct of a trade or business (other than the trade or business of performing services as an employee) or investment interest. Qualified residence interest, however, is not treated as personal interest and is deductible subject to limitations.[119] Qualified residence interest means interest on either acquisition indebtedness or home equity indebtedness.

Acquisition indebtedness

Acquisition indebtedness is indebtedness incurred in acquiring, constructing or substantially improving any qualified residence of the taxpayer. Acquisition indebtedness is reduced as payments of principal are made and cannot be increased by refinancing. Thus, for example, if the taxpayer incurs $200,000 of acquisition indebtedness to acquire his principal residence and pays down the debt to $150,000, his acquisition indebtedness with respect to the residence cannot thereafter be increased above $150,000 (except by indebtedness incurred to substantially improve the residence). Refinanced acquisition debt continues to be treated as acquisition debt to the extent that the principal amount of the refinancing does not exceed the principal amount of the acquisition debt immediately before the financing. The indebtedness must be secured by the qualified residence and is limited to $1 million. Qualified residence means the taxpayer's principal residence and one other residence of the taxpayer selected to be a qualified residence.

Home equity indebtedness

Certain home equity indebtedness may give rise to deductible qualified residence interest. Home equity indebtedness, for this purpose, means debt secured by the taxpayer's principal or second residence to the extent the aggregate amount of such debt does not exceed the difference between the total acquisition indebtedness with respect to the residence, and the fair market value of the residence. The amount of home equity indebtedness on which interest is treated as deductible qualified residence interest may not exceed $100,000 ($50,000 for married persons filing a separate return).[120]

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[118] Sec. 163(h)(1).

[119] Sec. 163(h)(2)(D) and (h)(3).

[120] The $100,000 limitation on home equity indebtedness was enacted by the Revenue Act of 1987. The Tax Reform Act of 1986 had previously limited the deductibility of personal interest. The exception in the Tax Reform Act of 1986 for qualified residence interest allowed a

Interest on qualifying home equity indebtedness is deductible, regardless of how the proceeds of the indebtedness are used.[121] A taxpayer and a mortgage company can contract for the home equity indebtedness loan proceeds to be transferred to the taxpayer either in a lump sum payment or a series of payments (e.g., a reverse mortgage).

Thus, under present law, the total amount of a taxpayer's home equity indebtedness with respect to his principal residence and a second residence, when combined with the amount of his acquisition indebtedness with respect to such residences, may not exceed a $1,100,000 overall limitation ($550,000, for married persons filing a separate return).

Reasons for Change

The present-law deduction for interest on home equity indebtedness is inconsistent with the goal of encouraging home ownership while limiting significant disincentives to saving. A taxpayer may deduct interest on a loan of up to $100,000 secured by his residence that has no relation to the acquisition or substantial improvement of the residence. This acts as a disincentive to savings and is unrelated to the purpose of encouraging home ownership. Further, the present-law home equity indebtedness rules provide inconsistent treatment by allowing deductible interest for homeowners' consumption spending that is not allowed to similarly situated non-homeowners.

Description of Proposal

The proposal repeals the deduction for interest on home equity indebtedness.

Effective Date

The proposal is effective for interest paid on debt incurred after the date of enactment. Interest on home equity indebtedness originally incurred before the date of enactment and refinanced on or after the date of enactment remains deductible only to the extent of the outstanding principal of the indebtedness at the time of refinancing.

The following examples illustrate the application of the effective date:

Example 1.–A taxpayer has a home with a fair market value of $500,000 in a taxable year beginning after the date of enactment. The taxpayer has a first mortgage of $250,000 (at 6.5 percent) which qualifies as an acquisition loan. The taxpayer has a home equity loan of $75,000 (at seven percent) but pays no interest during the year. Both the $250,000 first mortgage and the $75,000 home equity loan were originally incurred before the effective date. After the date of enactment, the taxpayer incurs a new home equity loan of $225,000 (at six percent) and pays off

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deduction for interest on a loan secured by a principal or second residence up to the sum of the amount of the cost of the residence plus the amount of qualified medical expenses and qualified educational expenses (not in excess of the fair market value of the residence).

[121] Examples of such personal expenditures include health costs and education expenses for the taxpayer's family members or any other personal expenses.

the $75,000 home equity loan. The taxpayer may continue to deduct the interest on the first mortgage of $250,000 as an acquisition loan and may also deduct one-third of the interest of the new home equity loan ($75,000/$225,000).

Example 2.–Same facts as above except that the taxpayer did not have an outstanding home equity loan on the date of enactment. The taxpayer may continue to deduct the interest on the first mortgage of $250,000 as an acquisition loan, but none of the interest on the new home equity loan.

Discussion

In general

Encouraging savings is a policy goal reflected throughout the Code. In part for this reason, personal interest generally is not deductible. Another policy reflected in the Code is the promotion of home ownership. To promote home ownership, the Code allows a deduction for qualified residence interest (including interest on home equity indebtedness). Interest on home equity debt, however, more closely resembles non-deductible personal interest than interest incurred to purchase a taxpayer's principal or second residence, and therefore the general tax policy against subsidizing personal debt (other than for homeownership) should apply to home equity indebtedness. There are three major arguments for eliminating the deduction for home equity debt: (1) it creates conflicting policies; (2) it causes complexity in the tax law; and (3) it yields disparate treatment of similarly situated taxpayers.

Conflicting policies

If a tax deduction for personal interest were allowed, it would reduce the effective interest cost of the indebtedness and thereby encourage individuals to incur such debt. By generally disallowing a deduction for personal interest, present law discourages personal debt of individuals and encourages personal saving. Because home equity interest is interest paid on a personal debt, allowing a deduction for such interest creates an inconsistent policy as between home equity debt and other personal debt. Further, it is unlikely that the deduction for interest on home equity debt significantly adds to the present-law incentive to encourage homeownership because most decisions to purchase a home are unlikely to be affected by the ability to deduct home equity indebtedness.[122] Also, individuals who currently benefit from the home equity debt rules have already achieved homeownership and are unlikely to stop being homeowners because the home equity debt rules are repealed.

Complexity

The present-law rule that home equity interest is only deductible for indebtedness up to the amount that the fair market value of the home exceeds acquisition indebtedness adds complexity to the tax law by requiring the homeowner to determine the fair market value of the home on a periodic basis. This source of complexity is compounded in periods of fluctuating

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[122] The deduction for interest on home equity indebtedness may conflict with the goal of homeownership if taxpayers are encouraged to incur unsustainable levels of debt.

real estate prices. Repeal of the home equity debt rules would eliminate this source of complexity.

Further, the present-law home equity debt rules can be manipulated by taxpayers. For example, many automobile dealerships are 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. Dealers may take this interest in the home though a security interest in the car as 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.

The present-law home equity debt rules have some simplification value in certain circumstances. Specifically, when the amount of home equity indebtedness incurred as part of a home refinancing does not exceed $100,000, a taxpayer may not have to allocate interest because all the interest on the home refinancing is deductible. Unlike present law, the proposal requires a taxpayer to bifurcate the interest paid on the refinancing debt between the deductible and nondeductible portions if any home equity debt (other than grandfathered home equity debt) is incurred as part of a refinancing. Therefore the proposal can result in additional computational complexity in certain circumstances. However, this potential increase in complexity is small compared to the reduction in complexity related to valuation that would be effected by the proposal.

In determining how to characterize interest expense of an individual as, for example, investment interest (which is deductible within certain limits) or personal interest (which generally is nondeductible), or deductible qualified residence interest (including home equity interest), temporary regulations provide rules that essentially adopt a tracing approach.[123] These tracing rules could be simplified by reducing the number of categories of interest to which they apply. Denying deductibility for home equity debt rules would simplify the tracing and reduce complexity.

Disparate treatment of similarly situated taxpayers

Home equity debt is often incurred to finance an individual's personal expenditures, and not to finance homeownership. Such interest would be nondeductible as personal interest if it were not incurred with respect to home equity debt. Effectively, present law gives unequal treatment for otherwise similar interest costs based on whether the debtor owns a home. This result is inequitable.

The home equity deduction also treats homeowners unequally because the present-law home equity debt rules favor homeowners with equity in their home versus homeowners with little or no equity. Therefore, this tax benefit generally is more valuable to homeowners in areas with price appreciated homes than to homeowners in areas with flat or declining home prices. Taxpayers may respond to the proposal by incurring or maintaining larger amounts of acquisition indebtedness. If this occurs, disparate treatment of similarly situated taxpayers may continue.

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[123] Treas. Reg. sec. 1.163-8T (1987).

For example, assume Taxpayer A and Taxpayer B each has $250,000 of savings and no other debts when they purchase their principal residences for $500,000, respectively. Taxpayer A incurs $500,000 of acquisition indebtedness and leaves untouched the $250,000 of savings. Taxpayer B uses the $250,000 of savings as a down payment and incurs $250,000 of acquisition indebtedness. After these transactions, the two taxpayers are similarly situated with net worths of $250,000, but Taxpayer A may be able to offset future taxable income with a larger home mortgage interest deduction.[124] The same situation can arise under present law. Any effort to address this concern is beyond the scope of this proposal because it involves curtailing the present-law deduction for acquisition indebtedness.

[124] Taxpayer A may also have more taxable income as a result of the return on the $250,000 of savings than Taxpayer B.

F. Limit the Exclusion for Rental Value of a Residence Rented for Fewer Than 15 Days (sec. 280A)

Present Law

Gross income generally includes all income from whatever source derived, including rent from real property. Present law provides a de minimis exception to this rule if a dwelling unit is used during the taxable year by the taxpayer as a residence and is rented for fewer than 15 days during the taxable year. In this case, the rental income is not included in gross income. No deductions attributable to such rental use are allowed.

Reasons for Change

The present-law 15-day rule inaccurately measures economic income by excluding rental income earned by the taxpayer. The amount of the untaxed income can be significant even for fewer than 15 days' rental. A dollar limitation in conjunction with the 15-day rule would more accurately function as a de minimis threshold than a rule based exclusively on the rental period.

Description of Proposal

The proposal limits the total exclusion for the rental value of a residence rented fewer than 15 days to $2,000. Also the proposal allows certain deductions attributable to such rental use. Specifically, a taxpayer may claim the otherwise allowable deductions attributable to such rental use (e.g., depreciation) reduced in proportion to the ratio of excludable rental income to total rental income from the property.

Effective Date

The proposal is effective for taxable years beginning after the date of enactment.

Discussion

The following example illustrates the operation of the proposal:

Taxpayer A rents his residence for fewer than 15 days during the taxable year. The taxpayer receives $5,000 in rent and has $2,000 of otherwise applicable deductions arising from such rental use. Under present law, none of the $2,000 is deductible and none of the $5,000 of rental income is included in gross income. Under the proposal, the allowable amount of the deduction is reduced by the ratio of excludable gross rental income to total gross rental income (i.e., $2,000/$5,000). This reduces the otherwise applicable deductions arising from such rental use by 40 percent from $2,000 to $1,200. After reducing the gross rental income of $5,000 by the amount of the allowable deductions the taxpayer's net rental income is $3,800. Of this amount, $2,000 is excludable so the taxpayer has $1,800 of taxable income from the rental of the residence.

The principal justification for the present-law rule is that it reduces the administrative and record keeping burden on taxpayers and the IRS by excluding de minimis rental income

attributable to the taxpayer's residence. The fact that there is no dollar limit, however, is incompatible with the simplification argument underlying the de minimis exception, as rentals of fewer than 15 days on certain residences can be several thousands of dollars. The exception should be capped to better fit the de minimis rationale.

Any dollar limitation is arbitrary but an unlimited exception is not justified by the de minimis rationale. The de minimis exception provides for a less accurate measurement of income relating to the rental. It does this to alleviate the administrative and recordkeeping burden on the taxpayer and the IRS. This mismeasurement of income increases as the rental income rises even though the administrative and recordkeeping burden remains relatively constant. A dollar limitation would allow Congress to target the de minimis exception to taxpayers with relatively small amounts of rental income which is more consistent with the de minimis rationale.

The proposal will increase administrative and recordkeeping burden for those taxpayers whose rental income exceeds the dollar limitation. Unlike present law, the proposal allows deductions for such taxpayers and consequently affects the basis in their homes for tax purposes. The burden of this additional basis calculation, however, is relatively small when weighed against the more accurate measurement of economic income for such taxpayers achieved by the proposal.

G. Extend Pro-Rata Basis Allocation Requirement to All Part-Gift, Part-Sale Transactions (sec. 1011)

Present Law

A taxpayer that sells property to a charity for a price less than the fair market value generally must bifurcate the transaction into two parts (one part gift and the other part sale) under existing bargain sale rules. If a taxpayer makes a bargain sale of property and a charitable deduction is allowable for the donated portion of the property, then the adjusted basis used to determine the taxpayer's gain from the sale portion generally is an amount that equals the same percentage of the property's entire adjusted basis as the percentage that the sales price is of the fair market value of the property.[125] For example, assume a taxpayer bought 100 shares of stock for $1,000 and sold those shares to a charity for $5,000 when the fair market value of the shares was $10,000. The taxpayer's adjusted basis for purposes of determining gain from the sale portion is $500, which is 50 percent ($5,000 sales price divided by $10,000 fair market value) of the entire adjusted basis of $1,000. The taxpayer's gain from the sale portion, therefore, is $4,500, and a charitable deduction of $5,000 – the amount by which the fair market value exceeds the sales price – may be available.

This pro rata basis allocation rule for bargain sales to charities does not apply to part-gift, part-sale transactions for which a charitable deduction is not permitted. Instead, in determining the transferor's gain from the sale portion of such a transaction, the entire adjusted basis of the property transferred is used to offset the sales price.[126] Under this rule, if the taxpayer in the example described above transferred the stock to his or her child instead of to a charity, the adjusted basis used to determine the taxpayer's gain from the sale portion would be the entire adjusted basis of the stock, $1,000, and the taxpayer's gain would be only $4,000. If this basis rule applies, the transferee's basis generally is the amount paid for the property ($5,000 in the example) or the transferor's adjusted basis at the time of the transfer ($1,000 in the example), whichever is greater, plus any increase under section 1015(d) for Federal gift tax paid on the transfer.[127]

Reasons for Change

In general, when a taxpayer sells part of a larger property, the taxpayer is required to allocate basis to the portion sold based on that portion's fair market value.[128] Present law governing bargain sales to charities is consistent with this principle. Present law for other

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[125] Sec. 1011(b).

[126] Treas. Reg. sec. 1.1001-1(e).

[127] Treas. Reg. sec. 1.1015-4(a). For determining loss, however, the transferee's basis is limited to the fair market value of the property at the time of the transfer.

[128] Treas. Reg. sec. 1.61-6(a).

bargain sales, however, departs from this general rule and allocates the entire basis to the sale portion, thereby reducing the taxable gain for taxpayers making those sales. As a result, similar transactions are treated differently.

Description of Proposal

The proposal extends to all part-gift, part-sale transfers the present law pro-rata basis allocation rule applicable to bargain sales to charities. Consequently, for determining gain from any bargain sale, the proposal requires a taxpayer to allocate to the sale portion of property an amount of basis equal to that portion's pro rata share, based on respective fair market values, of the entire property's adjusted basis.

Under the proposal, the transferee's basis in property acquired in a part-gift, part-sale transaction is (1) the cost (sales price) of the purchased portion of the property plus (2) the transferor's basis in the gift portion of the property.

In the example above of a bargain sale to a taxpayer's child, the basis of the stock is allocated to the portion of the stock sold and the portion transferred as a gift based on the respective fair market values of the two parts so that the tax result is the same as if the taxpayer sold 50 shares and made a gift of 50 shares. The taxpayer recognizes a gain of $4,500, not $4,000 (the present-law result).

Effective Date

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

Discussion

Under the proposal, a taxpayer's taxable gain recognized on any bargain sale equals the taxpayer's gain that would be recognized on the disposition for fair market value of a portion of the property. Under present law, by contrast, taxpayers are permitted to shift gain to certain transferees. A taxpayer may, for example, sell a $100,000 painting for its adjusted basis of $5,000 and thereby shift the entire $95,000 appreciation in the painting to the transferee. This shift results in reduced tax liability if the transferee is in a lower tax bracket than the transferor. Even in the absence of tax rate differences, shifting of gain may create valuable tax deferral.

Present law thus produces different tax results for two economically similar transactions. A taxpayer may choose to sell a portion of property for its fair market value and then transfer the remaining part of the property by gift. Alternatively, the taxpayer may choose to sell the entire property at a bargain price. Under the proposal, the tax treatment of the two transactions is the same.

Basis allocation is required in a bargain sale to a charity because the charity's subsequent sale of the property generally will not be taxed to the charity. To reduce the amount of gain that escapes taxation altogether, therefore, the sale to a charity must result in the proper measurement of gain. The same policy applies, however, to a bargain sale to a buyer that is not a charity. The basis allocation rules should measure properly the amount of gain for both parties to any part-

gift, part-sale transaction – that is, the seller's gain on the initial sale and the buyer's gain on a subsequent sale.

The proposal may create administrative difficulties when property is hard to value. Under present law, the purchase price (rather than the fair market value) generally determines the tax treatment of the transferor or the acquirer's basis in the property acquired if the acquirer is not a charity. For example, if property with a basis of $50 is transferred for $100 consideration and is later determined to have been worth $200, the transferor's taxable gain of $50 and the transferee's basis ($100) will not be affected. Under the proposal, however, the taxpayer may have reported gain of $50 on the transfer even though he or she should have reported gain of $75, and the transferee's basis will be adjusted to $125 from $100. Ultimately, the administrative concerns potentially presented by the proposal as applied to property that is not readily valued must be weighed against the advantage of taxing a part-gift, part-sale transaction correctly and not permitting similar transactions to have different tax consequences. If administrative problems are of sufficient concern, the proposal might be modified to apply only to readily valued property such as publicly traded stock.

H. Simplify Taxation of Minor Children (sec. 1)

Present Law

Overview

In general, children are subject to the same income tax filing requirements and tax rules as other taxpayers, including those applicable to a taxpayer who may be claimed as a dependent by another taxpayer. For children under age 14, net unearned income (generally investment income that exceeds a certain amount) is taxed at the parent's rate if the parent's rate is higher than the child's. This is commonly referred to as the "kiddie tax." In limited circumstances, generally when a child is under 14 and his or her only income is dividends and interest within a certain range, a parent may elect to include the child's unearned income on the parent's return. The application of the kiddie tax may increase (but will not decrease) the amount of tax to be paid on the child's income. The parental election may cause the aggregate tax to be paid on the parent's and child's income to be higher than if the parent and child filed separate returns.

Filing requirements for children

An unmarried individual eligible to be claimed as a dependent on another taxpayer's return generally must file an individual income tax return if he or she has: (1) earned income over $5,000 (for 2005) and no unearned income; (2) unearned income over the minimum standard deduction amount for dependents ($800 in 2005) and no earned income; or (3) both earned income and unearned income totaling more than the smaller of (a) $5,000 (for 2005) or (b) the larger of (i) $800 (for 2005), or (ii) earned income plus $250.[129] Thus, if a dependent child has less than $800 in gross income, the child does not have to file an individual income tax return for 2005.[130]

A child who cannot be claimed as a dependent on another person's tax return 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.

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[129] 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 (2004)*, at 2, Table 1.

[130] A taxpayer generally need not file a return if he or she has gross income in an amount less than the standard deduction (and, if allowable to the taxpayer, the personal exemption amount). An individual who may be claimed as a dependent of another taxpayer is not eligible to claim the personal exemption for himself or herself. Sec. 151(d)(2). For taxable years beginning in 2005, the standard deduction amount for an individual who may be claimed as a dependent by another taxpayer may not exceed the greater of $800 or the sum of $250 and the individual's earned income.

Taxation of unearned income of children under 14

Special rules apply to the unearned income of a child who is under age 14.[131] 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 unearned income was more than $1,600 (for 2005); and (3) the child is required to file a return for the year.

For these purposes, unearned income is income other than wages, salaries, professional fees, or other amounts received as compensation for personal services actually rendered.[132] For children under age 14, net unearned income (for 2005, generally unearned income over $1,600) is taxed at the parent's rate if the parent's rate is higher than the child's rate. The remainder of a child's taxable income (i.e., earned income, plus unearned income up to $1,600 (for 2005), less the child's standard deduction) is taxed at the child's rates, regardless of whether the kiddie tax applies to the child. In general, a child is eligible to use the preferential tax rates for qualified dividends and capital gains.[133]

The kiddie tax applies regardless of the source of the property generating the income or when the property that gave 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 applies regardless of whether the child may be claimed as a dependent on the parent's return.

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 ($800 for 2005), 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.[134] A child's net unearned income cannot exceed the child's taxable income.

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, based upon the child's net unearned income relative to the aggregate net unearned income of all of the parent's children subject to the tax.

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[131] Sec. 1(g).

[132] Sec. 1(g)(4) and sec. 911(d)(2).

[133] Sec. 1(h).

[134] Sec. 1(g)(4).

Special rules apply to determine which parent's tax return and rate is used to calculate the kiddie tax. 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.[135]

Unless the parent elects to include the child's income on the parent's return (as described below) the child files a separate return to report the child's income,[136] and 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 on the child's unearned income, or

(2) the tax on the child's income without regard to the kiddie tax provisions.

Thus, application of the kiddie tax will not reduce (but in many cases will increase) a child's tax liability.

A child's qualifying dividends and capital gains are subject to the preferential tax rates for such income. Such dividends and capital gains are allocated between the child and the parent by allocating the $1,600 (for 2005) between such dividends and gains and the child's other investment income.[137]

Example.[138]–For 2005, a child who is age 13 has wages of $1,550, and total unearned income consisting of capital gains, dividends, and interest, of $2,800. The child may be claimed as a dependent on her parents' joint return. The child's adjusted gross income is $4,350,

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[135] Sec. 1(g)(5); Internal Revenue Service, Publication 929, *Tax Rules for Children and Dependents (2004),* at 6.

[136] The child must attach to the return Form 8615, *Tax for Children Under Age 14 With Investment Income of More Than $1,600 (2004).*

[137] IRS Publication 929, *Tax Rules for Children and Dependents (2004)*, at 8 (referring to Instructions to Form 8814, Child's Qualified Dividends and Capital Gain Distributions Worksheet, to divide the $1,600 base amount between the child's qualified dividends, capital gain distributions, and other interest and dividend income).

[138] This example is based on the illustrated example contained in IRS Publication 929, *Tax Rules for Children and Dependents (2004)* at 16-23. The amount of unearned income of a minor child taxed at the parent's rates is the same for both 2004 and 2005 (i.e., over $1,600).

standard deduction is $1,800 (i.e., $1,550 of earned income plus $250), and taxable income is $2,550. Because the child has unearned income for 2005 exceeding $1,600, the child is subject to the kiddie tax provisions. The child's net unearned income of $1,200 (i.e., $2,800 less $1,600) is subject to tax at the parents' rates. The remaining $1,350 of the child's taxable income (i.e., the excess of the child's earned income, and unearned income up to $1,600, over the standard deduction amount) is taxed at the child's rates. The child's capital gains and dividends are subject to the preferential tax rate for capital gains and qualifying dividends. Because the child has income other than dividends and interest, the parental election (described below) may not be made to include the child's unearned income on the parents' return.

Parental election to include child's dividends and interest on parent's return

Under certain circumstances, a parent may elect to report a child's dividends and interest 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 parent makes the election on Form 8814, "Parents' Election To Report Child's Interest and Dividends." The requirements for the parent's election are that:

(1) the child has gross income only from interest and dividends (including capital gains distributions and Alaska Permanent Fund Dividends);[139]

(2) such income is more than the minimum standard deduction amount for dependents ($800 in 2005) and less than 10 times that amount ($8,000 in 2005);

(3) no estimated tax payments for the year were made in the child's name and taxpayer identification number;

(4) no backup withholding occurred; and

(5) the child is required to file a return if the parent does not make the election.

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 minimum standard deduction amount for dependents (i.e., the child's gross income in excess of $1,600 for 2005). This amount is taxed at the parent's rate. The parent also must report an additional tax liability equal to the lesser of: (1) $80 (in 2005); or (2) 10 percent of the child's gross income (including qualifying dividends and capital gain distributions) exceeding the child's standard deduction ($800 in 2005).

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.[140] In addition, certain deductions that the child would have been entitled to take on

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[139] *Id.* at 7.

[140] *Id.*

his or her own return are lost.[141] 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.[142]

In addition, including a child's qualified dividends and capital gain distributions on a parent's return may increase the tax on a portion of such income. This is because the preferential tax rates for qualified dividends may be as low as five percent. If the parental election is made, however, the child's income between the standard deduction amount and the investment income threshold (i.e., between $800 and $1,600 for 2005) is taxed at 10 percent, even if it consists of qualified dividends (as defined in section 1(h)(11), including capital gain distributions) that would have been taxed at a lesser rate if the child had filed his or her own return.[143]

For all of these reasons, a parent making the election may cause an increased tax liability for the family.

Taxation of compensation for services of children

Compensation for a child's services is considered the gross income of the child, not the parent, even if the compensation is not received or retained by the child (e.g., it is the parent's income under local law).[144] 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.[145]

Reasons for Change

The "kiddie tax" was enacted to restrict the practice of high-income individuals transferring income-producing property to their children so that the income would be taxed at lower rates. This rationale for applying the kiddie tax rules to children under 14 also applies to older children who have not yet attained the age of majority.

The present-law kiddie tax provisions are complex, and lead to uncertainty about the tax rate that will apply to a child's unearned income. A main source of complexity is that present law requires a linkage between the child's return, the parent's return, and if applicable, the returns of the child's siblings. This linkage increases complexity in the initial filing of the child's return, and in subsequent filings or proceedings if the return of the child, the parent, or a sibling is amended or adjusted under audit. The rules are further complicated depending on

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[141] *Id.*

[142] Sec. 1(g)(7)(B).

[143] Internal Revenue Service, Publication 929, *Tax Rules for Children and Dependents (2004)*, at 7.

[144] Sec. 73(a).

[145] Sec. 6201(c).

whether the child's parents file jointly, separately, are married, unmarried, or remarried.[146] By simplifying the taxation of minor children, the proposal removes a potential source of noncompliance.

Description of Proposal

The proposal modifies the kiddie tax provisions by increasing the age of children to which the kiddie tax provisions apply from under 14 to under 18, unless the child is married or files as a head of household. The proposal also subjects the child's unearned income in excess of an exemption amount (initially $2,500, indexed for inflation) to the highest individual income tax rate applicable to income of that character, rather than to the parent's marginal rate. Under the proposal, a child's taxable income is first allocated to the excess (if any) of unearned income over the exemption amount (any such excess is taxed at the highest individual income tax rate applicable to income of that character), and then to income taxed at the child's tax rates. Unearned income in excess of the $2,500 amount (adjusted for inflation) is first treated as net capital gain[147] (to the extent thereof), and then other unearned income. (This allocation rule is demonstrated by Examples 1 and 2, below).

The proposal eliminates the present-law parental election to include certain unearned income of a child on a parent's return. Thus, under the proposal, a return is filed for every child whose income exceeds the filing requirement.

The proposal retains the present-law definitions of earned income and unearned income (i.e., unearned income is income other than wages, salaries, professional fees, or other amounts received as compensation for personal services actually rendered). The proposal does not modify the present-law determination of the amount of the standard deduction of an individual who may be claimed as a dependent by another taxpayer.

Example 1.–For 2005, a child who is age 17 has wages of $1,550, and total unearned income of $2,800, consisting of adjusted net capital gain of $2,000 and interest of $800. The child may be claimed as a dependent on her parents' joint return. Thus, the child's adjusted gross income is $4,350, the standard deduction is $1,800 (i.e., $1,550 earned income plus $250), and taxable income is $2,550.

Under the proposal, the child's income is taxed as follows. First, because the child's unearned income exceeds $2,500, the $300 excess is taxed at the highest tax rate applicable to income of the same character. Because the excess is first allocated to net capital gain, the full $300 is treated as net capital gain and is taxed at the 15-percent rate. Of the remaining $2,250 of taxable income, the remaining $1,700 of the net capital gain is taxed at the child's regular capital

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[146] The complexity of the present-law rules was previously noted by the staff of the Joint Committee on Taxation in the 2001 simplification study. 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, at 144.

[147] For this purpose net capital gain includes qualified dividend income. See sec. 1(h)(11).

gain rate (five percent) and $550 (taxable income less net capital gain) is taxed at the child's regular tax rate (10 percent).

Example 2.–The facts are the same as in Example 1, except that the child has no earned income for the year. Thus, the child's adjusted gross income is $2,800, the standard deduction is $800, and taxable income is $2,000. As in example 1, the child's unearned exceeds $2,500, and the $300 excess is allocated to net capital gain and is taxed at the highest tax rate for net capital gain, or 15 percent. The remaining $1,700 of taxable income is net capital gain and is taxed at the child's capital gain rate of five percent. The child has no taxable income in excess of net capital gain, and thus no income is taxed at the child's regular tax rate.

Example 3.–A child under age 18 has wages of $1,550 and unearned income consisting of net capital gain and interest of $2,400. Under the proposal, the child's adjusted gross income is $3,950, the standard deduction is $1,800, and taxable income is $2,150. Because the child's unearned income does not exceed $2,500, all of the child's taxable income is taxed at the child's rates (including the preferential rates for net capital gain).

Effective Date

The proposal is effective for taxable years beginning after the date of enactment.

Discussion

Elimination of use of parent's return and tax rates

The present-law requirement that net unearned income of a child under age 14 be taxed at the parent's rates generally requires a preparer of such a child's return to know the tax circumstances of the child's parents (i.e., filing status, taxable income, and actual tax liability), and the amount of net unearned income of other children of a parent, in order to determine the amount of the kiddie tax applicable to the child's unearned income. If the child's parents are married but file separate returns (including a custodial parent who divorced and remarried), each parent must know the amount of the taxable income of each parent to determine which parent's return is to be used to determine the child's tax on unearned income. If a parent's or a sibling's return is audited and adjusted, the child's return also must be audited and adjusted.

Under present law, the preparer's need to know certain tax information of the respective parents is not eliminated if the parental election is made, because only the parent whose return must be used when calculating the kiddie tax for the child's return may make the election (i.e., the election cannot be made without such information being known by both parents and, if applicable, their respective tax return preparers). Thus, certain tax information regarding both parents who file separately must be known, irrespective of whether the child files a separate return or one of the parents elects to include the child's unearned income on the parent's return.

The need to know certain tax information of the parents (including their marital status) and of certain siblings is eliminated if the child's unearned income is no longer taxed at the parent's tax rate. Alternatives include taxing the child's unearned income under the tax rate

schedule applicable to trusts and estates,[148] or under a rate schedule established specifically for this purpose. The rate schedule used for this purpose should be sufficiently compressed to discourage tax-motivated shifting of unearned income between a parent and a child. In its fiscal year 2005 budget, the Administration proposed modifying the kiddie tax by subjecting the child's earned income, and the first $2,500 (indexed for inflation) of unearned income, to tax at the child's rates, and unearned income over $2,500 at the highest regular income tax rate for individuals (or, for dividends and capital gains, the highest dividends or capital gains rate).[149]

The proposal reduces complexity by eliminating the need to calculate net unearned income and by eliminating the linkage between the various returns. At the same time, it curbs the tax-motivated shifting of unearned income to minor children by subjecting the child's unearned income in excess of a specified amount to the highest individual income tax rates applicable to that character of income.

Increase in age from under 14 to under 18

The present-law kiddie tax provisions apply only if the child is under age 14. Parents may shift unearned income to children over age 13 without subjecting such income to taxation at the parent's tax rate. For example, a parent may transfer stock to a custodial account for a child pursuant to the Uniform Transfer to Minors Act. If the stock is transferred to the child before the child attains age 14, the annual dividends and other unearned income of the child in excess of $1,600 (for 2005) are subject to tax at the parent's rate, if higher than the child's rate, for those taxable years in which the child is under age 14 at the end of the year. Once the child attains age 14, however, the dividends are taxed at the child's rate.

The kiddie tax was enacted to restrict the practice of high-income individuals transferring income-producing property to their children so that the income would be taxed at lower rates.[150] When Congress enacted the kiddie tax in 1986, it "believed that the prior law rules governing the taxation of minor children provided inappropriate tax incentives to shift income-producing assets among family members" and "concluded that it generally is appropriate to tax the unearned

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[148] This alternative was recommended by the staff of the Joint Committee in its 2001 simplification study, and has been endorsed by others. 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, at 147. Although both the present proposal and the simplification study proposal promote simplification, the present proposal reduces the number of rates that would apply to a child's unearned income, which should reduce complexity and provide taxpayers greater certainty with respect to the taxation of income subject to the kiddie tax.

[149] Department of the Treasury, *General Explanations of the Administration's Fiscal Year 2005 Revenue Proposals*, February 2004, at 91-92.

[150] As described above, the tax applies more broadly to include unearned income on property owned by the child, regardless of how or when the child acquired the property.

income of a minor child under age 14 at the parent's marginal rates."[151] To the extent that parents shift assets to their children, this rationale for applying the kiddie tax rules to children under 14 also applies to older children who have not yet attained the age of majority. However, as is the case under present law, the kiddie tax (as modified by the proposal) applies even if the child's unearned income is derived from assets that were not acquired from a parent. The likelihood of a child acquiring assets from sources other than a parent potentially increases with the child's age. Thus, the proposed increase in age could subject more of a child's income from such assets to tax at rates higher than the child's rates.

Elimination of parental election

The parental election permitted under present law provides two main simplification benefits. The primary advantage is the ability to report all of the tax liability of the parents and children together because of the requirement under present law linking the determination of such liabilities to one another. The election also avoids the need to file multiple tax returns. The advantage provided by the election under present law may be limited by the fact that it is not available in all cases in which a child has income and may result in a higher tax liability for the family, thus forcing taxpayers to make a choice between achieving simplification and paying more tax.

The proposal permits parents and their children to determine their tax liabilities independent of one another. Thus, there would no longer be an advantage to making such determinations on a single return. Allowing a parental election under the proposal would reduce the number of returns that would have to be filed. However, it is likely that the information and worksheets needed to report more than one person's tax liability on a single return would be very similar to the administrative burden required to file multiple returns. In addition, maintaining the election under the proposal would retain some of the complexities associated with the election, such as determining on which parent's return to include the child's income.

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[151] Joint Committee on Taxation, *General Explanation of the Tax Reform Act of 1986* (JCS-10-87), May 4, 1987, at 1253.

III. EMPLOYMENT TAXES

A. Provide Consistent FICA Treatment of Salary Reduction Amounts (sec. 3121(a))

Present Law

Compensation received for services performed as an employee, including benefits provided to employees, is generally subject to tax as wages under the Federal Insurance Contributions Act ("FICA").[152] FICA tax consists of two parts: (1) old age, survivor and disability insurance ("OASDI"), which correlates to the Social Security program that provides monthly benefits after retirement, disability, or death; and (2) Medicare hospital insurance ("HI"). The OASDI tax rate is 6.2 percent on both the employee and employer (for a total rate of 12.4 percent). The OASDI tax rate applies to wages up to the OASDI wage base ($90,000 for 2005). The HI tax rate is 1.45 percent on both the employee and the employer (for a total rate of 2.9 percent). Unlike the OASDI tax, the HI tax is not limited to a specific amount of wages, but applies to all wages.

For FICA tax purposes, "wages" generally includes all remuneration for employment unless a specific exception applies under the FICA rules.[153] The same definition of wages generally applies for purposes of determining an individual's quarters of coverage for purposes of eligibility for Social Security benefits and Medicare and for purposes of determining the amount of an individual's Social Security benefits.[154]

Employer contributions to certain tax-favored retirement plans are excepted from wages for FICA purposes.[155] However, this exception does not apply to contributions made by salary reduction.[156] Thus, for FICA purposes, contributions made by salary reduction are treated as

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[152] Secs. 3101-3128. FICA tax applies separately from income tax. Therefore, certain types of compensation may be: (1) excluded from income for income tax purposes, but subject to FICA tax; or (2) includible in income for income tax purposes, but exempt from FICA tax.

[153] Definitions similar to the FICA definition of wages apply also for purposes of taxes applicable to compensation under the Railroad Retirement Tax Act ("RRTA") (secs. 3201-3241) and to wages under the Federal Unemployment Tax Act ("FUTA") (secs. 3301-3311). However, a lower wage base applies for purposes of Tier 2 tax under RRTA ($66,900 for 2005) and for purposes of FUTA ($7,000).

[154] For 2005, the amount of wages required for a quarter of coverage is $920, or $3,680 for four quarters of coverage for the year.

[155] Sec. 3121(a)(5)(A) (qualified retirement plans), (C) (simplified employee pensions), (D) (tax-sheltered annuities), and (H) (SIMPLE IRAs). Employer contributions to these plans are also excluded from income for income tax purposes.

[156] Sec. 3121(a)(5)(C), (D), and (H) and (v)(1). For income tax purposes, contributions made to these retirement plans by salary reduction are treated as employer contributions and are excluded from income.

wages. Legislative history indicates that this treatment is intended to assure that salary reduction amounts are included in the FICA base. Otherwise, individuals could, in effect, control which portion of their compensation is included in wages for Social Security purposes, which would make the Social Security system partially elective and undermine the FICA tax base.[157]

Various types of employer-provided benefits are excepted from FICA wages, such as employer-provided health coverage (including reimbursements for medical expenses), dependent care assistance, and certain fringe benefits.[158] These types of benefits paid for by salary reduction under a cafeteria plan (including a flexible spending arrangements or "FSA") are also excepted from FICA wages if the benefits would be excepted from wages without regard to the cafeteria plan.[159] In addition, qualified transportation fringe benefits are excepted from FICA even if provided on a salary-reduction basis.

Reasons for Change

Present law provides inconsistent treatment of salary reduction amounts for FICA purposes. Contributions made to tax-favored retirement plans by salary reduction are wages for FICA purposes. However, salary reduction amounts used to provide other benefits are excluded from wages.

Description of Proposal

The proposal provides consistent treatment of salary reduction amounts for FICA purposes. Specifically, salary reduction amounts used to provide benefits under a cafeteria plan or to provide qualified transportation fringe benefits are included in FICA wages in a manner similar to salary reduction contributions to employer-sponsored retirement plans.[160] Such amounts are also taken into account in determining wages for purposes of determining Social Security benefits (both eligibility and amount) and Medicare eligibility.

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[157] S. Rep. No. 98-23, at 40 (1983). Legislative history also provides that treating salary reduction contributions to employer-sponsored plans as FICA wages is consistent with the treatment of individual contributions to an individual retirement account ("IRA"). Individuals may make IRA contributions based on their compensation income. Although such contributions may be deductible for income tax purposes (subject to limitations), the FICA rules do not provide an exemption for IRA contributions.

[158] Sec. 3121(a)(2), (18), and (20). These benefits are also excluded from income for income tax purposes.

[159] Sec. 3121(a)(5)(G). These benefits are also excluded from income for income tax purposes when provided under a cafeteria plan.

[160] The proposal applies also for purposes of the RRTA definition of compensation and the FUTA definition of wages.

Effective Date

The proposal is effective with respect to wages for services performed in calendar years beginning after the date of enactment.

Discussion

Under present law, retirement plan contributions made by salary reduction are wages for FICA purposes. Legislative history reflects the intent to assure that such salary reduction amounts are included in the FICA tax base and in wages for Social Security purposes in order to avoid undermining the FICA tax base and making the Social Security system partially elective. This rationale for the FICA treatment of retirement plan contributions made by salary reduction applies equally to salary reduction amounts used to provide benefits under a cafeteria plan or qualified transportation fringe benefits. However, present law provides disparate treatment of salary reduction amounts by excepting from FICA salary reduction amounts under a cafeteria plans or to provide qualified transportation fringe benefits. The proposal eliminates this disparity by treating all salary reduction amounts as FICA wages.

The proposal also provides consistent FICA treatment of amounts paid by employees to purchase benefits, regardless of whether the benefits are provided through an employer-sponsored plan.[161] For example, under present law, an employee who cannot purchase health insurance through his or her employment must pay FICA tax on his or her salary, including any amounts used to purchase individual health insurance coverage. Under the proposal, similar FICA treatment applies to salary reduction amounts used to purchase health insurance coverage through a cafeteria plan.

The proposal has the effect of increasing FICA taxes for some employers and employees, as well as increasing revenues for the Social Security and Medicare programs.[162] The proposal also results in additional wages for Social Security and Medicare purposes, which is likely to increase benefits for some individuals, as well as long-term costs under such programs.

Applying FICA tax consistently to salary reduction amounts may make payroll processing and employment tax compliance less complicated for some employers.

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[161] Legislative history regarding the application of FICA to salary reduction contributions to an employer-sponsored retirement plan indicates the intent of treating such contributions in a manner consistent with IRA contributions.

[162] In the case of employees whose other wages equal or exceed the OASDI wage base, only HI tax applies to the additional wages that result under the proposal.

B. Conform Calculation of FICA Taxes and SECA Taxes (sec. 1402(a)(12))

Present Law

As part of the financing for Social Security and Medicare benefits, a tax is imposed on the wages of an individual received with respect to his or her employment under the Federal Insurance Contributions Act ("FICA").[163] A similar tax is imposed on self-employment income under the Self-Employment Contributions Act ("SECA").

The FICA tax has two components. Under the old-age, survivors, and disability insurance component ("OASDI"), the rate of tax is 6.2 percent for the employee, and 6.2 percent for the employer. The amount of wages subject to this component is capped at $90,000 for 2005. Under the hospital insurance ("HI") component, the rate is 1.45 percent for the employee and 1.45 percent for the employer. The amount of wages subject to HI taxes is not capped.

Similarly, the SECA tax has two components. Under the OASDI component, the rate of tax is the combined employer and employee rates under the OASDI portion of FICA, i.e., 12.40 percent. Under the HI component, the rate is the combined employer and employee rate under the HI portion of FICA, i.e., 2.90 percent. The amount of self-employment tax under the OASDI is subject to the same limit as under FICA, i.e., this component is capped at $90,000 of self-employment income (for 2005). The amount of self-employment income subject to HI taxes is not capped.

For purposes of determining net earnings from self-employment for SECA liability, taxpayers are permitted a deduction from net earnings from self-employment equal to the product of the taxpayer's net earnings (determined without regard to this deduction) and one-half of the sum of the rates for OASDI (12.4 percent) and HI (2.9 percent), i.e., 7.65 percent of net earnings.[164] This deduction reflects the fact that the FICA rates apply to an employee's wages, which do not include FICA taxes paid by the employer, whereas a self-employed individual's net earnings are economically the equivalent of an employee's wages plus the employer share of FICA taxes. The deduction is intended to provide parity between FICA and SECA taxes.

Self-employed individuals may deduct one-half of self-employment taxes for income tax purposes.[165]

Reasons for Change

Although the intent of the present-law rules is to provide parity between FICA and SECA taxes, the deduction allowed under present law in calculating SECA taxes is larger than the

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[163] Sec. 3101.

[164] Sec. 1402(a)(12).

[165] Sec. 164(f).

amount needed to make SECA taxes the economic equivalent of FICA taxes. This is because the calculation of the deduction does not properly reflect the fact that net earnings are inclusive of SECA taxes. In addition, it does not take into account the fact that wages above the OASDI wage base are subject to tax only at the hospital insurance rate of 2.9 percent.

Description of Proposal

The proposal modifies the deduction from net earnings from self-employment to make SECA taxes economically equivalent to FICA taxes. Under the proposal, the deduction is determined as shown in Table 2.

Table 2.–Calculation of Deduction Allowed in Determining SECA Taxes

If self-employment income is...	Amount of deduction in calculating SECA base is...
Up to threshold amount[1]	7.1064 percent of self-employment earnings.
In excess of threshold amount	7.1064 percent of self-employment earnings up to the threshold amount, plus 1.4293 percent of self-employment earnings in excess of the threshold.

[1] Threshold amount is 1.0765 multiplied by the FICA taxable wage base. Threshold amount for 2005 is $96,885 ($90,000 x 1.0765).

Effective Date

The proposal is effective for taxable years beginning after the date of enactment.

Discussion

The Social Security Act amendments of 1983 attempted to put SECA taxes on the same economic footing as FICA taxes.[166] This involved applying the same rates of tax for the first

[166] The conference report to the Social Security Amendments of 1983 (H. Rep. No. 98-47, p. 146) states:

> "b. Effective in 1990 and thereafter, the credit would terminate and be replaced with a system designed to achieve parity between employees and the self-employed. Under this system:
>
> 1. The base of the self-employment tax would be adjusted downward to reflect the fact that employees do not pay FICA tax on the value of the employer's FICA tax.

time, and permitting the deduction from self-employment earnings in recognition of the fact that net earnings include the "employer share" of SECA taxes, whereas FICA tax rates apply to wages exclusive of the employer share of FICA tax.

The deduction is intended to make SECA taxes the economic equivalent of FICA taxes. The statute, however, permits a deduction equal to 7.65 percent of net earnings determined without regard to this deduction, whereas the "employer" tax of 7.65 percent applies to the amount determined after this deduction. Hence, the deduction, which represents the employer side of the SECA tax, is larger than the actual liability for the employer share of the SECA tax.[167] Thus, for the same economic wage, SECA tax collections are less than FICA tax collections. To make the SECA tax the economic equivalent of FICA tax, the deduction should instead have been determined as the deduction amount necessary to yield an amount that when grossed up by 7.65 percent equals the original amount of net earnings.

Beginning in 1991, the permitted deduction deviated further from consistency with FICA taxes when the taxable wage base with respect to HI taxes was raised (and eventually eliminated in 1994) but the deduction was not altered to reflect that fact. Rather, the deduction of 7.65 percent of net earnings continued to apply, despite the fact that the deduction with respect to the OASDI portion (6.2 percent) of the 7.65 percent should conceptually only reflect OASDI taxes paid up to the taxable wage base and not the entire amount of net earnings. The deduction thus leads to a taxable wage base that is conceptually too low for HI tax purposes for self-employed taxpayers with earnings above the OASDI taxable wage base.[168]

While prior to the raising of the HI cap the deduction worked in this same manner, it did not matter in practice since both OASDI and HI taxes were capped at the same level. Thus the deduction, though conceptually too high, had no effect on HI collections because if a taxpayer were above the OASDI taxable wage base, and thus permitted a deduction that was conceptually too large, he would also have been above the HI taxable wage base after the deduction and thus HI collections would not have been affected.

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2. A deduction would be allowed for income tax purposes for half of SECA liability, to allow for the fact that employees do not pay income tax on the value of the employer's FICA tax."

[167] For example, a self-employed taxpayer with $100 in net earnings is, under present law, permitted a deduction of $7.65, resulting in a SECA tax base of $92.35. The SECA tax on that base is $14.13 (15.3 percent of $92.35). Half of that, or $7.065, represents the employer share of SECA. Note however that the deduction permitted ($7.65), which is intended to represent the employer share of the tax, exceeds the employer share actually paid.

[168] Technically, the deviation from economic equivalence of FICA and SECA taxes due to the problem just described does not occur until net earnings from self-employment *after the proper deduction for the employer share of tax* exceeds the OASDI taxable wage base. The proposal as described accounts for this.

This excess deduction has no impact on the OASDI-equivalent portion of the SECA tax for high-income taxpayers above the OASDI taxable wage base, but it does affect HI collections when the HI taxable wage base exceeds that of the OASDI taxable wage base.

The proposal described above corrects the inequities of present law.[169] The following examples illustrate the difference between present law and the proposal.[170]

Example 1.

Wage-earner.–Taxpayer is employed for $25 per hour at a small accounting firm, earning $50,000 a year for 2,000 hours of work. The taxpayer's employer pays FICA taxes on the entire amount of the employee's earnings, because the employee earns less than the taxable wage base of $90,000 for 2005. The employer FICA tax is 7.65 percent of the $50,000, or $3,825. The employee pays tax at the same rate on the same base, so his tax is also $3,825, for total FICA taxes paid of $7,650. The taxpayer's true pre-tax compensation is thus $53,825 ($50,000 plus $3,825, the employer share of FICA). His wages after all FICA taxes is $46,175 ($53,825 - $7,650).

Self-employed individual.–A self-employed accountant has net-earnings from self-employment equal to the wage earner's true pre-tax earnings of $53,825. Under present law, the taxpayer is permitted a deduction from net earnings equal to 7.65 percent of net earnings, or $4,118 (7.65 percent of $53,825). The SECA tax of 15.3 percent is applied to the net earnings after this deduction of $49,707 ($53,825 - $4,118), resulting in a SECA tax of $7,605. The self-employed taxpayer's income after SECA taxes is $46,220 ($53,825 - $7,605).

Thus, for the same economic income, the self-employed taxpayer's SECA tax is $45 ($7,650 - $7,605) lower than that of the employee, resulting in self-employed income after SECA taxes exceeding the employee's comparable income after FICA taxes by the same amount.

Under the proposal, the deduction from net earnings for the self-employed individual is adjusted to 7.1064 percent of net earnings, resulting in a deduction of $3,825, and a base for SECA taxes of $50,000 ($53,825 pre-tax earnings less $3,825 SECA deduction). The SECA tax base is thus made equivalent to the FICA tax base for taxpayers with the same economic income. The SECA tax of 15.3 percent multiplied by the $50,000 tax base results in SECA tax liability of $7,650, the same as the combined employer and employee share of FICA taxes in the case of the employee.

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[169] The proposal has the effect of increasing SECA taxes for some individuals, as well as increasing revenues for the Social Security and Medicare Trust Funds. The proposal may also result in additional earnings for Social Security and Medicare purposes, which is likely to increase benefits for some individuals, as well as long-term costs under such programs.

[170] In the examples, amounts are rounded to the nearest dollar.

Example 2.

Wage-earner.–Taxpayer is employed for $100 per hour at a small accounting firm, earning $200,000 a year for 2,000 hours of work. The taxpayer's employer pays the OASDI portion (6.2 percent) of the FICA tax on the employee's earnings only up to the taxable wage base of $90,000 for 2005. The OASDI portion of the employer FICA tax is thus 6.2 percent of $90,000, or $5,580. The employee pays tax at the same rate on the same base, so his tax is also $5,580, for total OASDI portion of FICA taxes paid of $11,160. The employer HI portion (1.45 percent) of FICA tax is not capped and thus equals $2,900 (1.45 percent of $200,000). The employee pays HI tax at the same rate on the same base, so his HI tax is also $2,900, for total HI portion of FICA taxes of $5,800. FICA taxes for the employer and the employee are thus each $8,480, for total FICA tax of $16,960. The taxpayer's true pre-tax compensation is thus $208,480 ($200,000 plus $8,480, the employer share of FICA). His wages after all FICA taxes is $191,520 ($208,480 - $16,960).

Self-employed individual.–A self-employed accountant has net-earnings from self-employment equal to the wage earner's true pre-tax earnings of $208,480. Under present law, the taxpayer is permitted a deduction from net earnings equal to 7.65 percent of net earnings, or $15,949 (7.65 percent of $208,480). The OASDI portion of the SECA tax (12.4 percent) is applied to the net earnings after this deduction of $192,531 ($208,480- $15,949), but only up to the FICA wage base of $90,000, resulting in the OASDI portion of the SECA tax of $11,160. The HI portion of the SECA tax (2.9 percent) is not capped, and thus equals 2.9 percent of $192,531, or $5,583. The total SECA tax is thus $16,743, resulting in net income after SECA tax of 191,737 ($208,480- $16,743).

Thus, for the same economic income, the self-employed taxpayer's SECA tax is $217 ($16,960 - $16,743) lower than that of the employee, resulting in self-employed income after SECA taxes exceeding the employee's comparable income after FICA taxes by the same amount. Note that the self-employed taxpayer pays the same OASDI tax as the wage earner, because both taxpayers are above the taxable wage base of $90,000. The entire shortfall occurs in the HI portion of SECA, as a result of the deduction from net earnings that implicitly assumes that the self-employed taxpayer pays the OASDI tax on amounts above the taxable wage base.

Under the proposal, the deduction from net earnings for self-employed individuals occurs in two stages for taxpayers above the taxable wage base. For amounts up to the FICA taxable wage base increased by 7.65 percent ($90,000 times 1.0765 = $96,885 for 2005), a deduction of 7.1064 percent of earnings is allowed, equaling $6,885 ($96,885 times .071064). For this portion of the self-employed taxpayer's earnings, the SECA tax base is $90,000 ($96,885 pre-tax earnings less $6,885 SECA deduction) and the SECA tax is $13,770 ($90,000 x 15.3%). Note that the deduction equals one half of the SECA tax that will be owed, and equals the FICA tax that the employer and employee each owe in the case of the wage earner.

The amount of net earnings above $96,885 is $111,595 ($208,480 - $96,885), and is permitted a deduction of 1.4293 percent of such earnings, or $1,595, prior to collection of HI tax on amounts above the cap. The HI portion of SECA tax on net earnings amounts above the cap is thus 2.9 percent of $110,000 ($111,595 - $1,595), or $3,190. Total SECA collections are thus $13,770, an amount equivalent to the FICA (OASDI and HI) collections up to the taxable wage

base, plus $3,190, representing HI collections on amounts above the taxable wage base, for a total of $16,960. This amount is equivalent to the amount of FICA taxes collected on the wage earner with the same economic income.

C. Extend Medicare Payroll Tax to All State and Local Government Employees (sec. 3121(u)(2))

Present Law and Background

Hospital insurance taxes

As part of the financing for Medicare benefits, a hospital insurance ("HI") tax is imposed on the wages of an individual received with respect to his or her employment. One-half the HI tax is imposed on the employer and one-half on the employee; the tax rate is 1.45 percent for the employee and 1.45 percent for the employer. The amount of wages subject to HI taxes is not capped. [171]

Application of HI taxes to State and local government workers

The application of HI taxes to State and local government workers has expanded over time. Before the enactment of the Consolidated Omnibus Budget Reconciliation Act of 1985 ("COBRA 1985"),[172] State and local government employees were covered for Social Security and Medicare benefits only if the State and the Secretary of Health and Human Services entered into a voluntary agreement providing such coverage. In COBRA 1985, Medicare coverage (and the corresponding HI tax) was extended on a mandatory basis to State and local government employees hired after March 31, 1986,[173] for services performed after that date. The Omnibus Budget Reconciliation Act of 1990[174] extended Medicare coverage and the HI tax to State and local government employees who are not covered under a retirement system, effective with respect to services performed after July 1, 1991.

Under present law, State and local government employees are covered by Medicare and subject to the HI tax with respect to such employment if: (1) the employee was hired after March 31, 1986; or (2) the employee was hired before March 31, 1986, and either (a) there is a

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[171] HI taxes are imposed under the Federal Insurance Contributions Act ("FICA"). As part of the financing for Social Security benefits, FICA taxes also include an old-age, survivors, and disability insurance ("OASDI") component. The OASDI rate of tax is 6.2 percent for the employee, and 6.2 percent for the employer. The amount of wages subject to the OASDI portion of FICA taxes is capped at $90,000 (for 2005).

[172] Pub. L. No. 99-272.

[173] For purposes of this rule, an individual is considered to be hired after March 31, 1986, if the individual was performing substantial and regular services for the employer before April 1, 1986, the individual is a bona fide employee of the employer on March 31, 1986, and the individual's employment relationship with the employer was not terminated after March 31, 1986. These rules are generally referred to as the "continuous employment" requirement. Sec. 3121(u)(2)(C).

[174] Pub. L. No. 101-508.

voluntary agreement in effect with the State providing for such coverage or (b) the employee is not covered by a retirement system.[175] Thus, State and local government workers are *not* covered by Medicare or subject to the HI tax if they were hired before March 31, 1986, and they are *not* covered by a voluntary agreement and *are* covered by a retirement plan.

Application of HI taxes to Federal employees

Medicare coverage (and the HI payroll tax) is mandatory for Federal employees.

Reasons for Change

Most workers pay HI taxes during their entire working lives. However, many State and local government employees are not subject to the HI tax with respect to such employment yet receive the same Medicare coverage as other workers, either through other employment or spousal coverage. Expanding the HI tax to all State and local government workers would increase the equity of the payroll tax system.

Description of Proposal

The proposal extends Medicare coverage on a mandatory basis to all employees of State and local governments, without regard to their dates of hire or participation in a retirement system.[176] Such employees and their employers would become liable for the HI tax and the employees would earn credit toward Medicare eligibility based on their covered earnings.

Effective Date

This proposal is effective with respect to wages for services performed in calendar years beginning after the date of enactment.

Discussion

Extending the hospital insurance tax to all State and local employees places such employees in a comparable position to most other workers, who pay the tax during their entire working lives. Many State and local workers who do not pay the hospital insurance tax nevertheless are covered by Medicare, either through other employment or spousal coverage. In the case of State and local government workers who do not otherwise become eligible for Medicare, the proposal would extend Medicare coverage. This may provide needed health

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[175] Sec. 3121(b)(7)(F). Certain classes of State and local employees are exempt from the hospital insurance tax, such as certain election workers. The rules relating to Social Security coverage for State and local workers are different from the rules relating to Medicare and the hospital insurance tax. Under present law, State and local government workers are covered by Social Security (and subject to the corresponding taxes) if they are covered under a voluntary agreement with the State to be covered or if they are not members of a public retirement system.

[176] The proposal does not affect the exemptions for certain classes of employees, such as election workers.

coverage for affected workers. Extending the tax to all State and local government employees would also add needed funds to the Hospital Insurance Trust Fund.

Subjecting all State and local government employees to the hospital insurance tax would increase the employment costs of State and local governments. However, over time, all State and local government employees will be subject to the hospital insurance tax even if the proposal is not adopted, as workers hired before April 1, 1986, retire or otherwise leave the employ of the government, and are replaced with new employees who are subject to the tax. Thus, the proposal may be viewed as merely accelerating the full effect of prior changes in the law with respect to imposition of the hospital insurance tax.

Expanding Medicare coverage may increase to some extent costs of the Medicare program.

D. Modify FICA Tax Exception for Students (secs. 3121(b)(10) and 3306(c)(10))

Present Law

FICA and FUTA taxes

FICA

Under the Federal Insurance Contributions Act ("FICA"), a tax is imposed on wages paid with respect to employment.[177] FICA tax consists of two parts: (1) old age, survivor and disability insurance ("OASDI"), which correlates to the Social Security program that provides monthly benefits after retirement, disability, or death; and (2) Medicare hospital insurance ("HI"). The OASDI tax rate is 6.2 percent on both the employee and employer (for a total rate of 12.4 percent).[178] The OASDI tax rate applies to wages up to the OASDI wage base ($90,000 for 2005). The HI tax rate is 1.45 percent on both the employee and the employer (for a total rate of 2.9 percent). Unlike the OASDI tax, the HI tax is not limited to a specific amount of wages, but applies to all wages.

For FICA tax purposes, "wages" generally includes all remuneration for employment, and "employment" generally includes all service performed as an employee. However, some forms of compensation are excepted from the definition of wages, such as employer-provided health benefits. Similarly, certain types of services, or services performed by certain employees, are excepted from the definition of employment. Compensation or services that are excepted from the definition of wages or employment are not subject to FICA tax.

Under the Social Security Act, an individual's wages are credited to the individual's earnings record for purposes of determining an individual's eligibility for Social Security benefits and Medicare coverage and for purposes of determining the amount of an individual's Social Security benefits. Eligibility for Social Security benefits and Medicare coverage is based in part on credits (referred to as "quarters of coverage") received for wages. Up to four quarters of coverage can be earned for a year, depending on total wages for the year and the amount needed to earn each quarter of coverage. For 2005, credit for a quarter of coverage is provided for each $920 of wages, with a maximum of four quarters of coverage for $3,680 in wages.

The Social Security Act provides exceptions to "wages" and "employment" that parallel the FICA tax exceptions. Therefore, compensation or services that are not subject to FICA tax are also not taken into account in determining Social Security benefits.

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[177] Secs. 3101-3128.

[178] The employer is required to withhold the employee's share of FICA taxes from wages paid to the employee. Sec. 3102(a).

FUTA

Under the Federal Unemployment Tax Act ("FUTA"), employers must pay a tax of 6.2 percent of wages up to the FUTA wage base of $7,000.[179] An employer may take a credit against its FUTA tax liability for contributions to a State unemployment fund and certain other amounts. Similar to FICA, "wages" for FUTA purposes generally includes all remuneration for employment, and "employment" for FUTA purposes generally includes all service performed as an employee. However, some forms of compensation are excepted from the definition of wages, and certain types of services, or services performed by certain employees, are excepted from the definition of employment.

Student exception

An exception from employment for FICA purposes applies in the case of certain services performed by a student in the employ of a school, college, or university (the "student exception").[180] Specifically, FICA does not apply to services performed by a student who is enrolled and regularly attending classes at the school, college, or university. A similar exception applies for FUTA purposes.[181] The legislative history of the FICA exception for students provides that the exception is intended to apply to situations in which the employment is part-time or intermittent and the total amount of earnings is only nominal, the payment of tax is inconsequential and a nuisance, and the related benefit rights are also inconsequential.[182]

The scope of the student exception has been the subject of uncertainty in recent years, particularly with respect to its application to medical residents. In two cases, courts have held that the student exception applies to medical residents performing services at a hospital or other medical facility.[183]

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[179] Secs. 3301-3311.

[180] Sec. 3121(b)(10). The exception also applies to services performed as a student in the employ of an organization that is organized and operated exclusively for the benefit of, to perform the functions of, or to carry out the purposes of the school, college, or university, if the organization is operated, supervised or controlled by or in connection with such school, college, or university.

[181] Sec. 3306(c)(10)(B). In addition, under section 3121(b)(2), a FICA exception applies to domestic service performed in a local college club or local chapter of a college fraternity or sorority by a student who is enrolled and regularly attending classes at a school, college, or university.

[182] H.R. Rep. No. 76-728, at 17-18 (1939); S. Rep. No. 76-734, at 19 (1939).

[183] See *State of Minnesota v. Apfel*, 151 F. 3d 742 (8th Cir. 1998), *aff'g*, 1997 U.S. Dist. LEXIS 7506 (D. Minn. 1997), and *U.S. v. Mayo Foundation*, 282 F. Supp. 2d 997 (D. Minn. 2003). Compare *U.S. v. Mount Sinai Medical Center*, No. 02-22715-CIV (S.D. Fla. filed January 19, 2005) (holding that, as a matter of law, medical residents are not students who are exempt from FICA tax).

In February 2004, the IRS issued proposed regulations relating to the terms "school, college or university" and "student" for purposes of the student exception.[184] The preamble to the proposed regulations states that guidance is needed to address situations in which the performance of services and pursuit of a course of study are not separate and distinct activities, but instead are to some extent intermingled.[185] The IRS issued final regulations on December 21, 2004.[186] The final regulations are applicable for services performed on or after April 1, 2005. The provisions of the final regulations are discussed in the following sections.

Definition of school, college, or university

Under the regulations, an organization is considered a school, college, or university if: (1) its primary function is the presentation of formal instruction; (2) it normally maintains a regular faculty and curriculum; and (3) it normally has a regularly enrolled body of students in attendance at the place where its educational activities are regularly carried on.[187] This definition is the same as under the proposed regulations. The preamble to the proposed regulations noted that organizations (such as hospitals) providing on the job training typically carry on both noneducational and educational activities and that the primary character of the organization determines whether it is a school college, or university, not merely whether the organization carries on some educational activities.

Student status

In general

Under the student exception, FICA does not apply to services performed by a student who is enrolled and regularly attending classes at the school, college, or university. The regulations provide that whether an employee has the status of a student is determined based on the relationship of the employee with the organization employing the employee.[188] In order to have the status of a student, the employee must perform services for a school, college, or university at which the student is enrolled and regularly attending classes in pursuit of a course of study. In addition, the employee's services must be incident to and for the purpose of pursuing a course of study at the school, college, or university. The regulations provide specific criteria for applying these requirements.

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[184] 69 Fed. Reg. 8604 (proposed February 25, 2004).

[185] *Id.* at 8605.

[186] 69 Fed. Reg. 76404 (December 21, 2004). The regulations include provisions applicable for purposes of the other student exceptions under FICA and FUTA.

[187] Treas. Reg. sec. 31.3121(b)(10)-2(b). The regulations also refer to section 170(b)(1)(A)(ii) (relating to educational organizations) and the regulations thereunder.

[188] Treas. Reg. sec. 31.3121(b)(10)-2(d).

Enrolled and regularly attending classes

An employee is enrolled within the meaning of the student exception if the employee is registered for a course or courses creditable toward an educational credential. An educational credential is a degree, certificate, or other recognized educational credential granted by a school, college, or university.

For purposes of the "regularly attending classes" requirement, a class is an instructional activity led by a faculty member, or other qualified individual hired by the school, college, or university, for identified students following an established curriculum. Traditional classroom activities are not the sole means of satisfying this requirement. For example, research activities under the supervision of a faculty advisor necessary to complete the requirements for a Ph.D. degree may constitute classes for this purpose. The frequency of these and similar activities determines whether the employee may be considered to be regularly attending classes.

Incident to and for the purpose of pursuing a course of study

A course of study is one or more courses the completion of which fulfills the requirements necessary to receive an educational credential granted by the school, college, or university. A course of study also includes one or more courses at a school, college, or university, the completion of which fulfills the requirements necessary for the employee to sit for an examination required to receive certification by a recognized organization in a field.

Whether an employee's services are incident to and for the purpose of pursuing a course of study is determined on the basis of the relationship of such employee with the organization for which such services are performed as an employee. The educational aspect of the relationship, as compared to the service aspect of the relationship, must be predominant in order for the employee's services to be incident to and for the purpose of pursuing a course of study.

The educational aspect of the relationship is evaluated based on all the relevant facts and circumstances related to the educational aspect of the relationship. The service aspect of relationship is evaluated based on all the facts and circumstances related to the employee's employment. The evaluation of the service aspect of the relationship is not affected by the fact that the services performed by the employee may have an educational, instructional, or training aspect. Except in the case of a full-time employee, whether the educational aspect or service aspect of the relationship is predominant is determined by considering all the relevant facts and circumstances.

Full-time employees

The regulations provide that the services of a full-time employee are not incident to and for the purpose of pursuing a course of study. The determination of whether an employee is a full-time employee is based on the employer's standards and practices, except that, regardless of the employer's classification of the employee, an employee whose normal work schedule is 40 hours or more per week is considered a full-time employee.

Relevant factors for employees other than full-time employees

For employees who are not full-time employees, the employee's normal work schedule and number of hours worked per week are relevant factors in evaluating the service aspect of the employee's relationship with the employer. As an employee's normal work schedule or actual number of hours worked approaches 40 hours per week, it is more likely that the service aspect of the relationship is predominant. The regulations provide that certain other factors suggest that the service aspect of the relationship is predominant. For example, status as a professional employee (as defined in the regulations) suggests that the service aspect of the relationship is predominant, especially if the employee is required to be licensed under State or local law to work in the field in which the employee performs services. In addition, eligibility for certain employment benefits suggests that the service aspect of the relationship is predominant.

Administrative safe harbor

In conjunction with the issuance of the final regulations, the IRS has provided a safe harbor under which half-time undergraduate students and half-time graduate or professional students enrolled at an institution of higher education are generally eligible for the student exception.[189] For purposes of the safe harbor, the term "graduate or professional student" does not include a postdoctoral student, postgraduate fellow, medical resident, or medical intern. In addition, the safe harbor does not apply to full-time employees, professional employees, or employees who receive or are eligible for certain employment benefits. Employees who are not eligible for the safe harbor (other than full-time employees) may qualify for the student exception based on consideration of all the facts and circumstances.

Application of FICA exceptions containing dollar limits

Some FICA exceptions are subject to dollar limits. For example, cash remuneration of less than a specified amount ($1,400 for 2005) paid to an employee in a year for domestic service in a private home is exempt from FICA.[190] Similarly, cash remuneration of less than $150 paid to an employee in a year for agricultural labor may be exempt from FICA.[191] The FICA rules provide that, in cases in which a FICA exception is subject to a dollar limit, the employer may withhold the employee share of FICA from payments made to the employee even though, at the time of payment, the total amount paid to the employee is less than the limit and, thus, may be exempt from FICA.[192] Otherwise, once the total payments to the employee reach the limit, the employer must withhold the employee share of FICA that was not withheld from previous payments, in addition to withholding FICA with respect to current payments. Withholding the employee share of FICA from payments made before the limit is reached may result in erroneous

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[189] Rev. Proc. 2005-11, 2005-02 I.R.B. 1. Safe harbor guidance under Rev. Proc. 98-16, 1998-1 C.B. 403, applies for periods before the new regulations apply.

[190] Sec. 3121(a)(7)(B).

[191] Sec. 3121(a)(8)(B).

[192] See sec. 3102(a) and Treas. Reg. sec. 31.3102-1(b).

withholding; however, it avoids the need to withhold additional FICA amounts once the limit is reached.

The IRS has established procedures for situations in which FICA taxes are erroneously withheld from an employee's pay.[193] Under these procedures, the employer generally repays the employee for the erroneously withheld amount. In addition, if the employer has paid the erroneously withheld amount to the IRS, the employer may take credit for the amount in determining future taxes that must be paid to the IRS.

Reasons for Change

As indicated in legislative history, the student exception to FICA is intended to be narrow, applying to employment that is part-time or intermittent and involves nominal earnings. However, it appears that the student exception may be viewed by certain taxpayers as applying more broadly to include situations that are similar to full-time employment. Although recent IRS regulations help to clarify the scope of the student exception, clear statutory standards would make the exception more administrable. In addition, the original intent of the exception can be implemented more effectively through a dollar limit.

Description of Proposal

In general[194]

The proposal codifies the IRS regulations that clarify the scope of the present-law student exception.[195] In addition, the proposal amends the student exception so that it does not apply to individuals whose earnings subject to the exception exceed an annual dollar limit. The proposal also applies for purposes of determining wages for Social Security and Medicare purposes.

Codification of regulations

The proposal codifies the regulations relating to the definition of "school, college, or university." Thus, the student exception applies to services performed for an organization only if: (1) its primary function is the presentation of formal instruction; (2) it normally maintains a regular faculty and curriculum; and (3) it normally has a regularly enrolled body of students in attendance at the place where its educational activities are regularly carried on.[196]

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[193] See Treas. Reg. sec. 31.6402(a)-2.

[194] The proposal applies also for purposes of the other student exceptions under FICA and FUTA and for purposes of coverage under the Social Security Act.

[195] No inference is intended that the regulations are inconsistent with the student exception under present law.

[196] As under present law, the student exception may also apply to services performed as a student in the employ of an organization that is organized and operated exclusively for the benefit of, to perform the functions of, or to carry out the purposes of the school, college, or

The proposal also codifies the regulations relating to student status, including whether: (1) the student is enrolled and regularly attending classes in pursuit of a course of study at the school, college, or university for which the services are performed; and (2) the services are incident to and for the purpose of pursuing a course of study at the school, college, or university. Under the proposal, the Secretary of Treasury has explicit authority to provide rules for determining student status, including criteria such as those provided in the regulations. Thus, for example, it is expected that, under the proposal, as under the regulations, services of a full-time employee are not incident to and for the purpose of pursuing a course of study, so the student exception does not apply to a full-time employee.

Annual dollar limit

Under the proposal, the student exception applies to an individual for a year only if the individual's earnings from the school, college, or university are less than the amount needed to receive a quarter of FICA coverage for the year ($920 for 2005). Thus, if an individual's earnings exceed the limit, the individual's earnings are subject to FICA, regardless of whether the individual otherwise meets the requirements for the student exception. If the limit is exceeded, all of the individual's earnings are subject to FICA, including earnings up to the limit, thus enabling the individual to receive at least one quarter of coverage for the year.

Under the proposal, the rules and procedures relating to the withholding of the employee share of FICA that apply under present law in the case of FICA exceptions that are subject to dollar limits apply also for purposes of the student exception. For example, the employer may withhold the employee share of FICA from payments made to the employee even though, at the time of payment, the total amount paid to the employee is less than the limit.

Effective Date

The proposal relating to codification of the regulations is effective on the date of enactment.

The proposal relating to a dollar limit on the student exception is effective with respect to wages for services performed in calendar years beginning after the date of enactment.

Discussion

As indicated by its legislative history, the present-law student exception is intended to apply to situations in which the employment is part-time or intermittent, the total amount of earnings is only nominal, and the tax involved and the related Social Security benefit rights are inconsequential. Over time, however, it appears that the exception has been applied to situations beyond those intended, such as: (1) employees performing services on a full-time or close to full-time basis; (2) professional services that have an educational component, but that primarily further the work of the employer rather than the education of the employee; and (3) services performed in the employ of an organization other than a school, college, or university.

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university, if the organization is operated, supervised or controlled by or in connection with such school, college, or university.

Uncertainty as to the proper scope of the student exception results in part from a lack of clear standards for applying the exception. The regulations provide standards that enable the IRS and taxpayers to determine more accurately whether the exception applies. The proposal to codify the regulations is likely to make the exception more administrable and improve compliance.

The proposal to apply a dollar limit to the student exception is also consistent with the original intent of the student exception to apply in situations in which total earnings are nominal and benefit rights inconsequential. Under the proposal, the exception is limited to students whose earnings are too small to provide a quarter of coverage for Social Security benefit purposes. This will relieve employers and employees from having to pay small amounts of FICA taxes that do not result in a quarter of coverage, while enabling students whose earnings are high enough to result in at least one quarter of coverage to receive Social Security credit.

The use of a dollar limit also provides a clearer standard for applying the student exception, which makes the exception easier for the IRS and taxpayers to apply. For example, if an individual's pay rate and work schedule are such that the individual's earnings will exceed the limit, it is unnecessary to determine whether the individual's services are performed as an incident to and for the purpose of pursuing a course of study. Administrative issues may arise as to the proper FICA treatment of amounts paid to an employee before the limit is reached, particularly with respect to whether the employer may withhold the employee share of FICA. The proposal addresses such issues by applying the rules and procedures that apply in similar situations under present law.

The proposal has the effect of increasing FICA taxes for some employers and employees, as well as increasing revenues for the Social Security and Medicare programs. The proposal also results in additional wages for Social Security and Medicare purposes. In many cases, credit for wages earned while a student will have little, if any, effect on an individual's eligibility for Social Security benefits or Medicare coverage. However, in some cases, particularly employees with short work histories, these earnings may establish eligibility for disability or death benefits. To the extent that the proposal expands eligibility for Social Security benefits or Medicare coverage, it may also increase the long-term costs of the Social Security and Medicare programs.

In many cases, a school, college, or university provides employment to students in part as a form of financial aid. In such cases, application of FICA as a result of the proposal may be viewed as a cutback on an education-related tax benefit. However, legislative history does not indicate that the student exception is intended as an education-related tax benefit. In addition, the student exception creates inappropriate disparities in the FICA tax treatment of students employed by the school, college, or university where they attend classes and students employed by other employers. The proposal reduces these disparities.

E. Apply Employment Taxes to Sales Incentive Payments Made by Manufacturers (secs. 3121, 3306, and 3401)

Present Law

Employment taxes generally consist of the taxes under the Federal Insurance Contributions Act ("FICA"), the tax under the Federal Unemployment Tax Act ("FUTA"), and the requirement that employers withhold income taxes from wages paid to employees ("income tax withholding").[197]

FICA tax consists of two parts: (1) old age, survivor, and disability insurance ("OASDI"), which correlates to the Social Security program that provides monthly benefits after retirement, disability, or death; and (2) Medicare hospital insurance ("HI"). The OASDI tax rate is 6.2 percent on both the employee and employer (for a total rate of 12.4 percent). The OASDI tax rate applies to wages up to the OASDI wage base ($90,000 for 2005). The HI tax rate is 1.45 percent on both the employee and the employer (for a total rate of 2.9 percent). Unlike the OASDI tax, the HI tax is not limited to a specific amount of wages, but applies to all wages.

Under FUTA, employers must pay a tax of 6.2 percent of wages up to the FUTA wage base of $7,000. An employer may take a credit against its FUTA tax liability for contributions to a State unemployment fund and certain other amounts.

Employers are required to withhold income taxes from wages paid to employees. Withholding rates vary depending on the amount of wages paid, the length of the payroll period, and the number of withholding allowances claimed by the employee.

Employment taxes apply to all compensation for employment (including commissions and other sales incentives) unless an exception applies. Generally all amounts received in connection with the performance of services are considered compensation, even if paid by a person other than the person for whom services are performed.[198] In addition, if compensation is paid to an employee by a person other than the employer, the payor is generally responsible for complying with the applicable employment tax requirements, regardless of whether an employment relationship exists between the employee and the payor.[199] In such circumstances,

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[197] Secs. 3101-3128 (FICA), 3301-3311 (FUTA), and 3401-3404 (income tax withholding).

[198] See, e.g., Treas. Reg. sec. 1.61-2T(a)(5) (fringe benefits treated as provided by the person for whom services performed, regardless of whether actually provided by that person) and Treas. reg. sec. 1.83-6(d) (rules for transfers of property by a shareholder to an employee of a corporation in consideration of services performed for the corporation).

[199] Sec. 3401(d)(1) (for purposes of income tax withholding, if the employer does not have control of the payment of wages, the person having control of the payment of such wages is treated as the employer); *Otte v. United States*, 419 U.S. 43 (1974) (the person who has the control of the payment of wages is treated as the employer for purposes of withholding the

all compensation paid to the employee, whether paid by the employer or by another person, is taken into account in applying the OASDI and FUTA wage bases.[200] Thus, a single OASDI or FUTA wage base applies to all such compensation.

FICA tax does not apply to individuals engaged in a trade or business. Instead, such individuals are subject to tax under the Self-Employment Compensation Act ("SECA") on their net earnings from self-employment (generally defined as income derived from a trade or business, less the deductions attributable to the trade or business).[201] For SECA purposes, the term "trade or business" generally does not include the performance of services as an employee.[202] Thus, SECA tax does not apply to compensation paid to an employee.

In various situations, the Internal Revenue Service ("IRS") has ruled that amounts received by employees from a person other than the employer as compensation for services for the employer are wages for employment tax purposes. This position applies, for example, to: (1) salaries paid by a racing association to race track stewards employed by the state racing board; (2) a baseball league's receipts from post-season play distributed among players employed by the teams in the league; and (3) compensation paid by colleges and universities to athletic contest officials employed by an athletic association.[203] However, IRS guidance has held that commissions or other sales incentives paid by a manufacturer or distributor (referred to herein as "sales incentive payments") to sales people employed by a dealer are compensation for services for the manufacturer or distributor, rather than for services for the dealer.[204] IRS guidance holds that the sales incentive payments are not wages because the sales people are not employees of the manufacturer or dealer.[205] Thus, the sales incentive payments are includible in

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employee's share of FICA from wages); and *In re Armadillo Corporation*, 561 F.2d 1382 (10th Cir. 1977), and *In re The Laub Baking Company v. United States*, 642 F.2d 196 (6th Cir. 1981) (the person who has control of the payment of wages is the employer for purposes of the employer's share of FICA and FUTA).

[200] See, e.g., *Cencast Services, L.P., v. United States*, 62 Fed. Cl. 159 (2004).

[201] Secs. 1401-1403.

[202] Sec. 1402(c)(2).

[203] See, respectively, Rev. Rul. 73-253, 1973-1 C.B. 414; Rev. Rul. 57-456, 1957-2 C.B. 629; and Rev. Rul. 57-119, 1957-1 C.B. 331.

[204] Rev. Rul. 70-337, 1970-1 C.B. 191, and Rev. Rul. 70-331, 1970-1 C.B. 15. In the facts of these rulings, the manufacturer or distributor makes the sales incentive payments under an agreement with, or with the consent of, the dealer. In addition, Rev. Rul. 70-337 states that the sales people are hired by the dealers.

[205] Compare Rev. Rul. 66-162, 1966-1 C.B. 234, holding that commissions paid by a concessionaire of a leased department in a department store to sales people employed by the store are wages because the sales people are employees of both the store and the concessionaire.

income by the sales people, but are not subject to FICA, FUTA or income tax withholding. The IRS has also indicated that sales incentive payments are not subject to SECA tax.[206]

Reasons for Change

Under current IRS guidance and practices, sales incentive payments made by manufacturers or distributors to employees of a dealer are not subject to either FICA or SECA taxes, even though such payments are compensation for services. Such payments, like other compensation paid to employees, should be subject to employment taxes.

Description of Proposal

Under the proposal, sales incentives payments made by manufacturers or distributors to sales people employed by dealers are wages for employment tax purposes, regardless of whether an employment relationship exists between the sales people and the manufacturers or distributors. Thus, sales incentive payments are subject to FICA, FUTA, and income tax withholding, unless an exception applies. Consistent with present law, the manufacturer or distributor is responsible for complying with applicable employment tax requirements with respect to sales incentive payments. Also, as under present law, all wages paid to sales people, including sales incentive payments, are taken into account in applying the OASDI and FUTA wage bases.

Effective Date

The proposal is effective with respect to sales incentive payments for services performed in calendar years beginning after the date of enactment.

Discussion

Under present law, amounts received for services performed by an employee from a person other than the employer are generally treated as wages to the same extent as amounts received from the employer. Although services performed by sales people who are the employees of a dealer benefit the manufacturers and distributors of the products sold, treating sales incentive payments as compensation for services for the manufacturer or distributor creates an artificial standard that causes inconsistent employment tax results. In effect, by structuring compensation as payments from a manufacturer or dealer, the parties can determine among themselves to what extent compensation will be subject to employment taxes. This undermines the employment tax base.

Sales incentive payments are compensation for services and, therefore, should be subject either to FICA or SECA taxes. The proposal imposes FICA taxes rather than SECA taxes because this is consistent with IRS position in other, similar cases, as well as with judicial

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[206] See IRS Publication 3204, *Automotive Manufacturers' Incentive Program* (Rev. 3-2002).

precedents.[207] In addition, compliance is greater with respect to payments subject to FICA and wage withholding than with respect to other payments.[208]

The proposal has the effect of increasing FICA taxes for employees who receive commissions and other sales incentives from manufacturers or distributors and increasing FICA and FUTA taxes for the manufacturers or distributors. The proposal also increases revenues for the Social Security, Medicare, and unemployment programs. The proposal also results in additional wages for these purposes, which is likely to increase benefits for some individuals, as well as long-term costs under such programs.

Manufacturers and distributors who pay commissions or other sales incentives are subject to additional administrative requirements under the proposal, such as withholding FICA and income taxes from the payments, depositing employment taxes, and filing employment tax returns. However, manufacturers and distributors who are employers are already subject to these requirements with respect to other wages.

Under present law, commissions and other sales incentives paid by a manufacturer or dealer are includible in income, but are not subject to income tax withholding. As a result, an individual who receives such amounts generally must either adjust the amount of income tax withheld from his or her wages or pay quarterly estimated taxes. Otherwise, the individual may have to pay additional taxes when filing his or her return and could be subject to a penalty. Applying withholding to these amounts is likely to result in better coordination between the amount of tax withheld and the individual's tax liability, leading to improved compliance.

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[207] Authorities for this approach are cited in footnotes 199 and 203.

[208] The increase in compliance as a result of tax withholding is discussed in detail in Part I.A. of this Report.

F. Modify Determination of Amounts Subject to Employment or Self-Employment Tax for Partners and S Corporation Shareholders (sec. 1402)

Present Law

In general

As part of the financing for Social Security and Medicare benefits, 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 FICA tax).[209] A similar tax is imposed on the net earnings from self-employment of an individual under the Self-Employment Contributions Act (the SECA or self-employment tax).[210]

FICA tax

In general

The FICA tax has two components. Under the old-age, survivors, and disability insurance component (OADSI), the rate of tax is 12.40 percent, half of which is imposed on the employer, and the other half of which is imposed on the employee.[211] The amount of wages subject to this component is capped at $90,000 for 2005. Under the hospital insurance component (HI), the rate is 2.90 percent, also split equally between the employer and the employee. The amount of wages subject to the HI component of the tax is not capped. The wages of individuals employed by a business in any form (for example, a C corporation) generally are subject to the FICA tax.

S corporation shareholders

An S corporation is treated as a pass-through entity for Federal income tax purposes, and its income generally is taxed to the shareholders. A shareholder of an S corporation who performs services as an employee of the S corporation is subject to FICA tax on his or her wages, but generally is not subject to FICA tax on amounts that are not wages (such as distributions to shareholders).[212] Nevertheless, an S corporation employee is subject to FICA tax on the amount of his or her reasonable compensation, even though the amount may have been characterized as other than wages. A significant body of case law has addressed the issue of whether amounts paid to shareholder-employees of S corporations constitute reasonable

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[209] See Chapter 21 of the Code.

[210] Sec. 1401.

[211] Secs. 3101 and 3111.

[212] Though unrelated to the FICA tax, present law provides that an S corporation is treated as a partnership and a two-percent shareholder is treated as a partner, for purposes of applying rules relating to employee fringe benefits. Sec. 1372.

compensation and therefore are wages subject to the FICA tax, or rather, are properly characterized as another type of income that is not subject to FICA tax.[213]

In cases addressing whether payments to an S corporation shareholder-employee were wages for services or were corporate distributions, courts have recharacterized a portion of corporate distributions as wages if the shareholder performing services did not include any amount as wages.[214] In recent cases involving whether reasonable compensation was paid (not exclusively in the S corporation context), courts have applied a multi-factor test to determine reasonable compensation, including such factors as whether the individual's compensation was comparable to compensation paid at comparable firms.[215] The Seventh Circuit, however, has adopted an "independent investor" analysis differing from the multi-factor test in that it asks whether an inactive, independent investor would be willing to compensate the employee as he was compensated.[216] The independent investor test has been examined and partially adopted in some other Circuits, changing the analysis under the multi-factor test.[217]

Self-employment tax

In general

The self-employment tax rate has two components. Under the OASDI component, the rate of tax is 12.40 percent. Under the HI component, the rate is 2.90 percent. The amount subject to self-employment tax under the OASDI component is capped at $90,000 of self-employment income (for 2005). However, the amount of self-employment income subject to the HI component is not capped.

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[213] See, e.g., *Renewed Focus on S Corp. Officer Compensation*, AICPA Tax Division's S Corporation Taxation Technical Resource Panel, Tax Advisor, May 2004, at 280.

[214] *Radtke v. U.S.*, 895 F.2d 1196 (7th Cir. 1990); *Spicer Accounting, Inc. v. U.S.*, 918 F.2d 90 (9th Cir. 1990); see also, e.g., *Joseph M. Grey Public Accountant, P.C., v. U.S.*, 119 T.C. 121 (2002), *aff'd*, 93 Fed. Appx. 473, 3d Cir., April 7, 2004, and *Nu-Look Design, Inc. v. Comm'r*, 356 F.2d 290 (3d Cir. 2004), in which an officer and sole shareholder of an S corporation argued unsuccessfully that he had no wages and that he received payments in his capacity as shareholder or as loans, rather than as wages subject to employment tax.

[215] See, e.g., *Haffner's Service Stations, Inc. v. Commissioner*, 326 F.3d 1 (1st Cir. 2003).

[216] *Exacto Spring Corp. v. Commissioner*, 196 F.3d 833 (7th Cir. 1999).

[217] In *Metro Leasing and Dev. Corp. v. Commissioner*, (9th Cir. 2004) at 10-11, the Ninth Circuit court noted that it is helpful to consider the perspective of an independent investor, and pointed to other Circuits that apply the multi-factor test through the lens of the independent investor test, citing *RAPCO Inc. v. Commissioner*, 85 F.3d 950 (2d Cir. 1996).

In the case of an individual with self-employment income, the income subject to self-employment tax is the net earnings from self-employment.[218] This equals 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. Specified types of income or loss are excluded, such as rentals from real estate in certain circumstances, dividends and interest, and 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.

Partners (including LLC members)

For an individual who is a partner in a partnership, the net earnings from self-employment generally include the partner's distributive share (whether or not distributed) of income or loss from any trade or business carried on by the partnership. This rule applies to individuals who are general partners. 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.[219] 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 of remuneration for those services. This special rule reflects State law at the time it was enacted in 1977, under which limited partners ordinarily were not permitted to participate in management of the partnership's activities without losing their limited liability protection.[220] In recent years, State law has been

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[218] For purposes of determining net earnings from self-employment, taxpayers are permitted a deduction from net earnings from self-employment equal to the product of the taxpayer's net earnings (determined without regard to this deduction) and one-half of the sum of the rates for OASDI (12.4 percent) and HI (2.9 percent), i.e., 7.65 percent of net earnings. This deduction reflects the fact that the FICA rates apply to an employee's wages, which do not include FICA taxes paid by the employer, whereas a self-employed individual's net earnings are economically the equivalent of an employee's wages plus the employer share of FICA taxes. The deduction is intended to provide parity between FICA and SECA taxes. See the separate proposal relating to conforming the calculation of FICA and SECA taxes, elsewhere in this document. In addition, self-employed individuals may deduct one-half of self-employment taxes for income tax purposes (sec. 164(f)).

[219] Sec. 1402(a)(13). For this purpose, limited partner status is determined under State law.

[220] Social Security Amendments of 1977 (Pub. L. No. 95-216). The exclusion of limited partners from the self-employment tax (except with respect to guaranteed payments for services)

changing, with the result that individuals who are limited partners under applicable State law may participate in the management and operations of the partnership without jeopardizing their limited liability.[221] This change in the State law rules for limited partners parallels the expansion of limited liability companies.

Limited liability companies are a relatively new form of business entity provided under State law, in which members generally may participate in the management and operations of the business, though they are protected from liability for its debts and obligations. Limited liability companies generally may choose to be 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.[222] 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 since then.

Reasons for Change

The employment tax treatment of partners who are neither limited nor general partners is uncertain. In particular, owners of a limited liability company may view themselves as comparable to limited partners, even though they are not limited partners under applicable State law. This uncertainty makes compliance with the law difficult for taxpayers and administration of the law difficult for the IRS. The uncertainty in treatment creates an opportunity for abuse by taxpayers willing to make the argument that they are not subject to any employment tax (FICA or self-employment), even though this argument is contrary to the spirit and intent of the

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reflects the perception at that time that the value of accruing benefits under the Social Security system outweighed the tax cost, and that limited partnerships were used for investment rather than for service businesses. See Patricia E. Dilley, *Breaking the Glass Slipper - Reflections on the Self-Employment Tax*, 54 Tax Law. 65 (Fall 2000), at note 91.

[221] See, e.g., Revised Uniform Limted Partnership Act (2001), sec. 303, providing, "[a]n obligation of a limited partnership, whether arising in contract, tort, or otherwise, is not the obligation of a limited parter. A limited partner is not personally liabile, directly or indidirectly, by way of contribution or otherwise, for an oblgation of the limited partnersip solely by reason of being a limited partner, even if the limited partner participates in the mamagement and control of the limited partnership."

[222] Prop. Treas. Reg. sec. 1.1402(a)-2 (January 13, 1997).

employment tax rules. In addition, the increasing ability of individuals who are limited partners under State law to perform services for the partnership suggests that the limited partner rule is out of date and should be changed.

It has become increasingly common for individuals who perform services in businesses that they own to choose the S corporation form to seek to reduce their FICA taxes. S corporation shareholders may pay themselves wages below the wage cap, while treating the rest of their compensation as a distribution by the S corporation in their capacity as shareholders.[223] They may take the position that no part of the S corporation distribution to them as shareholders is subject to FICA tax. While present law provides that the entire amount of an S corporation shareholder's reasonable compensation is subject to FICA tax in this situation, enforcement of this rule by the government may be difficult because it involves factual determinations on a case-by-case basis.

More broadly, there are significant differences in the employment tax treatment of individuals who are owners of interests in passthrough entities and who perform services in the business. S corporation shareholder-employees are treated like other employees (i.e., subject to FICA), whereas a broader category of income of some partners (other than limited partners) is subject to self-employment tax. These discontinuities cause taxpayers' choice-of-business form decisions to be motivated by a desire to avoid or reduce employment tax, rather than by nontax considerations.

Description of Proposal

Treatment of partners

Under the proposal, the present-law rule for general partners generally applies to any partner for determining net earnings from self-employment. Thus, all partners are subject to self-employment tax on their distributive share (whether or not distributed) of partnership income or loss. As under present law, specified types of income or loss are excluded from net earnings from self-employment of a partner, such as certain rental income, dividends and interest, certain gains, and other items. However, under the proposal, in the case of a service partnership, all of the partner's net income from the partnership is treated as net earnings from self-employment. A service partnership is a partnership, substantially all of whose activities involve the performance of services in the fields of health, law, engineering, architecture, accounting, actuarial science, performing arts, or consulting (similar to sec. 448(d)(2)).

If, however, any partner (regardless of whether he or she is a general partner, limited partner, or neither a general nor limited partner, such as a limited liability company member) does not materially participate in the trade or business of the partnership, a special rule provides that only the partner's reasonable compensation from the partnership is treated as net earnings from self-employment. Thus, some general partners who would be subject to self-employment

[223] Because the HI tax has no wage cap, this approach may be viewed as a tax planning opportunity with respect to HI tax even at higher wage levels.

tax on their distributive share of partnership income under present law will be subject to tax only on reasonable compensation from the partnership under the proposal.

Treatment of S corporation shareholders

Under the proposal, for purposes of employment tax, an S corporation is treated as a partnership and any shareholders of the S corporation are treated as general partners. Thus, S corporation shareholders are subject to self-employment tax on their shares of S corporation net income (whether or not distributed) or loss. As under the present-law self-employment tax rules, specified types of income or loss are excluded from net earnings from self-employment of a shareholder, such as certain rental income, dividends and interest, certain gains, and other items. However, under the proposal, in the case of a service business, all of the shareholder's net income from the S corporation is treated as net earnings from self-employment. A service S corporation is one, substantially all of whose activities involve the performance of services in the fields of health, law, engineering, architecture, accounting, actuarial science, performing arts, or consulting (similar to sec. 448(d)(2)).

If a shareholder does not materially participate in the trade or business activity of the S corporation, a special rule provides that only reasonable compensation from the S corporation is treated as net earnings from self-employment.

Effective Date

The proposal is effective for taxable years of partners or S corporation shareholders (as the case may be) beginning after the date of enactment.

Discussion

Treatment of partners

The proposal changes the self-employment tax treatment of partners to take account of changes in applicable State law and in business practices. 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 the present-law self-employment tax rules, which refer specifically to general and limited partners, to limited liability company owners has raised difficult questions of interpretation, creating complexity and compliance problems for both taxpayers and tax administrators. The proposal ends the present-law uncertainty by identifying a minimum base on which all partners must pay employment tax.

The reference in the self-employment tax rules to "limited partners" does not reflect changes in State limited partnership laws permitting individuals designated as limited partners under State law to perform management services as well as other services for the partnership. The present-law rule limiting the amount of self-employment tax of a limited partner to the amount of guaranteed payments does not treat partners performing services comparably, and should be conformed to the rule for general partners.

The conceptual premise of the proposal is that the base for the employment and self-employment tax should be labor income. Historically, the tax has applied to labor income, relating very roughly to the rules for accruing benefits under the Social Security system, which requires the individual to perform quarters of labor.[224] The proposal applies this notion more uniformly than does present law to individuals who perform services for or on behalf of a passthrough entity in which they own an interest (i.e., a partnership, limited liability company, or S corporation). The proposal treats such individuals similarly to sole proprietors, as well as similarly to each other. Not only does this more uniform treatment improve the fairness of the tax law and increase the internal theoretical consistency of the tax rules, it also tends to improve tax neutrality by reducing the importance of FICA and self-employment tax differences in taxpayers' choice of business entity.[225]

Previous proposals in this area have sought greater theoretical purity by proposing a carve-out from the self-employment tax for income from the business that is from capital rather than from labor.[226] Under this approach, an attempt is made to determine a reasonable return from partnership capital, which is excluded from the partner's self-employment income. This type of approach raises administrability concerns, as rates of return can vary significantly among different types of businesses, at different times in the life of a business activity, and with different management of the business, among other factors.[227] By contrast, the proposal (like present law) generally provides that certain readily identifiable types of income such as dividends, interest and rents that generally are not labor income are not subject to self-employment tax. Only in the case of a service business, typically one in which income is

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[224] See Dilley, *Breaking the Glass Slipper - Reflections on the Self-Employment Tax*, at note 18. Benefit accruals have historically been tied to performance of labor (quarters of service), but the amount of FICA taxes collected does not necessarily relate to the individual's Social Security benefits.

[225] For some individuals, the proposal has the effect of increasing the amount of earnings subject to employment tax. In the case of individuals whose earnings equal or exceed the OASDI wage base, only HI tax applies to the additional earnings that result under the proposal.

[226] The AICPA 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 AICPA, 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 AICPA 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. The AICPA proposal 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.

[227] Alternatively, this approach might specify a definition for a reasonable rate of return on capital. It could be based, for example, on a percentage or multiple of the applicable Federal rate, as defined under present law. While this approach may conceptually take account of a partner's return on capital, it may not represent the simplest and most direct approach, nor would it be accurate in most cases.

primarily from labor rather than capital, is this rule not applicable under the proposal. The proposal does eliminate readily identifiable capital income from the self-employment tax base, but does not require a factual inquiry on a case-by-case basis as to what income of the partnership may be attributable to capital, and therefore is more predictable and more administrable than other approaches.

As a means of further isolating labor income of partners that is subject to self-employment tax, the proposal provides that if a partner does not materially participate in the trade or business of the partnership, only the partner's reasonable compensation from the partnership is treated as net earnings from self-employment.[228] Material participation is a standard that has been frequently applied since its enactment in 1986 as a component of the passive loss rules (sec. 469). Though it does require a factual inquiry, the standard is well developed in the section 469 regulations.[229]

Though also a factual inquiry, the question of whether an individual's compensation is reasonable is one that has been repeatedly addressed in case law.[230] The addition of the independent investor test used in the Seventh Circuit and partially adopted in some other Circuits has changed the previously predictable analysis under the multi-factor test applied in many judicial decisions to determine reasonable compensation. It could be questioned whether the determination of reasonable compensation has the predictability that is desirable in a legislative proposal, given the changing analysis among the Circuit courts. However, the proposal looks to reasonable compensation to determine net earnings from self employment only if the individual does not materially participate in the trade or business, limiting the situations in which this standard applies under the proposal.[231]

Treatment of S corporation shareholders

In addition to addressing the issues that relate also to partners (discussed above), the proposal relating to S corporation shareholders serves the purpose of minimizing present-law

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[228] Present law does not provide this rule for general partners. Under the proposal, however, in the case of a general partner who does not materially participate in the partnership's trade or business, only his or her reasonable compensation from the partnership is included in net earnings from self-employment. Such a general partner may be subject to a lower self-employment tax under the proposal than under present law.

[229] These regulations provide several bright-line tests for material participation, including, for example, a test based on the number of hours the individual works in the business activity. Rules in the section 469 regulations providing that a limited partner is deemed not to materially participate in the partnership's business would not apply for purposes of the proposal.

[230] See the present law description, above.

[231] Reasonable compensation has also been suggested as a standard for determining the net earnings from self-employment of all limited partners and LLC members, but the administrative concerns with the standard could make this approach less attractive than the more mechanical approach taken under the proposal.

opportunities to avoid the employment tax by recharacterizing wages as some other type of S corporation distribution. Disparate treatment of wages and other distributions under present law creates an undesirable incentive for individuals performing services to avoid FICA tax on labor income, including on the uncapped HI component, by setting up business as an S corporation and characterizing as wages a small amount of service income below the wage cap, while the rest is passed through the S corporation to the shareholder-employee free of FICA tax.

The self-employment tax (and the earlier-instituted FICA tax) were originally designed both to measure Social Security benefit accruals by determining whether individuals earned income from working, and to collect revenues to fund such benefit accruals.[232] However, taxpayers' incentives have changed as the wage base and the resulting tax cost to individual taxpayers of accruing benefits has risen, and the value of Social Security benefits to high-income taxpayers has become relatively lower as a percentage of income. The motivation of higher-income taxpayers to avoid the tax was further increased by the elimination of the cap on the HI component of the tax by the Revenue Reconciliation Act of 1993.[233] Rather than having an incentive to accrue benefits, taxpayers now have the opposite incentive: to avoid or reduce the tax cost, which may exceed the value to them of the social insurance benefit. The tax rules are not currently designed to prevent avoidance, and indeed, may facilitate it because the rules apply unevenly depending on whether the taxpayer chooses to do business through an S corporation, partnership, or sole proprietorship. Eliminating this unevenness not only increases the fairness of the tax as between similarly situated taxpayers, but also is consistent with a purpose to raise revenue among all workers comparably. Under the proposal, the employment tax rules no longer skew taxpayers' choice of business entity because of differing FICA and self-employment tax results. By treating S corporation shareholders who perform services for or on behalf of the S corporation in the same manner as partners who perform services for or on behalf of the partnership, the proposal improves the neutrality of the tax law.[234]

The proposal has the effect of applying the self-employment tax collection system to S corporation shareholder-employees, rather than the withholding regime that applies to them (along with other employees) under the present-law FICA tax rules. Withholding may be a more effective and faster collection mechanism than self-assessment as under the self-employment rules. However, preserving a withholding regime on S corporation shareholder wages, and imposing self-employment tax only on the portion of the shareholder's distributive share that exceeds previously taxed wages, would require a mechanism to prevent double-counting from one taxable year to the next, which could impose additional administrative and recordkeeping

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[232] See Dilley, *Breaking the Glass Slipper - Reflections on the Self-Employment Tax*, at note 23-30.

[233] Because eligibility for hospital insurance under Medicare is based on an individual's quarters of coverage, not the amount of the individual's wages, paying HI tax on higher wages does not increase the individual's Medicare benefits.

[234] For some individuals, the proposal has the effect of increasing the amount of earnings subject to employment tax. In the case of individuals whose earnings equal or exceed the OASDI wage base, only HI tax applies to the additional earnings that result under the proposal.

burdens on the S corporation. Further, the detriment of eliminating FICA withholding on S corporation shareholder employees is offset by the dual benefits under the proposal of improving tax neutrality and reducing tax avoidance. Therefore, the proposal applies the self-employment tax rules to S corporation shareholder-employees in the same manner that those rules apply to partners.

IV. PENSIONS AND EMPLOYEE BENEFITS

A. Conform Definition of Qualified Medical Expenses (secs. 105, 106, 213, 220, and 223)

Present Law

Itemized deduction for medical expenses

Under present law, expenses for "medical care" are deductible as an itemized deduction to the extent that a taxpayer's aggregate medical expenses exceed 7.5 percent of the taxpayer's adjusted gross income.[235] For this purpose, "medical care" is defined as under section 213(d), described below, except that expenses for medicines and drugs can be taken into account only if the medicine or drug is prescribed or is insulin (sec. 213(b)).

Exclusion for amounts received under employer-sponsored accident or health plans

Present law provides that amounts received under an accident or health plan for employees are excludable from gross income to the extent the amounts are paid directly or indirectly to the taxpayer to reimburse the taxpayer for expenses incurred by the taxpayer for the medical care (as defined in sec. 213(d)) of the taxpayer or the taxpayer's spouse or dependents.[236] Arrangements commonly used by employers to reimburse medical expenses of their employees (and their spouses and dependents) include health flexible spending arrangements ("FSAs") and health reimbursement accounts ("HRAs").

Health FSAs are typically funded on a salary reduction basis, meaning that employees are given the option to reduce current compensation and instead have the compensation used to reimburse the employee for medical expenses. If the health FSA meets certain requirements, then the compensation that is forgone is not includible in gross income or wages and reimbursements for medical care (as defined under sec. 213(d)) from the health FSA are excludable from gross income and wages. Health FSAs are subject to certain requirements, including rules that require that FSAs have certain characteristics similar to insurance, and that they not provide deferred compensation. One of these rules is the so-called "use-it-or-lose-it rule," which provides that any amounts remaining in the health FSA at the end of the year that are not used to reimburse expenses are forfeited by the employee.

HRAs operate in a manner similar to health FSAs, in that they are an employer-maintained arrangement that reimburses employees for medical expenses (as defined under sec. 213(d)). Some of the rules applicable to HRAs and health FSAs are similar, e.g., the amounts in the arrangements can only be used to reimburse medical expenses and not for other purposes.

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[235] Only expenses that are not reimbursed by insurance or otherwise may be taken into account for purposes of the deduction. For purposes of the alternative minimum tax, the adjusted gross income threshold is 10 percent, rather than 7.5 percent.

[236] This exclusion does not apply to amounts attributable to (and not in excess of) deductions allowed under section 213 for any prior taxable year.

Some of the rules are different. For example, HRAs cannot be funded on a salary reduction basis, and amounts remaining at the end of the year are carried forward to be used to reimburse medical expenses in the next year.

Health savings accounts; Archer medical savings accounts

Present law provides that individuals with a high deductible health plan (and no other health plan other than a plan that provides certain permitted coverage) may establish a health savings account ("HSA"). Subject to certain limitations, contributions to an HSA are deductible above-the-line if made by the individual and are excludable from income if made by the employer (including contributions made through a cafeteria plan through salary reduction). Earnings on contributions to an HSA accumulate on a tax-free basis. Distributions from an HSA that are for qualified medical expenses are excludable from gross income. "Qualified medical expenses" are expenses for medical care (as defined under sec. 213(d)) for the taxpayer and his or her spouse and dependents (except that health insurance is generally not a qualified medical expense for HSA purposes).

Archer medical savings accounts ("MSAs") are similar to, but generally less favorable than, the more recently enacted HSAs. Like HSAs, Archer MSAs allow contributions to accumulate earnings on a tax-free basis. Distributions used for medical expenses are excludable from gross income. The definition of medical expense is similar to that used for HSAs. After 2005, generally no new MSAs may be established.

Definition of medical care

Section 213(d) defines "medical care" to mean amounts paid for: (1) the diagnosis, cure, mitigation, treatment, or prevention of disease, or for the purpose of affecting any structure or function of the body; (2) transportation primarily for and essential to medical care referred to in (1); (3) qualified long-term care services; and (4) insurance covering medical care referred to in (1) or (2), or for eligible long-term care premiums for a qualified long-term care insurance contract.[237] Expenditures for items that are merely beneficial to the general health of an individual, such as expenditures for vacation or vitamins, are not medical care. Expenditures for "medicines and drugs" are medical care. Toiletries (e.g., toothpaste), cosmetics (e.g., face creams), and sundry items are not "medicines and drugs" and amounts expended for such items are not expenditures for "medical care." In general, cosmetic surgery and similar procedures do not constitute medical care.

For purposes of the exclusions for reimbursements under employer accident and health plans and distributions from HSAs, the limitation (applicable to the itemized deduction) that only prescription medicines or drugs and insulin are taken into account does not apply. Thus, for example, amounts paid from an FSA, HRA, or HSA to reimburse the employee for nonprescription drugs, such as nonprescription aspirin, allergy medicine, antacids, or pain

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[237] Sec. 213(d). The amount of long-term care premiums that may be taken into account for purposes of the itemized deduction is subject to a dollar limit based on the age of the covered individual.

relievers, are excludable from income; however, if the employee paid for such amounts directly (without such reimbursement), the expenses could not be taken into account in determining the itemized deduction for medical expenses.

Reasons for Change

Under present law, individuals who work for an employer that has a reimbursement plan and individuals with an HSA can purchase nonprescription medicines and drugs, such as aspirin, on a tax-free basis. However, individuals who purchase such items absent such arrangements must do so on an after-tax basis. Eliminating this disparity would increase the fairness of the Federal tax system. In addition, the present-law rule for employer plans provides a tax subsidy for what are routine personal expenses.

Description of Proposal

Under the proposal, the definition of medical expenses for purposes of the tax treatment of reimbursements from employer-sponsored accident and health plans, HSAs, and MSAs are conformed to the definition of medical expenses that may be taken into account for purposes of the itemized deduction for medical expenses. For example, under the proposal, nonprescription medicines could not be reimbursed through an FSA.

Effective Date

The proposal is effective for expenses paid or incurred in taxable years beginning after the date of enactment.

Discussion

As described above, present law contains a variety of provisions that provide tax benefits for medical expenses. The exclusion for employer-provided health benefits is generally justified on the ground that it encourages employees to prefer health benefits over taxable wages, thereby increasing the number of individuals with health insurance coverage. A generally stated purpose for HSAs combined with high deductible plans is to provide an incentive for individuals to be more cognizant of health care expenses. The policy behind the itemized deduction for medical expenses is that such expenses generally are not discretionary and that high levels of such expenses adversely impact the individual's ability to pay taxes. The present-law definition of "medical care" for each of these provisions creates inequities in the Federal tax system because individuals with similar expenses receive differing treatment.

Personal expenses are generally not deductible for Federal income tax purposes. Providing a tax subsidy for over-the-counter medicines may be likened to providing a deduction for personal expenses. Such medicines (e.g., aspirin and cough syrup) are often routine purchases made by most taxpayers. Providing a tax subsidy for the purchase of over-the-counter medicine is not integral to the policy objectives of the present-law provisions for health expenses, and may be counter to such policies.

Providing a subsidy for over-the-counter medicines may also result in result in less compliance, as it may be more difficult to distinguish products that are medical from those that

are not, such as toiletries and products that promote general health. Thus, continuing to subsidize such expenses may lead more taxpayers to claim tax benefits for such general health products.

Some argue that certain over-the-counter medicines are, like prescription drugs, expensive and not routine for most taxpayers. Also, some over-the-counter products, such as certain allergy medicines and smoking cessation products, were recently available by prescription only. Some argue that it is appropriate to provide a subsidy for some of these products.

B. Limit Deduction for Personal Use of Company Aircraft and Other Entertainment Expenses (sec. 274(e))

Present Law

In general

Under present law, no deduction is allowed with respect to (1) an activity generally considered to be entertainment, amusement or recreation, unless the taxpayer establishes that the item was directly related to (or, in certain cases, associated with) the active conduct of the taxpayer's trade or business, or (2) a facility (e.g., an airplane) used in connection with such activity.[238] The Code includes a number of exceptions to the general rule disallowing deductions of entertainment expenses. Under one exception, the deduction disallowance rule does not apply to expenses for goods, services, and facilities to the extent that the expenses are reported by the taxpayer as compensation and wages to an employee.[239] The deduction disallowance rule also does not apply to expenses paid or incurred by the taxpayer for goods, services, and facilities to the extent that the expenses are includible in the gross income of a recipient who is not an employee (e.g., a nonemployee director) as compensation for services rendered or as a prize or award.[240] The exceptions apply only to the extent that amounts are properly reported by the company as compensation and wages or otherwise includible in income. In no event can the amount of the deduction exceed the amount of the actual cost, even if a greater amount is includible in income.

Except as otherwise provided, gross income includes compensation for services, including fees, commissions, fringe benefits, and similar items. In general, an employee or other service provider must include in gross income the amount by which the fair value of a fringe benefit exceeds the amount paid by the individual. Treasury regulations provide rules regarding the valuation of fringe benefits, including flights on an employer-provided aircraft.[241] In general, the value of a non-commercial flight is determined under the base aircraft valuation formula, also known as the Standard Industry Fare Level formula or "SIFL".[242] If the SIFL valuation rules do not apply, the value of a flight on a company-provided aircraft is generally equal to the amount

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[238] Sec. 274(a).

[239] Sec. 274(e)(2). See below for a discussion of the recent modification of this rule for certain individuals.

[240] Sec. 274(e)(9).

[241] Treas. Reg. sec. 1.61-21.

[242] Treas. Reg. sec. 1.61-21(g).

that an individual would have to pay in an arm's-length transaction to charter the same or a comparable aircraft for that period for the same or a comparable flight.[243]

In the context of an employer providing an aircraft to employees for nonbusiness (e.g., vacation) flights, the exception for expenses treated as compensation was interpreted in *Sutherland Lumber-Southwest, Inc. v. Commissioner ("Sutherland Lumber")* as not limiting the company's deduction for operation of the aircraft to the amount of compensation reportable to its employees,[244] which can result in a deduction many times larger than the amount required to be included in income. In many cases, the individual including amounts attributable to personal travel in income directly benefits from the enhanced deduction, resulting in a net deduction for the personal use of the company aircraft.

Covered employees

The American Jobs Creation Act of 2004 ("AJCA"),[245] modified the exceptions in the case of covered employees such that the exceptions to the general entertainment expense disallowance rule for expenses treated as compensation or includible in income apply only to the extent of the amount of expenses treated as compensation or includible in income of the covered employee. Thus, *Sutherland Lumber* was overturned only with respect to covered employees. Covered employees are individuals who, with respect to an employer or other service recipient, are subject to the requirements of section 16(a) of the Securities and Exchange Act of 1934, or would be subject to such requirements if the employer or service recipient were an issuer of equity securities referred to in section 16(a). Such individuals generally include officers (as defined by section 16(a)),[246] directors, and 10-percent-or-greater owners of private and publicly-held companies.

As a result of the enactment of AJCA, in the case of covered employees, no deduction is allowed with respect to expenses for (1) a nonbusiness activity generally considered to be entertainment, amusement or recreation, or (2) a facility (e.g., an airplane) used in connection with such activity to the extent that such expenses exceed the amount treated as compensation or includible in income to the covered employee. For example, a company's deduction attributable to aircraft operating costs and other expenses for a covered employee's vacation use of a company aircraft is limited to the amount reported as compensation to the covered employee.

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[243] Treas. Reg. sec. 1.61-21(b)(6).

[244] *Sutherland Lumber-Southwest, Inc. v. Comissioner.*, 114 T.C. 197 (2000), *aff'd*, 255 F.3d 495 (8th Cir. 2001), *acq.*, AOD 2002-02 (February 11, 2002).

[245] Pub. L. No. 108-357, sec. 907.

[246] An officer is defined as the president, principal financial officer, principal accounting officer (or, if there is no such accounting officer, the controller), any vice-president in charge of a principal business unit, division or function (such as sales, administration or finance), any other officer who performs a policy-making function, or any other person who performs similar policy-making functions.

Reasons for Change

Permitting a business to deduct entertainment benefits provided to its employees in an amount greater than the compensation reportable to such employees effectively allows taxpayers to deduct personal expenses, contrary to general income tax principles. Congress curbed this practice in the AJCA, but only with respect to covered employees. The same rule applicable to all individuals would prevent the outcome more broadly and would simplify the law, thereby removing a potential source of noncompliance.

Description of Proposal

Under the proposal, in the case of all individuals, the exceptions to the general entertainment expense disallowance rule for expenses treated as compensation or includible in income apply only to the extent of the amount of expenses treated as compensation or includible in income. Thus, under those exceptions, no deduction is allowed with respect to expenses for (1) a nonbusiness activity generally considered to be entertainment, amusement or recreation, or (2) a facility (e.g., an airplane) used in connection with such activity to the extent that such expenses exceed the amount treated as compensation or includible in income. The proposal is intended to overturn *Sutherland Lumber* for all individuals. As under present law, the exceptions apply only if amounts are properly reported by the company as compensation and wages or otherwise includible in income.

Effective Date

The proposal is effective for expenses incurred after the date of enactment.

Discussion

Prior to the decision in *Sutherland Lumber*, many viewed the exceptions to the general entertainment expense disallowance rule for expenses treated as compensation or includible in income as a limit on the amount deductible by the employer, rather than as a full exception to the general entertainment disallowance rule. Others took the position that the deduction was not limited to the amount of the income inclusion. They contended that any amount of income inclusion excepted all costs from the entertainment disallowance rule. This issue has received considerable attention in the context of nonbusiness (e.g., vacation) use of employer-provided aircraft.

Sutherland Lumber held that the exception is not limited by the amount includible in income. Some view the decision as contrary to the statutory language and intent. The *Sutherland Lumber* holding was also followed in subsequent Tax Court cases.[247] Based on the holding in *Sutherland Lumber*, the IRS issued internal guidance explaining the application of the exception to pass-through entities, such as subchapter S corporations and partnerships.[248]

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[247] *Midland Financial Co. v. Commissioner*, T.C. Memo 2001-203; *National Bancorp of Alaska, Inc. v. Commissioner*, T.C. Memo 2001-202.

[248] Chief Counsel Advice 200344008.

Allowing S corporations and partnerships to deduct the full cost of an aircraft use can result in an individual being entitled to a net deduction for the personal use of a company aircraft. While the individual would have income inclusion as determined under Treasury regulations, the deduction flowing through the S corporation or partnership to the individual would, in most cases, be several multiples of the amount required to be included in income (e.g., the deduction could be ten times the size of the amount of income inclusion). This may result in an unintended substantial windfall to businesses, especially closely-held businesses, that provide nonbusiness related entertainment benefits to their employees. As interpreted in this manner, the exception permits a taxpayer to deduct personal entertainment expenses, contrary to general income tax principles.

The proposal limits the exception to the entertainment disallowance rule to the amount includible in the income of the individual. Thus, in the employer-provided aircraft context, the amount deductible by the company is limited to the amount includible in the income of the individual. As under present law, the amount of the deduction cannot exceed the actual cost.

Critics of the proposal argue that the deduction should be related to the actual cost to the company even though the amount includible in income is significantly less. They argue that, while the use of the aircraft may be of a personal nature, providing the employee the use of the aircraft is a necessary cost of doing business. A response is that Congress has long held that the deduction for expenses associated with nonbusiness activities should be strictly limited. For example, Congress prohibited any deduction for travel expenses for spouses accompanying employees on business travel even though some may argue that such costs are integral to the business (e.g., some may argue that allowing executives' families to travel with them allows the executive to be away from home longer on business-related travel).

AJCA limited the exceptions in the case of covered employees to the extent of the amount treated as compensation or includible in income. The proposal extends this rule to all individuals. Having different rules for covered employees and all other individuals creates unnecessary complexity in complying with the law. Under present law, companies are subject to different rules for the same activity depending on whether the service provider is a covered employee. For example, nonbusiness use of a company aircraft by both covered and noncovered employees would result in two different deduction amounts for the company. It is appropriate to extend the limiting rule to all individuals.

C. Limit Deduction for Income Attributable to Property Transferred in Connection with the Performance of Services to Amount Included in Income by the Service Provider (sec. 83)

Present Law

Section 83 governs the amount and timing of income and deductions attributable to transfers of property in connection with the performance of services. If property is transferred in connection with the performance of services, the person performing the services (the "service provider") generally must recognize income for the taxable year in which the property is first substantially vested (i.e., transferable or not subject to a substantial risk of forfeiture).[249] The amount includible in the service provider's income is the excess of the fair market value of the property over the amount (if any) paid for the property.[250]

A deduction is allowed to the person for whom such services are performed (the "service recipient") equal to the amount "included" in gross income under section 83.[251] The deduction is allowed for the taxable year of the service recipient in which or with which ends the taxable year for which the amount is included in the service provider's income. Treasury regulations provide for a deduction by the service recipient equal to the amount included as compensation in the service provider's gross income under section 83.[252] The preamble to the regulations states that the "amount included" in gross income means the amount reported on an original or amended return or included in gross income as a result of an IRS audit of the service provider.[253]

The regulations also provide a special rule (sometimes referred to as a safe harbor), under which the service provider is deemed to have included an amount as compensation in gross income if the service recipient satisfies the reporting requirements with respect to that amount (i.e., the amount is reported on a Form W-2 or 1099 issued to the service provider).[254] The

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[249] Sec. 83(a).

[250] Under section 83(b), even if the property is not vested at the time of transfer, the service provider may nevertheless elect within 30 days of the transfer to recognize income for the taxable year of the transfer. The service provider makes an election by filing with the IRS a written statement that includes the fair market value of the property at the time of transfer and the amount (if any) paid for the property. The service provider must also provide a copy of the statement to the service recipient.

[251] Sec. 83(h).

[252] Treas. Reg. sec. 1.83-6(a)(1).

[253] 60 Fed. Reg. 36995, 36996 (July 19, 1995).

[254] Treas. Reg. sec. 1.83-6(a)(2). For purposes of the safe harbor, whether the service recipient satisfies the reporting requirements is determined without regard to the exception from the reporting requirements that generally applies to payments to corporations (currently at Treas.

preamble explains that this rule results from the potential difficulty of demonstrating actual inclusion by the service provider.[255] The regulations thus allow the deduction without requiring the service recipient to demonstrate actual inclusion by the service provider.

In *Venture Funding, LTD., v. Commissioner*,[256] the Tax Court considered an employer's entitlement to a deduction for compensation income attributable to stock transferred to employees. The employer did not report any compensation income attributable to the transfer on either Forms W-2 or Forms 1099 issued to the employees, and none of the employees included any compensation in income as a result of the transfer. The Tax Court interpreted the reference in the deduction provision of section 83 to the amount "included" in the service provider's income to mean the amount taken into account in determining the tax liability of the service provider and thus denied the employer a deduction.[257]

The U.S. Court of Federal Claims considered the same issue recently in *Robinson v. United States*.[258] The case involved stock transferred to an employee in connection with the performance of services in 1995. The employer did not initially report any compensation income attributable to the transfer on either Form W-2 or Form 1099 issued to the employee for 1995, and the employee did not include any compensation in income as a result of the transfer.[259] In 1998, the employer issued to the employee an amended Form W-2 for 1995, which reflected compensation income attributable to the transfer of stock and claimed a deduction for 1995 based on the compensation income. The IRS was in the process of auditing the employee's 1995 tax return, and the amount of compensation income (if any) to be included in the employee's income

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Reg. sec. 1.6041-3(p)), i.e., reporting of payments to a corporation is required in order to meet the safe harbor.

[255] 60 Fed. Reg. 36995, 36996 (July 19, 1995).

[256] 110 T.C. 236 (1998), *aff'd per curiam*, 198 F. 3d 248 (6th Cir. 1999).

[257] Under Treasury regulations in effect for the year in question, an employer could take a deduction for the amount "includible" in an employee's income as compensation under section 83 (rather than the amount actually included), but only if the employer withheld income tax attributable to the compensation income. The employer in *Venture Funding* had not met the income tax withholding requirement and thus was not entitled to a deduction under the regulations. As described in the text, current Treasury regulations do not condition the deduction on withholding if the amount of compensation is properly reported.

[258] 52 Fed. Cl. 725 (2002), *rev'd by* 335 F.3d 1365 (Fed. Cir. 2003).

[259] Although the stock was not substantially vested at the time of transfer, the employee elected to apply section 83(b) at that time. However, the employee took the position that he had paid fair market value for the stock ($2 million) and that no compensation income for 1995 resulted from the transfer. The employer learned of the employee's election in 1998 and claimed a deduction for 1995 for compensation income based on a stock value of more than $20 million. Because the employer in *Robinson* was an S corporation, the deduction affected the tax liability of the employer's shareholders, who were the plaintiffs in the case.

was an open issue. The IRS therefore argued in *Robinson* that a decision on the employer's entitlement to a deduction could not be made until the issue of the amount to be included in the employee's income was resolved. The court stated that the plain meaning of the deduction provision in section 83 is that an employer is allowed a deduction only to the extent that an equal amount actually is included in the employee's income. Because the amount to be included in the employee's income had not been finally determined, the court held that the employer's entitlement to a deduction was not ripe for decision by the court.

On appeal, the U.S. Court of Appeals for the Federal Circuit rejected the Government's interpretation that "included" means actual inclusion on the service provider's tax return.[260] The court instead interpreted "included" to mean the amount included in gross income as a matter of law (that is, the amount legally required to be included in the service provider's gross income under section 83), without regard to the amount, if any, actually included on the service provider's return or timely reported as compensation for services. The court thus invalidated the approach in the regulations, which conditions the deduction on either demonstration of the amount actually included in the service provider's income or timely reporting of the compensation income by the service recipient.

Reasons for Change

Under section 83, the amount of the deduction to which a service recipient is entitled as a result of a transfer of property in connection with the performance of services should be the amount actually included in the service provider's income. This link helps to avoid mismatches in the amount of income and deductions attributable to such transfers. Because the *Robinson* decision eliminates this link, it increases the potential for such mismatches, thus creating tax administration and compliance issues.

Description of Proposal

The proposal overrides the *Robinson* decision and reaffirms the clear language of section 83 that the amount of the deduction allowed with respect to a transfer of property in connection with the performance of services is determined by reference to the amount actually included in income by the service provider under section 83. Thus, the proposal allows a deduction under section 83 equal to the amount of income actually included in the service provider's income (either on the service provider's tax return or as a result of an audit). The proposal also provides that an amount is treated as included in the service provider's income if it is timely reported on the correct IRS form by the service recipient as compensation income of the service provider, thus retaining the safe harbor provided in Treasury regulations.[261]

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[260] *Robinson v. United States*, 335 F.3d 1365 (Fed. Cir. 2003), *cert. denied*, 72 U.S.L.W. 3446 (U.S. January 12, 2004). The *Robinson* decision is binding in the U.S. Court of Federal Claims, a court of national jurisdiction in which taxpayers may bring suits over tax issues. The *Robinson* decision therefore has nationwide applicability.

[261] As under present law, the exception to the reporting requirements for payments to corporations does not apply for this purpose.

Effective Date

The proposal is effective for transfers of property made after the date of enactment. No inference is intended from the proposal that under present law an amount may be deducted under section 83 if the amount has not been included in gross income by the service provider or reported as compensation by the service recipient.

Discussion

Many transactions between taxpayers result in income inclusion for one taxpayer and a deduction for the other. In some cases, one taxpayer's income or deduction is determined separately from the other. However, some Code provisions, including section 83, specifically provide that the timing and amount of one taxpayer's deduction is based on the timing and amount of the other taxpayer's income. Such a structure helps to avoid mismatches between income and deductions.

Such mismatches can lead to a tax "whipsaw" if the service recipient takes a deduction for an amount greater than the amount included in income by the service provider. Whipsaw situations often raise special enforcement difficulties for the IRS. For example, by the time the mismatch is discovered, the statute of limitations may preclude the IRS from arguing that a larger amount should have been included in income by the service provider.

Transactions in which consideration is paid in the form of property rather than cash, such as property transferred in connection with the performance of services, may also cause special compliance issues because of the need to determine the property's value, particularly if the property is not publicly traded. When property is transferred in connection with the performance of services, the service recipient is generally in the best position to know the value of the property and the amount required to be included in income by the service provider. Proper reporting by the service recipient of the amount to be included in income by the service provider also helps to avoid mismatches in the service recipient's deduction and the service provider's income.

The proposal addresses these issues by specifying that the amount of the service recipient's deduction is the amount actually included in the service provider's income and allowing the service recipient to deem the amount to have been included in the service provider's income if the service recipient has complied with the reporting requirements applicable to the income. The proposal thus restores the plain reading of section 83 as in effect before *Robinson*.

D. Payments in Redemption of Stock Held by an ESOP Not Deductible as Dividends (sec. 404(k))

Present Law

Employee stock ownership plans

An employee stock ownership plan ("ESOP") is a type of tax-qualified retirement plan that is designed primarily to invest in employer securities and that meets certain other requirements. An ESOP is subject to the rules applicable to tax-qualified retirement plans generally and receives the same tax benefits. That is, employees do not include ESOP benefits in gross income until the benefits are distributed even though the plan is funded and the benefits are nonforfeitable. The employer is entitled to a current deduction (within limits) for contributions to an ESOP even though an employee's income inclusion is deferred.

In addition, ESOPs receive certain benefits not applicable to qualified plans generally. For example, ESOPs may borrow from related parties to acquire the employer securities held by the plan. In such cases, the securities acquired with the loan are held in a suspense account in the plan and allocated to the accounts of plan participants as the loan is repaid. Examples of the special tax benefits accorded ESOPs include the ability of the employer to deduct contributions used to repay a loan without regard to the normal limits on deductions and, as discussed in more detail below, the ability of the employer to deduct certain dividends paid with respect to stock held by an ESOP.

As is the case with qualified plans generally, ESOP assets are held in a tax-exempt trust for the exclusive purpose of paying benefits to plan participants and beneficiaries. Upon termination of employment (or other event as specified in the plan) a plan participant is entitled to payment of his or her vested account balance. The circumstances giving rise to a distribution and the specific payment terms are as specified in the plan, subject to applicable qualification requirements.

Deduction for certain dividends paid on employer securities held in an ESOP

In general, a corporation may not deduct dividends paid to shareholders. A corporation generally may, however, deduct the amount of "applicable dividends" paid in cash by the corporation with respect to applicable employer securities held by an ESOP.[262] The dividend deduction is in addition to otherwise allowable deductions for contributions to the ESOP.

An applicable dividend is any dividend which, in accordance with the provisions of the ESOP is: (1) paid in cash to the ESOP participants; (2) paid to the ESOP and distributed in cash to participants not later than 90 days after the close of the plan year in which paid; (3) at the

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[262] Sec. 404(k). Applicable employer securities are, with respect to any dividend, employer securities which are held by an ESOP which is maintained by the corporation paying the dividend or any other corporation in the same controlled group on the record date for such dividend.

election of the ESOP participants, paid as described in (1) or (2), or paid to the plan and reinvested in qualifying employer securities; or (4) used to make payments on a loan, the proceeds of which were used to acquire stock held by the ESOP.[263]

The Secretary of the Treasury may disallow the deduction for any dividends if the Secretary determines that the dividend constitutes, in substance, the avoidance or evasion of taxation.

Applicable dividends that are distributed to plan participants are includible in gross income. Certain rules generally applicable to qualified plan distributions do not apply. Thus, for example, a distribution of dividends may not be rolled over tax-free to another qualified plan and the rules prohibiting involuntary cash-outs of benefits do not apply.

Deductibility of payments in redemption or reacquisition of stock held by an ESOP

In general; IRS ruling

Some taxpayers have taken the position that payments in redemption of stock allocated to participants' accounts and paid to a terminating or retiring participant in partial or full satisfaction of the plan's obligations to pay benefits are deductible as dividends under section 404(k). The IRS issued a ruling on this issue in 2001, and held that such payments are not applicable dividends under section 404(k).[264] In reaching its conclusion, the IRS noted that allowing a deduction for such payments would allow a deduction for amounts that do not represent economic costs to the employer and would vitiate rights that the plan participants would otherwise have with respect to the distribution if it were not treated as an applicable dividend, including the ability to make a tax-free rollover and the protections against involuntary cash-outs.

Boise Cascade v. United States

In 2003, the same issue was addressed by the Court of Appeals for the Ninth Circuit in *Boise Cascade v. United States.*[265] The facts of the case were essentially the same as those presented in the 2001 IRS ruling. The case involved convertible preferred stock which was created for and held solely by the ESOP. When a participant in the ESOP terminated employment, the company automatically redeemed convertible preferred stock equal in value to

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[263] Sec. 404(k)(2). In the case of dividends paid with respect to stock allocated to participants' account that are used to repay a loan, the deduction is not available unless the plan provides that employer securities with a fair market value of not less than the amount of the dividend are allocated to the participant for the year.

[264] Rev. Rul. 2001-6, 2001-1 C.B. 491. The IRS also found that, regardless of whether the payments were deductible under section 404(k), the payments were not deductible under section 162(k), which denies a deduction for any amount paid or incurred by a corporation in connection with the reacquisition of its stock or the stock of a related person.

[265] The case involved the 1989 taxable year.

the participant's vested account balance. This amount was then paid out pursuant to the terms of the plan.[266] The Court of Appeals for the Ninth Circuit held that the payments in redemption of the stock were deductible dividends under section 404(k).

A key element of the court's decision was whether the payments were properly characterized as dividends. As relevant here, payments in redemption of stock are treated as full or partial payment in exchange for the stock if the redemption is not essentially equivalent to a dividend.[267] A redemption is not essentially equivalent to a dividend only if the redemption results in a "meaningful reduction of the shareholder's proportionate interest in the company."[268] In making this determination, certain attribution rules apply that treat persons as constructively owning stock held by others. Under these rules, stock owned, directly or indirectly, by or for a trust (other than a qualified trust, including an ESOP), is owned by its beneficiaries in proportion to the actuarial interest of such beneficiaries in such trust.[269]

The court said that the question of whether the redemption payments were dividends depended on whether the ESOP trust or the participants owned the stock when the redemption payments were made. The parties stipulated that, if the participants were deemed to own the stock, the redemption resulted in a meaningful reduction in the participants' interests and therefore could not be considered a dividend. The parties also stipulated that if the ESOP were the owner, then the redemptions did not result in a meaningful reduction in the ESOP's interest and could be characterized as dividends.

The court said that under the attribution rules applicable to determining whether a redemption is treated as an exchange or a distribution, unlike stock owned by other types of trusts, stock owned by a tax-exempt employees' trust is not considered owned by its beneficiaries. Further, the court said, under general trust principles, the ESOP participants in this case did not beneficially own the stock. Therefore, according to the court, for purposes of the rules for taxing distributions of property by corporations, the ESOP trust, not the participants, owned the company stock held by the ESOP when the redemption payments were made. Thus, as stipulated by the parties, a meaningful reduction in the trust's proportionate interest in the corporation did not occur and the payments were dividends which were deductible by the company as "applicable dividends."[270]

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[266] The plan provided that the stock could be redeemed either in the form of cash or common stock, at the election of Boise Cascade. The payments in question were all made in the form of cash.

[267] Sec. 302(b).

[268] *United States v. Davis*, 397 U.S. 301 (1970). Small changes in a shareholder's interest have been found to be a meaningful reduction. See, e.g., Rev. Rul. 76-385, 1976-2 C.B. 92 (reduction from .0001118 percent to .0001081 percent is meaningful).

[269] Sec. 318(a)(2)(B)(i).

[270] The court also concluded that section 162(k) did not preclude the deduction. During the year at issue in *Boise*, section 162(k) applied to expenses in connection with the

IRS response

In a Chief Counsel notice[271] issued after the decision in *Boise,* the IRS reiterated its position that redemption payments of the type involved in the case are not deductible, and stated that the decision in *Boise Cascade* is incorrect and that deductions for amounts paid to redeem stock held by ESOPs should continue to be denied in jurisdictions outside the Ninth Circuit. The notice states that in many cases, a redemption payment will not meet the definition of a dividend (even if the ESOP is treated as the owner of the stock). In addition, it expands on the IRS reasoning for its position and notes that to treat the payments in question as deductible dividends would duplicate the earlier deduction the employer was allowed with respect to contributions to the plan and would undermine important employee rights that would otherwise apply to a distribution of benefits from the plan, such as the ability to rollover the distribution and thereby keep it in a tax-favored vehicle for future use.[272]

Reasons for Change

Redemption payments like those involved in *Boise Cascade* are not the economic equivalent of a dividend. Treating the trustee of the ESOP as the sole shareholder caused the transaction to be misidentified as a dividend despite the fact that the transaction clearly had economic consequences to the individual plan participants which were inconsistent with those of a dividend. To allow a deduction for such payments would allow an employer a deduction for a transaction which is not a dividend and therefore was not intended to qualify for deduction. Finally, allowing a deduction for these types of redemption payments would circumvent the deduction limitations applicable to ESOPs and could have an adverse impact on plan participants because they would lose substantial rights, such as the ability to make a tax-free rollover.

Description of Proposal

The proposal provides that, for purposes of determining whether an amount is deductible as a dividend under section 404(k), each ESOP participant is treated as the direct owner of any shares allocated to his or her account.[273]

"redemption" of stock. The section was modified to apply to expenses in connection with the "reaquisition" of stock in the Small Business Job Protection Act of 1996, effective for amounts paid or incurred after September 13, 1995, in taxable years ending after such date.

[271] CC-2004-038 (October 1, 2004).

[272] The notice also concludes that section 162(k) denies the deduction.

[273] As noted above, the court in *Boise Cascade* also found that section 162(k) did not deny the deduction. Because the proposal provides that there is no deduction for the reacquisition payments, the applicability of 162(k) does not arise under the proposal. No inference is intended whether, under present law, deduction of these amounts is permitted under section 162(k).

Effective Date

The proposal is effective for payments made after the date of enactment. No inference is intended from the proposal that payments affected by the proposal are deductible under present law.

Discussion

The deduction for certain dividends paid with stock held by an ESOP is an exception to the generally applicable rule that dividends are not deductible. The deduction is generally thought to encourage the establishment of ESOPs by employers and thereby extend the benefits of stock ownership to employees.

The rule in *Boise Cascade* would expand the dividend deduction to payments that are not economically dividends. As noted above, a payment in redemption of stock is not a dividend if the payment results in a meaningful reduction in the shareholder's interest. If the ESOP is viewed as the owner of the stock, rather than the plan participants, in many cases any redemption of stock would be viewed as a dividend, even though the interests of individual ESOP participants have changed substantially. For example, as was the case in *Boise Cascade*, it is common for ESOPs to hold convertible preferred stock of a type that is created specifically for the ESOP and that is not held by other shareholders. In such cases, the employer corporation could redeem substantial amounts of stock, but the ESOP would still hold 100 percent of the outstanding stock of that class. Depending on the terms and conditions of the stock of that class, it is possible that there would not be a meaningful reduction in the interest of the ESOP. From each individual participant's perspective, however, there has been a significant change in interest. The situation in *Boise* would not be atypical, in that the participant has no interest in the corporation after the redemption. While in some contexts it may be appropriate to treat an ESOP or other qualified retirement plan as a single shareholder, in this context, this treatment obscures the true nature of the transaction.

Allowing a deduction for redemption payments of the type in *Boise* undermines the rules relating to deductions for contributions to qualified retirement plans. Subject to certain limitations, employers are entitled to a deduction for contributions to a qualified retirement plan, including an ESOP. Because contributions are deductible, no deduction is allowed upon subsequent distributions of plan benefits to participants. Treating the redemption payments as deductible dividends allows the employer a deduction both for contributions to the plan as well as for distributions from the plan.

E. Provide Greater Conformity for Section 403(b) and Section 401(k) Plans (secs. 402(g), 403(b), and 415(c)(3))

Present Law

In general

Present law permits tax-deferred savings through salary reduction under certain employer-sponsored retirement plans, including qualified cash or deferred arrangements ("section 401(k) plans") and tax-sheltered annuity plans ("section 403(b) plans").[274] Taxable employers are entitled to a current deduction for salary reduction contributions, while employees who make salary reduction contributions generally do not include such contributions or the earnings on the contributions in gross income until such amounts are distributed. Permitting employees to make tax-deferred contributions is intended to encourage retirement income savings.

Section 401(k) plans

A section 401(k) plan is a type of defined contribution retirement plan.[275] Section 401(k) plans are subject to the rules generally applicable to defined contribution plans. In addition, special rules apply to such arrangements.[276]

Under a section 401(k) plan, an employee may elect to have its employer make payments on a pre-tax basis as contributions to a defined contribution plan on the employee's behalf, or to the employee directly in cash. Contributions to the plan made at the election of the employee are called elective deferrals. Employee contributions to a section 401(k) plan may also be made on an after-tax basis if the plan provides for them.

A section 401(k) plan may also provide for employer contributions. Employer contributions consist of two types: nonelective contributions and matching contributions. Nonelective contributions are employer contributions that are made without regard to whether

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[274] Present law provides for several other types of elective deferral arrangements, including savings incentive match plan for employees ("SIMPLE") section 401(k) plans, employer-sponsored SIMPLE IRAs, salary reduction simplified employee pension plans, and eligible deferred compensation plans of State or local governments or tax-exempt organizations under section 457. The proposal does not affect these types of elective deferral arrangements.

[275] Legally, a "section 401(k) plan" is not a separate type of plan, but is an arrangement that is part of a qualified profit-sharing, stock bonus or pre-ERISA money purchase plan. In the Code, section 401(k) plans are referred to as "qualified cash or deferred arrangements." The term "section 401(k) plan" is commonly used to refer to qualified cash or deferred arrangements and that term is used here for simplicity.

[276] State and local governments may not maintain 401(k) plans, but can maintain similar arrangements, unless the plan was in existence before May 6, 1986. Many governmental 457 plans operate in a manner similar to section 401(k) plans.

the employee makes elective deferrals. Matching contributions are employer contributions that are made only if the employee makes elective deferrals. Depending on the type of defined contribution plan and the plan terms, employer nonelective contributions and matching contributions may be required or may be discretionary on the part of the employer.

Section 403(b) plans

Section 403(b) plans are another form of employer-based retirement plan that provide the same tax benefits as section 401(k) plans. Section 403(b) plans may be maintained only by (1) tax-exempt charitable organizations, and (2) educational institutions of State or local governments (including public schools).

Employers may contribute to section 403(b) plans on behalf of their employees, and employees may make elective deferrals. Employee contributions to a section 403(b) plan may also be made on an after-tax basis if the plan provides for them. Additionally, a section 403(b) plan may provide for employer nonelective and matching contributions.

Conformity of the general rules for section 401(k) and section 403(b) plans

Historically, some of the rules relating to section 401(k) and section 403(b) plans have been the same and some have been different. In many cases, these differences have been due to differences in traditional practices with respect to 403(b) plans. Over time, the trend has been to conform the rules by applying the rules applicable to 401(k) plans to 403(b) arrangements.[277] Under present law, these plans generally operate in a similar fashion. For example, employer contributions and employee elective deferrals to section 401(k) and section 403(b) plans are not includible in participants' income. After-tax employee contributions are included in the employee's income for the year the contributions are made. Distributions from such plans generally are includible in gross income in the year paid or distributed, except to the extent an amount distributed represents a return of a participant's after-tax contributions (i.e., basis).

As another example, participants' elective deferrals to section 401(k) and section 403(b) plans generally may not be distributed prior to the occurrence of one or more specified events, including severance from employment, death, disability, attainment of age 59-½ , or hardship.[278] Early distributions from section 401(k) and section 403(b) plans generally are subject to an additional 10-percent early withdrawal tax unless an exception applies.[279] In addition, minimum

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[277] Proposed regulations reflecting these and other changes to the rules for section 403(b) plans were issued on November 16, 2004. 69 Fed. Reg. 67065 (November 16, 2004). The regulations are proposed to be generally applicable to plan years beginning after December 31, 2005.

[278] Secs. 401(k)(2)(B) and 403(b)(11). Under a special rule for section 401(k) plans, elective deferrals may also be distributed upon the termination of a plan in certain cases. Sec. 401(k)(10).

distribution rules apply to both section 401(k) and section 403(b) plans. Under these rules, distribution of minimum benefits generally must begin no later than the required beginning date.[280]

Recent changes in the law further illustrate the process of conformity. For example, under prior law, contributions to 403(b) plans were limited by an exclusion allowance, which generally provided that the maximum contribution for a year was 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. The Economic Growth and Tax Relief Reconciliation Act of 2001 ("EGTRRA") eliminated the exclusion allowance for years beginning after 2001 and generally applied to 403(b) plans the limits applicable to contributions under 401(k) plans (as well as other tax-qualified plans).

Additionally, many of the nondiscrimination rules applicable to section 401(k) plans also apply to section 403(b) plans, including the minimum coverage requirements, the general prohibition against discrimination in contributions or benefits, the limit on annual compensation, the minimum participation requirements, and the special nondiscrimination test applicable to employer matching contributions and after-tax employee contributions to such plans.[281]

Notwithstanding the conformity of many rules, present law contains some special rules for section 403(b) plans.

Special definition of compensation under limit on annual additions

For purposes of the limit on annual additions, compensation generally means the taxable compensation of the employee for the year, plus elective deferrals and similar salary reduction contributions. However, under a special definition of "includible compensation" applicable to section 403(b) plans, an employee may be treated as if receiving compensation for up to five years after termination of employment.[282] Under this rule, the limit on annual additions is based on the participant's compensation for the last year of service before termination of

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[279] The exceptions from the additional 10-percent early withdrawal tax include when the distribution is due to death or disability, is made in the form of certain periodic payments, is made to an employee after separation from service after attainment of age 55, or is used to pay medical expenses in excess of 7.5 percent of adjusted gross income. Sec. 72(t).

[280] The required beginning date generally is April 1 of the calendar year following the later of the calendar year in which the participant (1) attains age 70-½ or (2) retires.

[281] Sec. 403(b)(12).

[282] Secs. 403(b)(3) and 415(c)(3)(E).

employment.[283] As a result, contributions to a section 403(b) plan may continue to be made for former employees for up to five years.

Additional elective deferrals

The maximum annual amount of elective deferrals that an individual can make to a section 401(k) or section 403(b) plan is $14,000 (for 2005).[284] If elective deferral contributions are made to both a section 401(k) and a section 403(b) plan for the same employee, a single limit applies to the contributions under both plans. Additionally, an individual who has attained age 50 before the end of the taxable year may also make "catch-up contributions" to section 401(k) and section 403(b) plans. As a result, the limit on elective deferrals is increased for an individual who has attained age 50 by $4,000 (for 2005).[285]

Under a special rule for section 403(b) plans, employees who have completed 15 years of service with certain organizations may make additional elective deferrals of up to the lesser of: (1) $3,000; (2) $15,000, reduced by amounts deferred in prior years; or (3) the excess of $5,000 multiplied by the number of years of service of the employee over deferrals to the plan in prior years. The organizations include educational organizations, hospital, home health service agencies, health and welfare service agencies, churches, or convention of churches.[286]

Under the proposed regulations relating to section 403(b) plans,[287] for participants who are eligible to make both additional deferrals under the special rule for section 403(b) plans and catch-up contributions, contributions are treated first as additional deferrals under the special section 403(b) rule and then as amounts contributed as catch-up contributions, to the extent any catch-up contributions exceed the special section 403(b) rule amount. For example, assume a participant is eligible to make both types of contributions and that the maximum additional deferral which the participant may make for 2005 under the special section 403(b) rule is $3,000. Under the proposed regulation, the maximum total elective deferral contribution that the participant may make for 2005 is $21,000. This is the sum of the basic limit on elective

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[283] This special rule codified a position taken by the Internal Revenue Service in private letter rulings which permitted post-retirement contributions to section 403(b) plans. Priv. Ltr. Ruls. 9625043 (March 26, 1996) and 9233030 (May 19, 1992).

[284] EGTRRA increased many of the limits applicable to employer-sponsored retirement plans, generally effective for years beginning after December 31, 2001. Under EGTRRA, the dollar limit on elective deferrals increases to $15,000 for 2006. After 2006, the limit is adjusted for inflation in $500 increments. The provisions of EGTRRA generally do not apply for years beginning after December 31, 2010.

[285] The additional amount permitted for catch-up contributions increases to $5,000 for 2006. After 2006, the limit is adjusted for inflation in $500 increments. The catch-up contribution provisions are subject to the general sunset provision of EGTRRA.

[286] Sec. 402(g)(8).

[287] 69 Fed. Reg. 67075 (November 15, 2004).

deferrals, $14,000 (for 2005), plus the $3,000 additional deferral under the special section 403(b) rule, plus a catch-up contribution of $4,000 (for 2005).[288]

Special nondiscrimination test for elective deferrals

A special nondiscrimination rule applies to elective deferrals under section 403(b) plans. The rule is referred to as the "universal availability rule." Under the universal availability rule, all employees generally must be eligible to make elective deferrals of more than $200 if any employee may elect to have the employer make such contributions to the plan. This rule is intended to ensure the eligibility of all employees to make elective deferrals under a section 403(b) plan.

In contrast, the nondiscrimination test applicable to elective deferrals under a section 401(k) plan compares the actual levels of elective deferrals made by employees. The test is called the actual deferral percentage test or the "ADP" test.[289] The ADP test is designed to ensure the level of elective deferral contributions under the plan is not weighted too heavily in favor of compensated employees ("HCEs")[290] The ADP test compares the actual deferral percentages ("ADPs") of the HCE group and the nonhighly compensated employee ("NHCE") group. The ADP for each group generally is the average of the deferral percentages separately calculated for the employees in the group who are eligible to make elective deferrals for all or a portion of the relevant plan year. Each eligible employee's deferral percentage generally is the employee's elective deferrals for the year divided by the employee's compensation for the year.

The plan generally satisfies the ADP test if the ADP of the HCE group for the current plan year is either (1) not more than 125 percent of the ADP of the NHCE group for the prior plan year, or (2) not more than 200 percent of the ADP of the NHCE group for the prior plan year and not more than two percentage points greater than the ADP of the NHCE group for the prior plan year. Alternatively, a section 401(k) plan may be deemed to satisfy the ADP test if it meets the requirements of a safe harbor.[291] If the ADP test for a plan year is not satisfied, the plan will technically no longer be qualified. However, the regulations provide measures for

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[288] See Prop. Treas. Reg. sec. 1.403(b)-4(c)(4), Ex. 4 (69 Fed. Reg. 67089).

[289] Sec. 401(k)(3).

[290] "Highly compensated employee" means any employee who (1) was a five-percent owner of the employer at any time during the year or (2) for the preceding year, had compensation from the employer in excess of $95,000 (for 2005) and if the employer elects, was in the top-paid group of employees for such year. Sec. 414(q).

[291] Under the safe harbor, a section 401(k) plan is deemed to satisfy the ADP test if the plan satisfies one of two contribution requirements and a notice requirement. A plan satisfies the contribution requirement under the safe harbor rule if the employer either (1) satisfies a matching contribution requirement or (2) makes a nonelective contribution to a defined contribution plan of at least three percent of an employee's compensation on behalf of each nonhighly compensated employee who is eligible to participate in the arrangement. Sec. 401(k)(12).

correcting failures of the ADP test, including distributing the amount of elective deferrals (and allocable income) by HCEs which cause the plan to fail the test.[292]

Reasons for Change

Although many of the rules for section 401(k) and 403(b) plans have been conformed over time, special rules for section 403(b) plans still exist under present law. Present law rules for section 403(b) plans relating to the definition of includible compensation, additional elective deferrals, and universal availability are inequitable and create complexity in many cases. The proposal provides greater conformity of the rules for section 401(k) and section 403(b) plans by eliminating these special rules.

Description of Proposal

The proposal further conforms the rules for section 401(k) and section 403(b) plans by eliminating some of the special rules applicable to section 403(b) plans.

Under the proposal, the definition of compensation applicable to section 403(b) plans for purpose of the limit on annual additions is conformed to the definition of compensation applicable to defined contribution plans generally, including section 401(k) plans. The special rule permitting contributions to a section 403(b) plan for an employee for up to five years after termination of employment is eliminated.

The proposal eliminates the special rule for section 403(b) plans which permits employees who have completed 15 years of service with certain employers to make additional elective deferrals.

The proposal applies the ADP test to elective deferrals under section 403(b) plans.[293] The universal availability rule is eliminated.

Effective Date

The proposal is effective for plan years beginning after the date of enactment.

Discussion

Conform definition of compensation and eliminate additional elective deferrals

Allowing contributions to section 403(b) plans for up to five years after termination of employment and the rule permitting additional elective deferrals to section 403(b) plans for employees who have completed 15 years of service with certain organizations gives certain employees an advantage in building retirement savings which participants in section 401(k) plans

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[292] Treas. Reg. secs. 1.401(k)-1(f)(1)(i)-(ii) and 1.410(b)-7(c)(3).

[293] As under present law, State and local government employers are not subject to the ADP test under the proposal.

(and, in the case of the 15-year rule, other section 403(b) plans) do not have. The proposal provides equity between the different types of plans by adopting the rules applicable to section 401(k) plans. The 401(k) plan rules are more widely applicable under present law as there is greater coverage under those plans than under 403(b) annuities.

These special rules arguably offer a "catch-up" benefit to employees of certain types of organizations who may be viewed as low-paid relative to employees of other types of organizations. However, present law allows participants in section 403(b) plans and other plans, including section 401(k) plans, who have attained age 50 before the end of the taxable year to make catch-up contributions. In addition, retirement savings are generally intended to replace compensation received while an individual is working. The rule allowing contributions based on assumed compensation after termination of employment is inconsistent with this policy objective.[294]

The special rules for section 403(b) plans add complexity to the tax system. For example, for purposes of the special five-year rule, it may be difficult for employers to track data relating to employees who have terminated employment. In addition, monitoring whether individuals' elective deferrals exceed the overall limit for purposes of the rule permitting additional elective deferrals may also present a significant recordkeeping burden.[295] The special rules also make comparing plans more difficult for employers, thus adding complexity to an employer's decision as to what type of plan to adopt. Further, these special rules may create confusion for employees. Employees may not understand variations in the limits on elective deferrals which can result from the rule permitting additional elective deferrals. Such confusion may result in overall decreased participation.

Nondiscrimination testing

The universal availability rule is a general requirement which ensures that all employees are given the opportunity to make elective deferrals under a section 403(b) plan if any employee can make elective deferrals. However, even if the rule is satisfied, the actual levels of contributions made to the plan may favor highly compensated employees. The ADP test, on the other hand, is designed to ensure that benefits provided under a plan are not weighted too heavily in favor of highly compensated employees by testing actual deferrals made under the plan. Like other nondiscrimination rules, the ADP test reflects the concern that lower-income individuals typically save less than higher-income individuals. These same concerns apply to section 403(b) plans as well as section 401(k) plans. The ADP test is viewed by many as better enforcing the goals of nondiscrimination. While a universal availability rule ensures that all employees are

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[294] To the extent that it is desirable to encourage tax-favored savings after retirement, that goal could be accomplished in a more equitable manner, e.g., through the use of widely available tax-savings vehicles.

[295] The exclusion allowance was a cumulative limit over all years of service, such that some of the special rules that require tracking of cumulative contributions under section 403(b) plans are consistent with that limit, but are no longer appropriate now that section 403(b) plans are subject to the limit on annual deferrals and limit on annual additions.

offered the opportunity to make elective deferrals, it does not ensure that contributions are actually made. In contrast, testing of actual deferrals ensures that contributions are actually made for rank-and-file employees, as well as highly compensated employees.

The universal availability test is easier to administer than the ADP test, and imposing the ADP test on 403(b) plans will increase administrative burdens for those plans. However, these administrative burdens are not likely to be greater than those imposed on employers with section 401(k) plans.[296] Employers who make matching contributions to 403(b) plans and thus are applying the special nondiscrimination test for those contributions, already have arrangements in place which may be able to be modified to accommodate ADP testing. Also, employers who wish to avoid testing may take advantage of the safe harbor methods of satisfying the ADP tests.

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[296] The tension between retirement policy objectives (such as ensuring that plans benefit rank and file employee as well as highly compensated employees) and administrative burdens is a common theme with respect to retirement plans, particularly given the voluntary nature of the retirement plan system. Retirement policy often involves balancing concerns that rules are adequate to protect policy interests with concerns that if the rules are too onerous, some employers may elect not to maintain plans.

F. Extend Early Withdrawal Tax to Eligible Deferred Compensation Plans of State and Local Governments (sec. 72(t))

Present Law

Early withdrawal tax

In general, a distribution from a tax-favored retirement arrangement 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 of inclusion and exclusion apply in the case of Roth IRAs, distributions that are rolled over into another tax-favored retirement arrangement, distributions of employer securities, and certain other situations.

Taxable distributions made before age 59-½, death, or disability are generally subject to an additional 10-percent income tax unless an exception applies. This early withdrawal tax applies to all taxable distributions from tax-favored retirement arrangements, except distributions from an eligible retirement plan of a tax-exempt or State or local government employer (a "section 457 plan"). Thus, the early withdrawal tax applies to taxable distributions from qualified retirement plans and annuities, tax-sheltered annuities (sec. 403(b)), and both traditional and Roth IRAs.[297]

A number of exceptions apply to the early withdrawal tax, depending on the specific type of arrangement from which the distribution is made. In the case of a qualified retirement plan, exceptions (in addition to the exceptions for death and disability) include distributions that are: (1) part of a series of substantially equal periodic payments (not less frequently than annually) made for the life (or life expectancy) of the employee or the joint lives (or life expectancies) of the employee and his or her designated beneficiary; or (2) made to an employee after separation from service after attainment of age 55.

Section 457 plans

Among the various types of tax-favored retirement plans under present law are eligible deferred compensation plans under section 457. A section 457 plan is a plan that is maintained by a State or local government or a tax-exempt organization[298] and that meets certain requirements. In the case of a governmental section 457 plan, compensation deferred under the plan is not includible in gross income until paid and, in the case of a section 457 plan of a tax-exempt organization, compensation deferred under the plan is not includible in gross income

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[297] A similar early withdrawal tax also applies to deferred annuities (sec. 72(q)) and modified endowment contracts (sec. 72(v)).

[298] Section 457 does not apply to a plan maintained by a church or a church-controlled organization. Sec. 457(e)(13).

until paid or made available.[299] Section 457 applies both to arrangements that permit employees to elect whether to defer compensation or receive it currently and those that do not permit such an election; many section 457 plans take an elective deferral approach.

Over time, the rules relating to section 457 plans of State and local governments and of tax-exempt entities have diverged. Presently, section 457 plans of State and local governments operate in many cases similar to section 401(k) or other qualified retirement plans and some of the rules relating to governmental section 457 plans mirror those relating to qualified retirement plans. For example, assets under a governmental section 457 plan are required to be placed in a trust for the exclusive benefit of plan participants,[300] similar to the requirements applicable to qualified retirement plans. In contrast, section 457 plans of tax-exempt organizations (like nonqualified deferred compensation plans of private companies) cannot be funded. As another example, the general rule for taxation of distributions from governmental section 457 plans (i.e., that amounts are not taxable until paid) parallels the rule applicable to qualified plans, whereas the rule applicable to distributions from 457 plans of tax-exempt employers does not. In addition, rollovers between governmental section 457 plans and other tax-favored retirement arrangements are permitted (subject to certain separate accounting requirements), whereas rollovers between 457 plans of tax-exempt employers and other types of plans are not.

Reasons for Change

The early withdrawal tax reflects the concern that the tax incentives for retirement savings are inappropriate unless the savings generally are not diverted to nonretirement uses. The early withdrawal tax discourages early withdrawals and also recaptures a measure of the tax benefits that have been provided. Governmental section 457 plans currently provide benefits similar to those under qualified retirement plans, thus, the same rationale for applying the early withdrawal tax to qualified retirement plans applies to governmental section 457 plans.

Description of Proposal

Under the proposal, the early withdrawal tax applicable to qualified retirement plans is extended to section 457 plans of State and local governments.

Effective Date

The proposal is effective for distributions in taxable years beginning after the date of enactment.

Discussion

The proposal would provide parity between the treatment of qualified retirement plans and governmental section 457 plans with respect to the early withdrawal tax. This change is consistent with other recent changes to governmental section 457 plans, including the addition of

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[299] Sec. 457(a).

[300] Sec. 457(g).

the requirement that the trust be funded and the taxation of distributions. As is the case with qualified plans, imposition of the early withdrawal tax may prevent erosion of governmental 457 plan benefits prior to when they are needed for retirement by the individuals.

The proposal would also be a step toward simplification with respect to rollovers between governmental section 457 plans and other types of arrangements, by eliminating a reason for the separate accounting requirement.

Imposition of the early withdrawal tax will increase the tax liability of plan participants to whom the tax applies compared with present law to the extent that participants take early withdrawals. In some cases, however, the early withdrawal tax may serve as an incentive to leave benefits in the section 457 plan until a later date, thus serving the purpose of the tax.

G. Modify Prohibited Transaction Rules for Individual Retirement Arrangements ("IRAs") to Reduce Tax Shelter Transactions (sec. 4975)

Present Law

Roth IRAs

Individuals with adjusted gross income below certain levels may make nondeductible contributions to Roth IRAs.[301] The maximum annual contribution that may be made to a Roth IRA is the lesser of a certain dollar amount ($4,000 for 2005)[302] or the individual's compensation for the year. An individual who has attained age 50 before the end of the taxable year may also make catch-up contributions to a Roth IRA up to a certain dollar amount ($500 for 2005).[303]

The contribution limit is reduced to the extent an individual makes contributions to any other IRA for the same taxable year.[304] In the case of married individuals, a contribution of up to the dollar limit 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 taxpayers with adjusted gross income over certain levels. Unlike the case with traditional IRAs, contributions to a Roth IRA may be made even after the account owner has attained age 70-½.

Amounts held in a Roth IRA which are withdrawn as qualified distributions are not includible in income. A qualified distribution is a distribution that (1) is made 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) is made after attainment of age 59-½, on account of death or disability, or is made for first-time homebuyer expenses of up to $10,000.

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[301] Sec. 408A.

[302] The Economic Growth and Tax Relief Reconciliation Act of 2001 ("EGTRRA") increased the dollar limit on IRA contributions to $4,000 for 2005 through 2007 and $5,000 for 2008. After 2008, the limit is adjusted for inflation in $500 increments. The provisions of EGTRRA generally do not apply for years beginning after December 31, 2010. Thus, the dollar limit on annual IRA contributions returns to $2,000 in 2011.

[303] Under EGTRRA, the additional amount permitted for catch-up contributions to an IRA is $500 for 2005 and $1,000 for 2006 and thereafter. As a result of the general sunset provision of EGTRRA, catch-up contributions are not permitted after 2010.

[304] The contribution limits for IRAs are coordinated so that the maximum annual contribution that can be made to all of an individual's IRAs is the lesser of the dollar limit or the individual's compensation for the year.

Distributions from a Roth IRA that are not qualified distributions are includible in income to the extent attributable to earnings.[305] The amount which is includible in income is also subject to an additional 10-percent early withdrawal tax unless the withdrawal made after attainment of age 59-½ is due to death or disability, is made in the form of certain periodic payments or another exception to the tax applies.[306]

Traditional IRAs

Annual contributions to traditional IRAs are subject to the same dollar limit ($4,000 for 2005) as contributions to Roth IRAs.[307] As under the rules relating to Roth IRAs, an annual contribution of up to the dollar limit for each spouse may be made to a traditional IRA provided the combined compensation of the spouses is at least equal to the contributed amount. An individual who has attained age 50 before the end of the taxable year may also make catch-up contributions to a traditional IRA up to a certain dollar amount ($500 for 2005).

An individual may make deductible contributions to a traditional IRA up to the IRA contribution limit if neither the individual nor the individual's spouse is an active participant in an employer-sponsored retirement plan. If an individual (or the individual's spouse) is an active participant in an employer-sponsored retirement plan, the deduction is phased out for taxpayers with adjusted gross income over certain levels.[308] 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 a traditional IRA, subject to the same limits as deductible contributions. An individual who has attained age 70-½ prior to the close of a year is not permitted to make contributions to a traditional IRA.

Amounts held in a traditional IRA are includible in income when withdrawn, except to the extent the withdrawal is a return of nondeductible contributions. Additionally, amounts withdrawn prior to attainment of age 59-½ ("early withdrawals") from a traditional IRA

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[305] To determine the amount includible in income, a distribution that is not a qualified distribution is treated as made in the following order: (1) regular Roth IRA contributions; (2) contributions attributable to conversions of traditional IRAs (on a first-in, first-out basis); and (3) earnings.

[306] Sec. 72(t).

[307] Sec. 408.

[308] For 2005, the deduction phase-out ranges are as follows: (1) for single taxpayers, the range is $50,000-$60,000; (2) for married taxpayers filing jointly, the range is $70,000-$80,000; and (3) for married taxpayers filing a separate return, the range is $0-$10,000. If the individual is not an active participant in an employer-sponsored retirement plan, but the individual's spouse is, the deduction is phased out for taxpayers with adjusted gross income between $150,000 and $160,000.

generally are subject to the same additional 10-percent early withdrawal tax applicable to taxable distributions from a Roth IRA unless an exception applies.[309]

Prohibited transactions

The Code prohibits certain transactions between certain tax-preferred retirement plans and a disqualified person.[310] Traditional and Roth IRAs are subject to the prohibited transaction rules.[311]

Under the Code, if a prohibited transaction occurs, the disqualified person is subject to a two-tier excise tax.[312] The first level tax is 15 percent of the amount involved in the transaction. The second level tax is imposed if the prohibited transaction is not corrected within a certain period and is 100 percent of the amount involved. Amount involved generally means the greater of the amount of money and the fair market value of the other property given or the amount of money and the fair market value of the other property received.[313]

Prohibited transactions include certain direct or indirect transactions between a plan and a disqualified person: (1) the sale, exchange, or leasing of property; (2) the lending of money or other extension of credit; and (3) the furnishing of goods, services or facilities. Prohibited transactions also include any direct or indirect: (1) transfer to, or use by or for the benefit of a disqualified person of the income or assets of the plan; (2) in the case of a fiduciary, an act that deals with the plan's income or assets for the fiduciary's own interest or account; and (3) the receipt by a fiduciary of any consideration for the fiduciary's own personal account from any party dealing with the plan in connection with a transaction involving the income or assets of the plan.

In general, "disqualified person" means: (1) a fiduciary; (2) a person providing services to the plan; (3) an employer any of whose employees are covered by the plan; (4) an employee organization any of whose members are covered by the plan; (5) a direct or indirect owner of a specified interest in such an employer or employee organization; (6) a member of the family of an individual which meets certain definitions of a disqualified person; (7) a corporation, partnership, or trust or estate of which (or in which) a specified interest is owned by certain other

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[309] Sec. 72(t).

[310] Sec. 4975.

[311] The prohibited transaction rules under the Code also apply to other tax-favored savings vehicles, including qualified retirement plans, health savings accounts (sec. 223), medical savings accounts (sec. 220), and Coverdell education savings accounts (sec. 530). Under ERISA, similar prohibited transaction rules apply to employer-sponsored retirement plans and welfare benefit plans. In general, IRAs are not subject to ERISA. The prohibited transaction rules under the Code and ERISA do not apply to governmental plans or church plans.

[312] Sec. 4975(a)-(b).

[313] Sec. 4975(f)(4).

disqualified persons; (8) offers and directors (or individuals having powers or responsibilities similar to those of officers or directors), 10-percent or more shareholders, or highly compensated employees (earning 10 percent or more of the yearly wages of the employer) of certain other disqualified persons; or (9) a 10-percent or more (in capital or profits) partner or joint venturer of certain other disqualified persons.

Under this definition, disqualified persons include corporations of which 50 percent or more of: (1) the combined voting power of all classes of stock entitled to vote; or (2) the total value of shares of all classes of stock of such corporation, is owned directly or indirectly, or held by certain other disqualified persons.[314] Thus, for example, a corporation 50 percent of the voting stock of which is owned by a plan is a disqualified person with respect to that plan.

Additionally, for purposes of the definition of disqualified person, a fiduciary includes any person who: (1) exercises any authority or control respecting management or disposition of the plan's assets; (2) renders investment advice for a fee or other compensation with respect to any plan moneys or property, or has the authority or responsibility to do so; or (3) has any discretionary authority or responsibility in the administration of the plan.[315] Thus, for example, an IRA owner with authority to control the investment of the assets in the IRA (a "self-directed IRA") is a fiduciary, and therefore, a disqualified person under the prohibited transactions rules.

Swanson v. Commissioner

In *Swanson v. Commissioner,*[316] the taxpayer, the sole shareholder of an S corporation ("S Corp.") arranged in 1985 for the organization of a C corporation ("C Corp.") and became its director and president. C Corp. provided services to S Corp. in exchange for fees. Also in 1985, the taxpayer established a self-directed IRA and directed its trustee to execute a subscription agreement for 100 percent (2,500 shares) of C Corp.'s original issue stock. The taxpayer subsequently directed the payment of $593,602 in dividends on C Corp. stock during 1986-1988.

The IRS viewed the transaction as an arrangement to avoid statutory limits on annual contributions to an IRA. In *Swanson,* the IRS argued that a prohibited transaction occurred when C Corp.'s stock was acquired by the IRA. According to the IRS, the stock acquisition was prohibited under the rule prohibiting the sale, exchange or leasing of property between a plan and a disqualified person.[317] The Tax Court disagreed, concluding that C Corp. was not a disqualified person with respect to the IRA because, at the time the shares were issued to the IRA, C Corp. was without shares or shareholders and thus, did not fit within the definition of a disqualified person under which certain share ownership levels by other disqualified persons is determinative of a corporation's disqualified person status.[318] Accordingly, the court concluded,

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[314] Sec. 4975(e)(2)(G).

[315] Sec. 4975(e)(2)(A).

[316] 106 T.C. 76 (1996).

[317] Sec. 4975(c)(1)(A).

[318] Sec. 4975(e)(2)(G).

the issuance of C Corp. shares and the distribution of dividends on those shares to the IRA was not a prohibited sale or exchange, or leasing of any property between a plan and a disqualified person.

The IRS also asked the court to consider whether the payment of dividends by C Corp. to the IRA involved self-dealing by a fiduciary in violation of the prohibited transaction rules. The Tax Court concluded that the payment of dividends by C Corp. to the IRA was not prohibited self-dealing by a disqualified person, in this case, a fiduciary, because the taxpayer did not deal for his own benefit or account. The court reasoned that the dividends did not become income of the IRA until they were issued to the IRA. Thus, the taxpayer's direction of the dividend payment was not prohibited self-dealing with respect to the IRA. The court also concluded that the taxpayer realized a benefit from the dividends only in his capacity as IRA beneficiary, which is not considered a prohibited transaction.

The Tax Court did not address whether the *Swanson* transaction violated any other prohibited transaction rules. Some taxpayers have relied on *Swanson* as the basis for similar transactions that attempt to avoid the IRA contribution limits and obtain tax-free returns. A November 2003 newspaper article described a transaction in which an individual contributed $2,000 to a Roth IRA, which purchased a newly-created C corporation.[319] Shares which the individual owned in another corporation were transferred to the C corporation. The C corporation later sold the shares for $1.5 million, which was placed in the Roth IRA. *Swanson* was cited as supporting the legality of the transaction.

Treasury guidance on Roth IRA shelters

In Notice 2004-8, the Treasury Department announced that certain transactions involving Roth IRAs are tax avoidance transactions and identified these transactions ("Roth IRA shelters") as listed transactions.[320] A listed transaction is a transaction that is the same as or substantially similar to one of the types of transactions that the IRS: (1) has determined to be a tax avoidance transaction; and (2) identified by notice, regulation, or other form of published guidance as a listed transaction.[321] Listed transactions must be disclosed on a tax return and may result in adverse tax consequences.

According to the Notice, a Roth IRA shelter involves: (1) an individual who owns an existing business such as a corporation or sole proprietorship (the "Business"); (2) a Roth IRA that is maintained for the individual; and (3) a corporation all the original-issue shares of which are acquired by the Roth IRA (the "Roth IRA Corporation"). The Roth IRA Corporation provides services to the Business in exchange for fees. The Roth IRA Corporation then distributes dividends on its shares to the Roth IRA. The Notice states that a Roth IRA shelter is a type of transaction that is used to avoid the limitations on contributions to Roth IRAs.

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[319] "The Secret Life of a Retirement Account", *New York Times*, November 11, 2003, section C, page 1.

[320] Notice 2004-8, 2004-4 I.R.B. 333 (January 26, 2004).

[321] Treas. Reg. sec. 1.6011-4(b)(2).

The IRS intends to challenge Roth IRA shelter arrangements on several grounds, according to the Notice. In the Notice, the IRS said that in appropriate cases, it may assert that the substance of the transaction is that the amount of the value shifted from the Business to the Roth IRA Corporation is a payment to the individual, followed by a contribution by the individual to the Roth IRA and a contribution by the Roth IRA to the Roth IRA Corporation. Additionally, under its authority to allocate gross income, deductions, credits or allowances among persons owned or controlled directly or indirectly by the same interests, if such allocation is necessary to prevent evasion of taxes or clearly to reflect income,[322] the IRS may also require that the income be allocated from the Roth IRA Corporation to the individual, business, or other entities under the control of the individual. The IRS may also take the position that these arrangements give rise to one or more prohibited transactions between a Roth IRA and a disqualified person. The IRS may also impose an excise tax on excess contributions to Roth IRAs.[323]

Reasons for Change

The Roth IRA shelter and transactions like those in *Swanson* are tax avoidance schemes designed to avoid the annual limits on contributions to IRAs and to shelter income. In doing so, these arrangements artificially shift taxable income away from the IRA owner or from an entity controlled by the IRA owner to the IRA, a tax-exempt entity.

Description of Proposal

The proposal expands the definition of disqualified person under the prohibited transaction rules.[324] Under the proposal, entities established by IRA owners are disqualified persons for purposes of the prohibited transaction rules. The proposal also makes all IRA owners disqualified persons under the prohibited transaction rules.

Effective Date

The proposal is effective for transactions on or after the date of enactment.

Discussion

The Roth IRA shelter and transactions like those in *Swanson* are designed to avoid the annual limits on contributions to IRAs through indirect contributions. These transactions shift value to an individual's IRA through one or more business entities controlled by the individual. Because the individual controls the business entity, the individual is in the position to shift otherwise taxable income or value away from it, often in a transaction that may create a deduction for the business entity. In doing so, the individual artificially shifts taxable income

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[322] Sec. 482.

[323] Sec. 4973.

[324] The proposal would also apply to other tax-favored arrangements to which the IRA prohibited transaction rules apply.

away from the business entity into the IRA. In other words, the transaction shifts income that would be currently taxable (e.g., to the IRA owner) to the IRA. In reality, the value shifted from the business entity is an indirect payment through an entity established by an individual, to the IRA for the benefit of the individual. The payment accumulates tax-free in the IRA and, if held in a Roth IRA, may generate tax-free distributions.

The prohibited transaction rules are intended to prevent persons with close relationships to plans, including IRAs, from using those relationships to enrich themselves at the expense of plan participants and beneficiaries. By making entities established by IRA owners disqualified persons, the proposal prevents IRA owners from using such an entity to sidestep the annual limits on contributions to IRAs by shifting value from the entity to the IRA. Additionally, by making all IRA owners disqualified persons (and not just owners of self-directed IRAs because of their status as fiduciaries) the proposal makes the prohibited transaction rules applicable to all IRAs on a more consistent basis.

H. Repeal Pick-Up Rules for Employee Contributions to State or Local Governmental Retirement Plans (sec. 414(h))

Present Law

Taxation of contributions to qualified retirement plans

Contributions to qualified retirement plans generally fall into three categories: employer contributions, employee contributions, and elective deferrals. Generally, the type or types of contributions made to a plan is determined by the terms of the plan.

Employer contributions to a qualified retirement plan are not includible in an employee's income at the time of contribution and are not wages for purposes of tax under the Federal Insurance Contributions Act ("FICA").[325] Employee contributions are generally made on an after-tax basis, that is, they are included in income at the time of contribution. Employee contributions are also generally wages for FICA tax purposes.

An amount contributed to a qualified retirement plan at the election of an employee is generally treated as an employee contribution and thus is includible in income. However, a defined contribution plan may include a qualified cash-or-deferred arrangement (referred to as a "401(k)" plan) under which employees may elect whether to receive certain amounts in cash or to have them contributed to the plan on a pretax basis (referred to as "elective deferrals"). Elective deferrals are subject to certain rules. For example, elective deferrals must be fully vested and may not exceed an annual limit ($14,000 for 2005).[326] Elective deferrals are not includible in income at the time of contribution; however, they are wages for FICA tax purposes.

A distribution of benefits from a qualified retirement plan generally is includible in gross income in the year it is paid or distributed, except to the extent the amount distributed represents a return of the employee's after-tax contributions (i.e., basis).

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[325] Secs. 3101-3128. FICA tax consists of two parts: (1) old age, survivor, and disability insurance ("OASDI"), which correlates to the Social Security program that provides monthly benefits after retirement, disability, or death; and (2) Medicare hospital insurance ("HI"). The OASDI tax rate is 6.2 percent on both the employee and employer (for a total rate of 12.4 percent). The OASDI tax rate applies to wages up to the OASDI wage base ($90,000 for 2005). The HI tax rate is 1.45 percent on both the employee and the employer (for a total rate of 2.9 percent). Unlike the OASDI tax, the HI tax is not limited to a specific amount of wages, but applies to all wages.

[326] A State or local governmental employer may not maintain a 401(k) plan unless it maintained a 401(k) plan before May 6, 1986. However, other arrangements similar to 401(k) plans are available to State and local governmental employers, such as eligible deferred compensation plans (section 457).

Special rules for State and local governmental plans

Some defined benefit pension plans require employee contributions. In many cases, governmental employees are required to participate in and contribute to a defined benefit pension plan as a condition of employment.[327] In such cases, the required employee contributions are generally withheld from employees' salaries. In some cases, a governmental plan may cover employees of different governmental entities. For example, a plan established by a State may cover employees of various State agencies or employees of the State and of local governments within the State. In such cases, the plan may provide employers with the option of paying required employee contributions on behalf of their employees, rather than withholding the required contributions from employees' salaries.

Under a special rule, in the case of a plan maintained by a State or local government, if contributions are designated as employee contributions, but the State or local governmental employer "picks up" (i.e., pays) the contributions, contributions so picked up ("pick-up contributions") are treated as employer contributions.[328] As a result of being treated as employer contributions, pick-up contributions are not includible in employees' income at the time of contribution.

Legislative history indicates that the pick-up rules were intended to apply to situations in which amounts are designated as employee contributions under a State or local governmental plan, but the governmental employer pays all or a part of the employee's contribution without withholding the amount from the employee's salary. In this situation, the portion of the contribution that is "picked up" by the government was viewed as, in substance, an employer contribution for Federal tax purposes, even though designated as an employee contribution for purposes of State law.[329]

IRS guidance has applied pick-up treatment in situations in which employees' salaries are reduced by the amount of the contribution as long as individual employees are not given the option of choosing to receive amounts directly instead of having them paid by the employer to the plan.[330] The IRS has issued numerous private letter rulings to taxpayers that deal with the application of the pick-up rules to particular arrangements. Many of these rulings apply pick-up treatment to employee contributions to a State or local governmental pension plan that are

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[327] A governmental plan may also allow an employee to purchase additional service credit (such as credit for military service) by making additional employee contributions.

[328] Sec. 414(h)(2).

[329] See H.R. Rep. No. 93-807, at 145 (1974).

[330] See, e.g., Rev. Rul. 81-36, 1981-1 C.B. 255. (The employer must also specify that the contributions are being paid by the employer in lieu of contributions by the employee.) Compare Rev. Rul. 81-35, 1981-1 C.B. 255, which denies pick-up treatment to contributions made pursuant to an individual employment agreement under which the employer contributes a certain percentage of the employee's salary to the State's pension plan on behalf of the employee.

required as a condition of employment and withheld from employees' salary. The IRS also has ruled favorably on arrangements that allow individual employees to make an irrevocable election to have contributions made to a plan on their behalf by payroll deduction if a State statute or similar provision provides that the contributions are being paid by the employer in lieu of contributions by the employee.[331] The rulings conclude that, in these circumstances, the employee does not have the option of receiving the amounts directly and that pick-up treatment applies.

Although pick-up contributions are treated as employer contributions for income tax purposes, pick-up contributions made pursuant to a salary reduction agreement are wages for FICA tax purposes.[332] However, compensation of State and local government employees who are covered by a qualified retirement plan may be generally exempt from FICA tax.[333]

Reasons for Change

The pick-up rules result in inconsistent tax treatment of employee contributions to qualified retirement plans. Employee contributions made to plans maintained by private employers or by the Federal government are includible in income. However, the pickup rules allow employee contributions to State and local governmental plans to be made on a pretax basis. In many cases, inconsistent treatment applies also for FICA tax purposes. These inconsistencies cause inequity in the tax system.

Description of Proposal

Under the proposal, the pick-up rules are repealed. Accordingly, contributions to a State or local government plan that are designated as employee contributions under the plan are treated as employee contributions for Federal tax purposes. Thus, such contributions are includible in income and are wages for FICA purposes.

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[331] See, e.g., Priv. Ltr. Rul. 200423040 (March 9, 2004) (employees may elect whether to participate in a defined benefit pension plan that requires employee contributions) and Priv. Ltr. Rul. 200317034 (October 10, 2002) (employees may elect to have contributions made to a defined benefit pension plan by payroll reduction to purchase additional service credit). In addition, under Priv. Ltr. Rul. 200317024 (September 30, 2002), pick-up treatment applies to contributions made to a defined contribution plan at the election of employees. This ruling suggests that the pick-up rules may be used to make pretax employee contributions to a defined contribution plan without complying with the rules applicable to elective deferrals.

[332] Sec. 3121(v)(1)(B). For this purpose, salary reduction agreement includes any arrangement in which there is a reduction in the employee's salary in connection with the employer's contribution of a corresponding amount to a pension plan on the employee's behalf, regardless of whether the employee approves or chooses participation in the plan or whether participation is mandatory. See H.R. Rep. No. 98-861, at 1415 (1984), and *State of New Mexico v. Shalala*, 153 F.3d 1160 (10th Cir. 1998).

[333] Sec. 3121(b)(7)(F).

Effective Date

The proposal applies to employee contributions made in taxable years beginning after the date of enactment.[334]

Discussion

The pick-up rules provide a special tax benefit for contributions made by State and local government employees that is not available to contributions made by employees of private employers or employees of the Federal government. Moreover, application of the pickup rules to employee contributions to defined contribution plans could be a means of avoiding the requirements applicable to elective deferrals. In conforming the treatment of contributions made by State and local government employees to the treatment of contributions made by other employees, the proposal furthers consistency in the tax system.

The pickup rules also lead to complexity, both with respect to whether contributions are eligible for pick-up treatment (as evidenced by the number of IRS rulings in this area) and particularly with respect to whether pickup contributions are made pursuant to a salary arrangement and are thus subject to FICA tax. Under the proposal, the designation of contributions as employee contributions under the terms of the plan determines the status of the contributions for Federal tax purposes.[335] As a result, the need to make a separate determination of the character of the contributions for income or FICA tax purposes is eliminated.[336]

Repeal of the pick-up rules may have the effect of increasing income taxes for participants in some State or local government plans with respect to employee contributions that are no longer eligible for pick-up treatment and thus are includible in income. Alternatively, some State and local governmental employers may choose to redesign their plans so that contributions that are currently designated as employee contributions are instead treated as

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[334] In the case of changes to the rules for qualified retirement plans, a delayed effective date is often provided with respect to governmental plans in order to provide sufficient time for making necessary plan amendments. If the proposal is adopted, it may be appropriate to consider whether a delayed effective should apply.

[335] Designation of contributions as employee contributions under a State or local government plan generally has significance under the terms of the plan (and under State or local law). For example, the plan might subject benefits attributable to employer contributions to a vesting requirement, but provide that benefits attributable to employee contributions are immediately vested. Similarly, the plan may include special distribution terms applicable only to employee contributions. The fact that the designation of contributions as employee contributions has significance under the plan (and under State or local law) provides further support for treating them as employee contributions for Federal tax purposes.

[336] The present-law FICA standard depends on the facts and circumstances and is sometimes a source of confusion. In eliminating a distinction based on whether contributions are made pursuant to a salary reduction agreement, the proposal may lead to increased FICA tax compliance.

employer contributions. In that case, such employer contributions would not be includible in employees' income or wages for FICA purposes.

In the case of employee contributions that are includible in income under the proposal, after-tax treatment of such contributions results in basis, so that a corresponding portion of the plan distributions made to participants is treated as a nontaxable return of basis. The need to determine the portion of a distribution that is includible in income may add complexity for participants. However, this information is generally required to be provided on the tax statements (Form 1099-R) that a qualified retirement plan provides to participants. To the extent that the portion of a distribution that is includible in income is reported on the Form 1099-R, participants would not have to make this determination themselves.

The proposal may add administrative complexity for some qualified retirement plans by creating the need to keep records on after-tax employee contributions. However, because pick-up contributions are employee contributions under the plan and may therefore receive special treatment under the plan, some plans may already keep such records.

The proposal may have the effect of increasing FICA taxes for some employers and employees (subject to the ability of State and local governmental employers to redesign their plans as discussed above), as well as increasing revenues for the Social Security and Medicare programs. Similarly, the proposal may result in additional wages for Social Security and Medicare purposes, which would be likely to increase benefits for some individuals, as well as long-term costs under such programs.

V. CORPORATE AND PARTNERSHIP PROVISIONS

A. Modify Extraordinary Dividend Rules for Common Stock (sec. 1059)

Present Law

A corporation that receives a dividend from another corporation is entitled to at least a 70 percent dividends received deduction if holding period requirements are met.[337] Thus the maximum rate on such a dividend is 10.5 percent (35 percent, the maximum corporate tax rate, times the 30 percent of the dividend that is taxable.) Under section 1059, if the dividend is an "extraordinary" dividend (as defined), the recipient corporation must reduce its basis in the dividend paying stock by an amount equal to the "nontaxed" portion of the dividend (the amount of the dividends received deduction with respect to the dividend).

A dividend received by an individual generally is taxed at a maximum rate of 15 percent. If a dividend received by an individual is an "extraordinary" dividend, any loss on the stock is treated as a long term capital loss to the extent of the dividend.[338] Thus, the loss will reduce the individual's net long-term capital gain (if any) before reducing the net short-term capital gain.

An extraordinary dividend is generally defined to include any dividend that (1) is paid within two years of the purchase of the stock and (2) exceeds 10 percent of the taxpayer's adjusted basis in the stock (five percent in the case of preferred stock).[339] If the aggregate of all dividends received within a year exceeds 20 percent of a taxpayer's adjusted basis, then such dividends are also extraordinary dividends.

All dividends received by the taxpayer that have ex-dividend dates within the same period of 85 days are aggregated to apply the 10-percent test or five percent of preferred stock.

If the taxpayer establishes to the satisfaction of the Secretary the fair market value of the stock as of the day before the ex-dividend date, then the taxpayer can use such fair market value in lieu of adjusted basis for purposes of applying the 10 percent and other thresholds.

Reasons for Change

Present law is intended to prevent "dividend stripping" transactions. In such transactions, a taxpayer purchases stock prior to a very large dividend for a price that reflects the expectation of the dividend, receives the dividend, and then sells the stock for a loss after the dividend, at a price that reflects the reduction in value following the payment. If the dividend is taxed at a rate lower than the rate imposed on income that can be sheltered by the loss, and if the basis of stock

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[337] Secs. 243 and 246.

[338] Sec. 1(h)(1), 1(h)(3), 1(h)(11) and 1(h)(11)(D).

[339] Sec. 1059

is not reduced by any portion of the dividend received, tax benefit can result without any true economic loss to the stockholder.

Present law unnecessarily allows dividend stripping transactions to occur on some very large dividends, due to the 10-percent threshold for dividends with respect to common stock.

Description of Proposal

The proposal reduces the threshold for extraordinary dividends on common stock from 10 percent of the adjusted basis of the stock to five percent of such adjusted basis. As under present law, the taxpayer can elect to use fair market value on the day before the ex-dividend date if such fair market value is established to the satisfaction of the Secretary.

Effective Date

The proposal is effective for distributions on or after the date of enactment.

Discussion

Stock basis reduction under section 1059 is generally appropriate if a taxpayer has purchased stock within a relatively short time prior to a dividend. In such a case, the shareholder could be viewed as having purchased two assets: first, a "right to dividend value" and second, the remaining value of the stock. The basis reduction after the dividend leaves the taxpayer with the proper remaining basis in the stock.

However, basis reduction may be too complicated in the case of purchases and sales of stock that capture, in the interim, regular quarterly dividends. Thus, present law applies the basis reduction rule only to certain purchases and sales where "extraordinary" dividends are involved, and does not attempt to apply the rule to regular quarterly dividends.

Nevertheless, the definition of "extraordinary" dividends is arguably too narrow, since it seems to exclude dividends that many would consider "extraordinary." In the case of common stock, only if all dividends aggregated within an 85 day period exceed 10 percent of the adjusted basis of the stock (or the fair market value of the stock, if the taxpayer elects uses that measure instead) is the dividend considered "extraordinary," unless the dividends over a full year aggregate to greater than 20 percent of the adjusted basis (or fair market value) of the stock. Yet a quarterly dividend equal to 10 percent of the higher or basis or fair market value of stock is a significant dividend. [340]

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[340] As one example, the very large dividend that Microsoft declared in 2004 would not have been an extraordinary dividend if its amount had been only slightly reduced. See Robert Willens, "Microsoft's Special Distribution - The Verdict is In" 17 *Tax & Accounting* Issue 135 (November 16, 2004).

There is increasing evidence that, as a result of the reduction of taxes on dividends and possibly for other reasons, corporations have increased their dividend payouts.[341] However, even with the increased payouts, annual dividend yields are still well below 10 percent. In 2004, there were only a handful of companies that had dividend yields above 10 percent. For most of the companies paying dividends, the dividend payments on the ex-dividend date were below five percent of the market price.

Under the proposal, the annual rate on common stock dividends would be modified to substitute a five percent of basis or fair market value test for the current 10-percent test.

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[341] Jeff Opdyke, "Tax Cut, Shareholder Pressure Stoke Surge in Stock Dividends," *Wall Street Journal online*, (January 18, 2005).

B. Reduce Tax-Indifferent Shareholder's Basis in Stock by Nontaxed Portion of Extraordinary Dividend (sec. 1059)

Present Law

In general

A shareholder generally is not required to reduce its basis in stock upon the receipt of a dividend on that stock. This rule applies to ordinary dividends as well as redemptions of stock that are treated as dividends.[342]

In the case of a dividend resulting from a redemption of stock, "proper adjustment" of the basis of the shares of stock outstanding after the redemption is made to account for the basis of the redeemed shares.[343] Treasury regulations provide three examples illustrating a proper adjustment. In one example, a husband owns half the stock of a corporation, and his wife owns the other half. The corporation redeems all of the stock owned directly by the husband. Under the constructive ownership rules applicable in determining whether the redemption is treated as a dividend, the husband is considered to own the stock owned by his wife. As a result, the husband's interest in the corporation has not been reduced and the redemption is treated as a dividend distribution. The example concludes that after the redemption the basis of the shares of stock owned by the wife includes the basis of the stock held by the husband before the redemption.[344]

Basis reduction rules

In certain situations, the general rule that a dividend distribution does not require basis reduction is superseded by more targeted rules. Under section 1059, if a corporate shareholder receives an extraordinary dividend and has not held the stock for more than two years before the dividend was announced (and in certain other circumstances), the corporation generally is required to reduce its basis in the stock with respect to which the dividend is paid. A dividend on common stock generally is an extraordinary dividend if the amount of the dividend is at least 10 percent of the taxpayer's adjusted basis in the stock. Certain dividends resulting from redemptions of stock are treated as extraordinary dividends, and basis adjustment is required without regard to the redeemed corporate shareholder's holding period in its redeemed stock. These dividends are those resulting from: (1) a partial liquidation; (2) a non-pro-rata redemption; (3) the application of a rule attributing stock of a corporation to the party holding an option on

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[342] A redemption is a payment by a corporation to acquire stock from a shareholder. A payment in redemption of a shareholder's stock generally produces sale treatment and therefore capital gain or loss to that shareholder, but a redemption is treated as a dividend if it does not satisfy one of several criteria that generally seek to determine whether a shareholder's proportionate interest in the distributing corporation has been meaningfully reduced. Sec. 302.

[343] Treas. Reg. sec. 1.302-2(c).

[344] *Id.*, Example 3.

that stock (the "option rule"); or (4) the application of section 304, relating to redemptions through the use of related corporations. If a dividend is extraordinary and basis reduction is required, the amount of the reduction is the amount of the nontaxed portion of the dividend, which effectively is the amount of the dividends received deduction allowed with respect to the stock (for example, 70 percent of the dividend in the case of a dividend on portfolio stock).

The basis reduction rule was intended to prevent dividend stripping -- the acquisition of stock shortly before the ex-dividend date, the receipt of a dividend with respect to which the dividends received deduction is allowed, and the sale of the stock after satisfying the holding period requirement for the dividends received deduction.[345] In the absence of a rule requiring basis reduction, dividend stripping generally would produce (1) short-term capital loss in an amount equal to the full amount of the dividend -- because on payment of a dividend the price of a share of stock generally declines by the amount of the dividend -- and (2) taxable income only for the portion of the dividend for which the dividends received deduction was not available.

Basis reduction generally is not required when the taxation of a dividend payment is reduced or eliminated for a reason other than the dividends received deduction -- when, for example, the shareholder receiving the dividend is a foreign person or a tax-exempt organization.

Basis-shifting transactions

Certain features of present law arguably permit basis-shifting transactions that generate tax losses. Those features of present law are the following. First, as described above, a redemption can be treated as a dividend because of the application of the option rule. Second, although a redemption treated as a dividend because of the option rule is an extraordinary dividend, the shareholder's basis in the redeemed shares is not reduced if the dividend is taxed at a reduced or zero rate for a reason other than the dividends received deduction. Third, foreign persons generally are not subject to U.S. tax on dividends paid by foreign corporations and often are subject to reduced treaty withholding rates on dividends paid by U.S. corporations. Fourth, under Treasury regulations described above, if an amount received in a stock redemption is treated as a dividend, basis shifts to shares not redeemed.

The following is an example of a transaction in which taxpayers have taken the position that basis in stock shifts from a shareholder that has its stock redeemed to a nonredeemed shareholder. A foreign corporation is wholly owned by two shareholders. One shareholder is a U.S. person, and the other is a foreign corporation. The foreign corporate shareholder also owns an option to acquire the stock owned by the U.S. person. The foreign shareholder has all its stock redeemed, but, because of the option rule, the redemption is treated as a dividend. Because the redeemed shareholder and the redeeming corporation are foreign, the redeemed shareholder is not subject to U.S. taxation on the dividend distribution. The U.S. shareholder takes the position that under Treasury regulations[346] its basis in its stock is increased by the basis of the stock redeemed from the other shareholder. The U.S. shareholder subsequently sells its stock

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[345] Deficit Reduction Act of 1984, S. Prt. 98-169, Vol. 1, at 172 (April 2, 1984).

[346] Treas. Reg. sec. 1.302-2(c).

and claims a loss. In 2001 the IRS issued a notice that this basis-shifting transaction was a listed transaction.[347] The Treasury Department issued proposed regulations that would make the tax treatment of this transaction less favorable by suspending the loss in certain circumstances.[348]

Reasons for Change

The existing extraordinary dividend rules require basis reduction if a dividend payment is not taxed in full because of the dividends received deduction. This basis reduction is intended to prevent the taxation of the dividend at a low rate with a corresponding capital loss allowable at a higher rate. However, these rules do not apply if a dividend payment is partly or entirely exempt from U.S. taxation for reasons other than the dividends received deduction. Consequently, in certain redemptions that are treated as dividends but are not subject to full U.S. taxation, tax basis is preserved and may be shifted to a shareholder whose stock is not redeemed. This shifting of basis may be from a tax-indifferent shareholder -- a foreign person or tax-exempt organization -- to a taxable shareholder. If the shift is to a taxable shareholder, that shareholder can use the additional basis to generate a tax loss on a subsequent disposition of the stock to which the basis has been shifted. Thus, the combination of failing to reduce basis by the nontaxed portion of an extraordinary dividend and the shifting of tax basis to a taxable person creates a taxable loss without corresponding taxable income. This result is contrary to the purpose of the extraordinary dividend rules.

Description of Proposal

The proposal provides that for purposes of the extraordinary dividend rules, the nontaxed portion of a dividend includes the amount of a dividend received by a shareholder to the extent the shareholder is not subject to current U.S. taxation. Shareholders not subject to current U.S. taxation (for example, foreign persons or tax-exempt organizations such as section 501(c) nonprofit organizations) generally are required to reduce their basis in stock of a corporation upon receiving an extraordinary dividend from that corporation to the extent the dividend is not subject to current U.S. taxation. The holding period rules governing this basis reduction are the same as under present law: In general, basis reduction is required if the shareholder has not owned the stock on which an extraordinary dividend is paid for more than two years before the dividend announcement date, but this holding period requirement does not apply to redemptions treated as extraordinary dividends without regard to holding period.

If a treaty between the United States and a foreign country reduces (but does not fully exempt) U.S. tax imposed on a dividend (and the dividend is not otherwise subject to U.S. tax), the proposal provides that the nontaxed portion of a dividend is determined based on the amount of the dividend multiplied by a fraction, the numerator of which is the tax rate applicable without reference to the treaty less the tax rate applicable under the treaty, and the denominator of which is the tax rate applicable without reference to the treaty. For example, if a foreign person with a stock basis in a U.S. corporation of $100 receives an extraordinary dividend of $100 that is

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[347] IRS Notice 2001-45, 2001-2 C.B. 129.

[348] Prop. Treas. Reg. sec. 1.302-5.

subject to a 15-percent reduced withholding rate under a tax treaty, the foreign person is required to reduce its stock basis by 50 percent of the dividend (the 15-percent reduction from the 30-percent withholding tax, divided by 30 percent), or $50.

For these purposes the nontaxed portion of a dividend does not include dividends that are currently subject to U.S. tax, such as dividends that are subject to the full 30-percent U.S. withholding tax or to the unrelated business income tax, or the portion of dividends received by a controlled foreign corporation or passive foreign investment company that are currently included in a U.S. shareholder's taxable income. Thus, those dividends generally do not cause a reduction in stock basis in a corporation.

Effective Date

The proposal is effective for distributions on or after the date of enactment.

Discussion

The proposal is based on two related principles. First, the theory of the extraordinary dividend rules supports a revision of those rules. Second, because the existing extraordinary dividend rules permit excess basis to remain in stock after certain dividend payments, those rules allow improper basis shifting. Each of these principles is discussed below.

The basis reduction for extraordinary dividends under the proposal is consistent with the theory of section 1059. If a dividend payment on a share of stock is likely to result in the distribution of earnings and profits not attributable to the earnings that accrued on that share while it was held by the shareholder, the payment represents a return of the shareholder's investment in the stock. Similarly, a non-pro-rata redemption treated as a dividend or a redemption treated as a dividend because of the option rule likely results, in part, in the return of a shareholder's investment rather than in the distribution of earnings attributable to the redeemed stock. As a result, in the absence of a rule mandating basis reduction, basis in the shares on which a dividend is paid, and basis that is shifted to non-redeemed shares in a redemption, is likely to be too high. This is equally true whether the dividend is not fully subject to tax by reason of the dividends received deduction or a taxpayer's exemption from tax.

Gaps in the existing extraordinary dividend rules lead to improper basis shifting from one shareholder to another. The basis shifting is improper for two related reasons. First, the basis that is shifted is basis that should have been eliminated under the policy of the extraordinary dividend rules described above. Second, because certain redemption transactions in which basis shifts result (but for the operation of the option rule) in the termination of a redeemed shareholder's interest in the redeeming corporation, arguably the redemption should not be accorded dividend treatment and the redeemed shareholder's basis in its stock should not be permitted to shift under Treasury regulations. In fact, in Notice 2001-45 the IRS announced its intention to attack basis-shifting transactions by (1) treating the redemption as a sale rather than a

dividend distribution under the prearranged plan principles of *Zenz v. Quinlavan*[349] or (2) disallowing as not "proper" any basis shift under the existing Treasury regulations.[350]

It might be argued that mandatory basis reduction for extraordinary dividends received by shareholders not subject to current U.S. taxation will inappropriately affect legitimate business transactions. In this view the general principle of basis preservation should not be violated absent evidence that a particular transaction is abusive. One response to this argument is discussed above: if a dividend is untaxed or partially taxed and does not represent a distribution of earnings attributable to the stock on which the dividend is paid, the theory of the extraordinary dividend rules supports departure from the general principle of basis preservation. In addition, for a shareholder not subject to U.S. taxation, basis preservation for U.S. tax purposes generally is unnecessary and therefore should yield to the goal of preventing the use of that basis to create allowable losses for U.S. taxpayers.

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[349] 213 F.2d 914 (6th Cir. 1954).

[350] The American Bar Association Section of Taxation's Committee on Corporate Tax suggested the same attacks but recommended the withdrawal, for policy and administrability reasons, of the specific approach proposed in Prop. Treas. Reg. sec. 1.302-5. Richard A. Shaw, Comments Concerning Proposed Regulations Providing Guidance Regarding the Treatment of Unutilized Basis of Stock Redeemed in Certain Transactions (August 2003).

C. Modify Active Business and Control Requirements for Section 355 Corporate Divisions (sec. 355)

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 the corporation had sold such property for its fair market value. In addition, the shareholders receiving the distributed property are ordinarily treated as receiving a dividend of the value of the distribution (to the extent of the distributing corporation's earnings and profits), or capital gain in the case of a stock buyback that significantly reduces the shareholder's interest in the parent corporation.

An exception to these rules applies if the distribution of the stock of a controlled corporation satisfies the requirements of section 355 of the Code. If all the requirements are satisfied, there is no tax to the distributing corporation or to the shareholders on the distribution.

One requirement to qualify for tax-free treatment under section 355 is that 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 (the "active business test").[351] 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 its assets consist of stock and securities of one or more corporations that it controls that are engaged in the active conduct of a trade or business.[352]

In determining whether a corporation is directly engaged in an active trade or business that satisfies the requirement, old IRS guidelines for advance ruling purposes required that the value of the gross assets of the trade or business being relied on must ordinarily constitute at least five percent of the total fair market value of the gross assets of the corporation directly conducting the trade or business.[353] More recently, the IRS has suspended this specific rule in connection with its general administrative practice of moving IRS resources away from advance rulings on factual aspects of section 355 transactions in general.[354]

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[351] Sec. 355(b).

[352] Sec. 355(b)(2)(A). The IRS takes the position that the statutory 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. Rev. Proc. 96-30, sec. 4.03(5), 1996-1 C.B. 696; Rev. Proc. 77-37, sec. 3.04, 1977-2 C.B. 568.

[353] Rev. Proc. 2003-3, sec. 4.01(30), 2003-1 I.R.B. 113.

[354] Rev. Proc. 2003-48, 2003-29 I.R.B. 86.

Another requirement for tax-free treatment under section 355 is that the distributed subsidiary must, immediately prior to the distribution, be under the "control" of the parent, as defined in section 368(c).[355] That section defines "control" as ownership of stock possessing at least 80 percent of the total combined voting power of all classes of stock entitled to vote and at least 80 percent of the total number of shares of all other classes of stock of the corporation. This section 355 definition of "control" is the definition generally used for purposes of the tax provisions that deal with corporate reorganizations and certain other restructurings.

This "control" definition differs from the definition that governs for purposes of determining whether corporations are sufficiently related that they are eligible to file a consolidated return. That definition, contained in section 1504(a)(1)(B), requires ownership of stock possessing at least 80 percent of the vote and 80 percent of the value of the subsidiary. Nonvoting preferred stock that does not participate in corporate growth to any significant extent is not counted as stock for this purpose.[356]

Reasons for Change

The original purpose of section 355 was to permit the tax free separation of a single enterprise involving different active businesses, which separation is in the nature of a rearrangement of existing business among existing shareholders. Section 355 should be confined more closely to this purpose by limiting its use in the case of transactions that more closely resemble "sales" of a business due to the presence of large amounts of cash or the lack of continuing participating equity ownership by the same shareholders.

Description of Proposal

To satisfy the active business test of section 355, the proposal requires at least 50 percent of the gross assets of each of the parent corporation and the distributed subsidiary to have been used in the active conduct of one or more trades or businesses.

For this purpose, the active business test is applied by reference to the relevant affiliated group rather than on a single corporation basis. For the parent distributing corporation, the relevant affiliated group consists 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 otherwise includible corporations under section 1504(b)),[357] immediately after the distribution. The relevant affiliated

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[355] Secs. 355(a)(1)(A) and 368(c).

[356] Such nonvoting preferred stock is considered economically more similar to debt for purposes of considering whether the parent controls the subsidiary for consolidated return purposes.

[357] Foreign corporations, insurance companies, and certain other types of corporations are not eligible to file consolidated tax returns with other corporations. However, these exceptions would not apply under the proposal for section 355 purposes, if the relevant stock ownership requirement is met.

group for a controlled distributed subsidiary corporation is determined in a similar manner (with the controlled corporation as the common parent).[358]

In addition, the same control test used for this new active business test is used to determine whether a distributed corporation was controlled by the parent immediately prior to a corporate division. Thus, the parent corporation is required to own stock possessing at least 80 percent of the voting power and 80 percent of the value of a controlled corporation (excluding certain nonvoting preferred stock that does not participate significantly in corporate growth) in order for the controlled corporation to be treated as a corporation eligible for a tax free corporate division, or as a corporation whose active business assets are counted in determining whether sufficient active business assets are retained in each of the parent and the subsidiary distributed group.

Effective Date

The proposal is effective for distributions on or after the date of enactment.

Discussion

The purpose of section 355 is to permit existing shareholders to separate existing businesses for good business purposes without immediate tax consequences. Absent section 355, a corporate distribution of property (including stock of a subsidiary) to shareholders would be a taxable event both to the distributing corporation and to the shareholders. A number of problems with section 355 have emerged.

Present law has arguably permitted the use of section 355 to separate out a relatively small business together with a very large proportion of cash. Recent press reports have referred to these transactions as "cash-rich" tax-free corporate divisions.[359] For example, the addition of

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[358] A similar proposal addressing the group to which the present law active business test is applied was contained in the Joint Tax Committee Staff Simplification recommendations 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, Vol. II at 251-252 and in section 304 of the Senate amendment to H.R. 4520 (but was not adopted in the final version of that legislation). See H.R. Rep. 108-755, 108th Cong. (2004) at 361-362.

[359] In one of the reported recent transactions, the Clorox Company distributed $2.1 billion cash and a business worth $740 million to a U.S. subsidiary of the German company Henkel KGaA in redemption of that subsidiary's 29 percent interest in Clorox. Other reported transactions were undertaken by Janus Capital Group and DST Systems, Inc. (with cash representing 89 percent of the value of the distributed corporation); Houston Exploration Company and KeySpan Corp. (87 percent cash); and Liberty Media Corporation and Comcast Corporation (53 percent cash). See, e.g., Allan Sloan, "Leading the Way in Loophole Efficiency," *Washington Post,* (October 26, 2004), at E.3; Robert S. Bernstein, "Janus Capital Group's Cash Rich Split-Off," *Corporate Taxation*, (November-December 2003) at 39; Robert S. Bernstein, "KeySpan Corp.'s Cash-Rich Split Off," Corporate Taxation, (September-October

a relatively small business to an otherwise cash stock redemption transaction can convert an essentially cash stock buyback, which would have been taxed to the recipient shareholder, into a tax-free transaction for the recipient shareholder. Increasing the active business asset requirement to a level such as 50 percent could provide some limit to the proportion of cash that can be distributed in such transactions.

Present law requires the active business test generally to be applied at the level of the particular single corporation that is the distributing parent or the distributed subsidiary, without general regard to the level of active business assets in any subsidiary corporations of such top tier corporations. Application of the rule only at that level may in part have contributed to the administrative approach of requiring only a relatively small amount of active business assets.

At the same time, present law differentiates between a holding company structure (where "substantially all" the holding company assets must be stock or securities of corporations engaged in the active conduct of a trade or business) and a structure in which the parent corporation itself conducts an active business (even though only five percent of the corporate assets might be devoted to that business). For example, a parent holding company that owned five subsidiaries of equal value might fail the active business test if four of its five subsidiaries conducted an active business and 100 percent of the value of each of those subsidiaries consisted of active business assets, but the fifth subsidiary held only investment assets.[360] If all of these enterprises had existed within a single corporate shall, the old five percent active business asset test would easily have been satisfied. These rules produce unnecessary complexity and resulting inefficiency. Tax planning is often required to reposition active business assets prior to a section 355 transaction, to satisfy the active business test (for example, by liquidating a small active business into the parent corporation of what had been a holding company chain). Allowing the active business test to be applied with reference to an entire chain of controlled corporations can alleviate this complexity and can also make it easier to satisfy the proposed new 50-percent standard for active business.

2004) at 38. Robert Willens, "Split Ends," *Daily Deal*, (August 31, 2004); and Richard Morgan, "Comcast Exits Liberty Media," *Daily Deal,* (July 22, 2004). See also, The Clorox Company Form 8-K SEC File No. 001-07151), (October 8, 2004); Janus Capital Group, Inc. Form 8-K (SEC File No. 001-15253) (August 26, 2003); The Houston Exploration Company Form 8-K (SEC File No. 001-11899) (June 4, 2004); Key Span Corp. Form 8-K (SEC File No. 001-14161 (June 2, 2004); and Liberty Media Corporation Form 8-K, (SEC File No. 001-16615) (July 21, 2004).

[360] In this case, only 80 percent of the holding company's assets would consist of stock of corporations engaged in an active trade or business. The IRS ruling guidelines have required a 90 percent threshold to satisfy the special holding company rule that "substantially all" of the holding company's assets be stock of companies engaged in an active trade or business.

Using a control test for section 355 purposes that requires 80 percent ownership of both the vote and the growth equity value of a subsidiary also advances the purpose of treating controlled entities as one in this context.[361]

Present law can permit a large percentage of participating growth equity to be held outside the group. For example, a parent corporation that owns 80 percent of both the vote and value of a subsidiary corporation may cause that subsidiary to issue an amount of stock to outsiders so long as the outsiders do not obtain 50 percent or more of the value[362] of the subsidiary, while leaving 80 percent of the voting power with the parent corporation. The parent can extract this cash from the subsidiary prior to the section 355 spin-off. Although more than 20 percent in value of new stock can similarly be issued under the proposal, such stock would have to be nonvoting preferred stock that does not participate to any significant extent in corporate growth – a type of stock that the consolidated return control rules view as similar to debt.

The 50-percent active business aspect of the proposal could be criticized as not going far enough, since at least 50 percent of assets can still be mere investment assets or cash. Consideration could be given to raising the threshold higher, for example, to an 80-percent active business asset requirement. 80 percent is the present law requirement for favorable tax treatment of investments in certain small business corporations.[363]

Any significant absolute cut-off test might prove inflexible in accommodating situations where corporations legitimately need to equalize values to shareholders in a division of business assets. However, if cash in excess of 50 percent of the assets transferred is necessary to equalize values, the question arises whether such an amount of cash should be allowed to be transferred tax-free. A corporation could distribute the excess cash prior to the division if necessary, keeping the basic business division tax-free but causing a taxable event to shareholders who are being economically cashed out in part in connection with the business division.

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[361] The Treasury Department in the past has proposed that such an 80 percent of vote and value test be used for all tax-free reorganization provisions of the Code. See, *General Explanations of the Administration's Fiscal Year 2001 Revenue Proposals*, Department of the Treasury, at 148 (February 2000). That proposal was not adopted. Use of such a test does require greater testing of the relative values of different classes of stock than does present law, in order to determine whether 80 percent of the total value of shares (in addition to 80 percent of the vote) has been acquired. While the new test might arguably prove somewhat complex in the case of an acquisitive transaction, it could be less difficult to apply in the case of a distribution from a preexisting control situation where the parent has already owned the required 80 percent of vote and value. Using such a test in section 355 for all purposes (rather than merely for the active business test) would provide consistency within that provision as revised.

[362] A separate provision of section 355 would tax the parent in an otherwise tax-free distribution of a subsidiary as if it had sold the distributed subsidiary, if 50 percent or more of the value (or vote) of the subsidiary is acquired by new shareholders as part of a plan related to the spin off. Sec. 355(e).

[363] Secs. 1202(c)(2), 1202(e)(1)(A), and 1045(b).

It is arguable that corporate business purposes might require large amounts of cash or other investment assets to prepare for upcoming business needs. However, if half the entire value of the entity can be cash or other investment assets, this would appear to be a significant leeway for such events.

Finally, although the distributed cash does remain in corporate solution, it may be very accessible to the shareholder even without a further distribution. The divisive transaction has occurred that has changed the shareholder's investment by separating the cash from the assets in which it had previously invested. Such a transaction may allow the shareholder indirectly to obtain the value of the cash in the separated corporation, by borrowing against stock that carries little business risk in comparison to its investment assets.

D. Modify Application of Unrelated Business Income Tax to S Corporation Shareholders (sec. 512)

Present Law

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. The shareholders take into account separately their shares of these items on their individual income tax returns.

A small business corporation may elect to be an S corporation with the consent of all its shareholders, and may terminate its election with the consent of shareholders holding more than 50 percent of the stock. A "small business corporation" generally is defined as a domestic corporation which has (1) no more than 100 shareholders, all of whom are U. S. individuals, certain types of trusts, estates, charitable organizations, qualified retirement plans, and IRAs holding certain bank stock, and (2) only one class of stock.

If a qualified tax-exempt entity (other than an employee stock ownership plan) holds stock in an S corporation, the interest held is treated as an interest in an unrelated trade or business, and the entity's share of the S corporation's items of income, loss, or deduction, and gain or loss on the disposition of the S corporation stock, are taken into account in computing unrelated business taxable income.[364]

Reasons for Change

The S corporation rules were designed to require that all income of the corporation be subject to tax at the shareholder level. This purpose should be carried out by making sure that all S corporation shareholders, including tax-exempt entities, must pay tax on their share of income from the S corporation.

Description of Proposal

Under the proposal, a tax-exempt entity (other than an employee ownership plan)[365] is a permissible shareholder of an S corporation only if it is subject to tax on its share of S corporation income. Thus, for example, an organization whose income would otherwise be tax-exempt under section 115 (relating to income derived from essential government function) must pay the unrelated business income tax on its share of S corporation income or not qualify as a permissible shareholder of the S corporation.

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[364] Sec. 512(e). However, the income of certain municipal qualified retirement plans may be exempt from tax as income derived from the exercise of an essential government function (sec. 115).

[365] The proposal does not apply to employee stock ownership plans as Congress has enacted special rules in this area.

Also, the unrelated business taxable income of a tax-exempt entity holding S corporation stock will not be less than the amount of such income taking into account only the S corporation items. In other words, losses from non-S corporation sources cannot offset income from S corporations.[366]

Effective Date

The proposal applies to taxable years beginning after date of enactment.

Discussion

In 1996, when Congress allowed certain tax-exempt entities to be shareholders in an S corporation, Congress stated "the provisions of subchapter S were enacted in 1958, and substantially modified in 1982 on the premise that all income of the S corporation would be subject to a shareholder-level tax. The underlying premise allows the rules governing S corporations to be relatively simple (in contrast, for example, to the partnership rules of subchapter K) because of the lack of concern about "transferring" income to non-taxpaying persons. Consistent with this underlying premise of subchapter S, the proposal treats all income flowing through to a tax-exempt shareholder, and gains and loss from the disposition of the stock, as unrelated business taxable income."[367]

Notwithstanding the intent of the 1996 legislation to treat all S corporation income allocated to a tax-exempt entity as unrelated business taxable income, there nevertheless may be certain income that is not subject to tax. The IRS has listed as a tax avoidance transaction, the use of certain tax-exempt entities, claiming that their allocated taxable income from an S corporation is not subject to the tax on unrelated business income, to shift income to the tax-exempt entity.[368] The proposal solidifies the intent of Congress that all income of the S corporation be subject to tax.

Since losses of tax-exempt organizations may be created by misallocation of deductions between exempt and non-exempt income of the entity, the limitation on the use of losses of tax-exempt entities to offset S corporation income is proposed.

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[366] Proper adjustments to net operating loss carryovers will be made to the extent losses are not allowed to offset S corporation income.

[367] Small Business Job Protection Act of 1996, S. Rpt. No. 104-281, at 61 (June 18, 1996).

[368] Notice 2004-30, 2004-17 I. R. B. 828 (April 1, 2004).

E. Modify Safe Harbor for Allocation of Nonrecourse Deductions and Exclude Nonrecourse Liabilities From Outside Basis (secs. 704 and 752)

Present Law

In general, the income, gain, loss, deduction, or credit of a partnership must be allocated among the partners in accordance with the partnership agreement.[369] If, however, the allocation in the partnership agreement does not have substantial economic effect (or there is no partnership agreement), then a partner's distributive share of income, gain, loss, deduction, or credit must be determined in accordance with the partner's interest in the partnership.[370]

An allocation has substantial economic effect if the allocation has (1) economic effect that is (2) substantial.[371] In order for an allocation to have economic effect, generally the partnership must properly maintain capital accounts, liquidate in accordance with positive capital accounts, and a partner with a deficit capital account on liquidation must be unconditionally obligated to restore the deficit.[372] An alternative test for economic effect is provided if a partner is not unconditionally obligated to restore a deficit capital account on liquidation.[373] Under the alternative test, an allocation may not create a deficit capital account or increase a deficit beyond what the partner has agreed to restore. An allocation is substantial if there is a reasonable possibility that the allocation will affect substantially the dollar amounts to be received by the partners from the partnership, independent of tax consequences.[374]

The term "partner's interest in the partnership" refers to the manner in which the partners have agreed to share the economic benefit or burden corresponding to the income, gain, loss, deduction, or credit that is allocated.[375] It is determined by taking into account all facts and circumstances relating to the economic arrangement of the partners including: (1) the partners' relative contributions to the partnership; (2) interests of the partners in economic profits and losses (if different from their interests in taxable income or loss); (3) interests of the partners in cash flow and other nonliquidating distributions; and (4) partners' rights to distributions of

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[369] Sec. 704(a).

[370] Sec. 704(b).

[371] Treas. Reg. sec. 1.704-1(b)(2)(i).

[372] Treas. Reg. sec. 1.704-1(b)(2)(ii)(b).

[373] Treas. Reg. sec. 1.704-1(b)(2)(ii)(d).

[374] Treas. Reg. sec. 1.704-1(b)(2)(iii).

[375] Treas. Reg. sec. 1.704-1(b)(3).

capital upon liquidation. A rebuttable presumption provides that all partners' interests are presumed to be equal (determined on a per capita basis).[376]

A partnership may incur a liability (referred to as a "nonrecourse liability") for which no partner (or related person) bears the economic risk of loss. Partnership property may or may not secure the liability. For example, a partnership may purchase a building using nonrecourse financing for which the building secures the debt, or an entity such as a limited liability company ("LLC")[377] may simply borrow money in which no property secures the borrowing and the members of the LLC have limited liability under State law. Allocations of deductions attributable to partnership nonrecourse liabilities (referred to as "nonrecourse deductions") cannot have economic effect because the lender, rather than the partners, bears the economic cost attributable to the deductions.[378] In addition, allocations of the gain (referred to as "partnership minimum gain") that would be realized if the property securing the debt were disposed of for no consideration other than full satisfaction of the liability cannot have economic effect because these allocations do not reflect any economic gain but merely constitute a recapture of the nonrecourse deductions. As a result, Treasury regulations require that nonrecourse deductions be allocated in accordance with the partners' interests in the partnership and partnership minimum gain be allocated to the partners that were allocated the nonrecourse deductions. The amount of nonrecourse deductions for a partnership taxable year generally equals the net increase in partnership minimum gain during the year.[379] The amount of partnership minimum gain is determined by first computing for each partnership nonrecourse liability any gain the partnership would realize if it disposed of the property subject to that liability for no consideration other than full satisfaction of the liability, and then aggregating the separately computed gains.[380]

The regulations contain a four-prong safe harbor that, if satisfied, deems allocations of nonrecourse deductions to be in accordance with the partners' interests in the partnership.[381] In order to meet the safe harbor, the following four requirements must be met: (1) the primary or alternate test for economic effect must be met throughout the full term of the partnership; (2) nonrecourse deductions must be allocated in a manner that is reasonably consistent with allocations that have substantial economic effect of some other significant partnership item attributable to the property securing the nonrecourse liabilities; (3) the partnership agreement contains a minimum gain chargeback provision (i.e., if there is a net decrease in partnership minimum gain, each partner must be allocated income and gain equal to its share of the net decrease in partnership minimum gain): and (4) all other material allocations and capital account adjustments under the partnership agreement are recognized under section 704(b).

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[376] Treas. Reg. sec. 1.704-1(b)(3).

[377] Limited liability companies are generally taxed as partnerships.

[378] Treas. Reg. sec. 1.704-2(b)(1).

[379] Treas. Reg. sec. 1.704-2(c).

[380] Treas. Reg. sec. 1.704-2(d).

[381] Treas. Reg. sec. 1.704-2(e).

In the preamble to the regulations, the Treasury acknowledged that a partnership may have a liability that is not secured by any property, is recourse to the partnership as an entity, and with respect to which no partner bears the economic risk of loss (i.e., an exculpatory liability).[382] As noted, an exculpatory liability is treated as a nonrecourse liability. The calculation of partnership minimum gain is difficult in the case of an exculpatory liability because the liability is not secured by specific property and the adjusted bases of partnership property may fluctuate. As a result, the Treasury has not prescribed precise rules for exculpatory liabilities and states that taxpayers should treat allocations attributable to exculpatory liabilities in a manner that reflects the principles of section 704(b).

A partner's basis in a partnership interest (the "outside basis"), is treated as including the partner's share of the partnership's liabilities.[383] Outside basis includes the partner's share of recourse liabilities as well as nonrecourse liabilities. A partner's share of a partnership recourse liability is the portion of that liability, if any, for which the partner or a related person bears the economic risk of loss.[384] A partner's share of the nonrecourse liabilities of a partnership includes that partner's share of partnership minimum gain.[385] To the extent that partnership nonrecourse liabilities exceed partnership minimum gain, the excess is allocated among the partners in accordance with the partner's share of partnership profits, taking into account all facts and circumstances relating to the economic relationship of the partners.[386]

Reasons for Change

Present law with respect to the allocation of nonrecourse deductions is ineffective in requiring taxpayers to allocate nonrecourse deductions in a manner consistent with their overall economic arrangement. This issue has become more serious as a result of the dramatic increase in the use of LLCs which has occurred since the nonrecourse deduction rules were originally promulgated. Partners have significant flexibility to allocate nonrecourse deductions in a tax-motivated manner which is inconsistent with their overall economic arrangement. Because the allocation of nonrecourse deductions is generally free of any non-tax economic consequences, partnerships may use such allocations to shift taxable income from one partner to another in a manner which reduces the tax liability of the partners in the aggregate. Further restrictions on the allocation and utilization of nonrecourse deductions are necessary to curtail certain forms of tax-motivated allocations.

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[382] T.D. 8385, 1992-1 C.B. 199, 203.

[383] Sec. 752.

[384] Treas. Reg. sec. 1.752-2(a).

[385] Treas. Reg. sec. 1.752-3(a). For this purpose, the partnership generally must take into account any allocations which would be required under section 704(c) if the partnership minimum gain were recognized.

[386] Treas. Reg. sec. 1.752-3(a)(3).

Description of Proposal

In general

Under the proposal, the present-law rules for nonrecourse deductions are generally maintained; however, the second prong of the present-law safe harbor (requiring allocations to be reasonably consistent with the allocation of some other significant item) is modified to provide certainty to partnerships and partners while also reducing the potential for abuses that may be available under the current safe harbor. In addition, the proposal recognizes that some nonrecourse liabilities may not be secured by any partnership property (e.g., exculpatory liabilities). As a result, the new safe harbor, unlike the present-law four-prong safe harbor, is applicable to nonrecourse deductions attributable to nonrecourse liabilities that are secured by partnership property as well as those that are unsecured. In addition, the proposal provides that nonrecourse liabilities of a partnership are excluded from a partner's outside basis.

Under the proposal, nonrecourse deductions must still, as a general rule, be allocated in accordance with the partners' interests in the partnership. Nonrecourse deductions are defined as under present law to include items of loss, deduction, or section 705(a)(2)(B) expenditures[387] attributable to nonrecourse liabilities of the partnership. A nonrecourse liability refers to a partnership liability for which no partner (or related person) bears the economic risk of loss. As a result, under the proposal, nonrecourse deductions may arise from exculpatory liabilities, which may be common in entities such as limited liability companies, and may also arise in the more traditional sense from nonrecourse liabilities that are secured by partnership property (e.g., nonrecourse liability secured by a building owned by the partnership).

Modification of safe harbor

Under the proposal, the first, third, and fourth prongs of the current regulatory safe harbor for allocations of nonrecourse deductions are retained. The second prong, however, is modified. As under current law, partnerships must satisfy all four prongs in order to be able to rely on the safe harbor.

Under the new second prong, if the aggregate capital account balances and recourse liabilities of the partnership constitute at least 20 percent of the total capitalization of the partnership at the time the nonrecourse liability arises (using book values), then the partners may allocate nonrecourse deductions in accordance with the relative capital account balances of the partners. Alternatively, if there is a reasonable expectation of significant residual (or catch-all) profits, then the partners may allocate the nonrecourse deductions in accordance with the residual profit sharing arrangement of the partners. In addition, any allocation arrangement which falls between relative capital account percentages and residual profit sharing percentages is acceptable if the required minimum capitalization and residual profit sharing expectation are both met.

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[387] Section 705(a)(2)(B) generally requires that the adjusted basis of a partner's interest in a partnership be reduced by permanently nondeductible expenses.

Nonrecourse liabilities excluded from outside basis

In addition to the safe harbor modification, the proposal provides that nonrecourse liabilities of the partnership are excluded from a partner's outside basis. As a result, a partner's outside basis would only be increased by contributions of money or property, distributive shares of income, gain, and tax-exempt income, and a portion of any recourse liability of the partnership.

Effective Date

The modified safe harbor proposal is effective for partnership taxable years beginning after the date of enactment. The proposal to exclude nonrecourse liabilities from outside basis is effective for nonrecourse liabilities incurred after date of enactment.

Discussion

In general

The four-part safe harbor in the regulations does not adequately restrict allocations of nonrecourse deductions to arrangements that are consistent with the partners' overall economic arrangement (i.e., partners' interests in the partnership). In particular, the requirement that the allocation of nonrecourse deductions be reasonably consistent with some significant item attributable to the partnership property that secures the liability has not been effective in restricting allocations to the partners' overall economic arrangement. Some partnerships have provided for a special allocation of a significant partnership item to support the allocation of the nonrecourse deduction. In addition, requiring the allocation of nonrecourse deductions to merely be reasonably consistent (as opposed to identical) with some significant item has led some partnerships to believe that a fairly wide range is permissible.

The regulations do not specifically address deductions attributable to exculpatory liabilities. With the increasing popularity of LLCs coupled with the greater limited liability protection given to all types of partners in both general and limited partnerships, there is an increasing need to provide clear guidance for the tax treatment of deductions attributable to exculpatory liabilities. The proposal retains the general guidance that deductions attributable to exculpatory liabilities need to be allocated in accordance with the partners' interests in the partnership. But the proposal also provides a new safe harbor that, if satisfied, deems allocations to be in accordance with the partners' interest in the partnership.

Modified safe harbor

Under the proposal, the modified safe harbor may be satisfied if the allocations are made in accordance with relative capital account balances at the time the nonrecourse liability arises. However, the relative capital account method may only be used if the capital accounts and recourse liabilities are at least 20 percent of the total capitalization of the partnership. For example, assume A contributes $5,000 and B contributes $15,000 to partnership AB, which purchases an office building (its only asset) for $100,000. The balance of the purchase price ($80,000) is financed through nonrecourse debt. The aggregate capital accounts represent 20 percent of the total capitalization of the partnership. As a result, the partnership may allocate the

nonrecourse deductions 25 percent to A and 75 percent to B and meet the safe harbor. Alternatively, if partnership AB expects to have significant residual profits at the time the nonrecourse liability arises, then it may allocate the nonrecourse deductions in accordance with the partners' residual profit sharing ratio. Assume the residual profit sharing ratio is 50 percent to A and 50 percent to B. Under the safe harbor, partnership AB may allocate the nonrecourse deductions in a 50/50 sharing ratio. If both the 20 percent capitalization rule and the residual profits expectation rule are met, partnership AB may allocate the nonrecourse deductions in any ratio between 50/50 and 25/75. Assuming the other prongs of the safe harbor are also met, the allocation will be deemed to be in accordance with the partners' interest in the partnership.

Partnerships whose capital accounts and recourse liabilities do not constitute at least 20 percent of the total capitalization and that do not reasonably expect to have significant residual profits are not eligible for the safe harbor. It is appropriate to deny a safe harbor in such cases because partnerships whose partners have proportionately less at risk are more likely to be used in tax motivated transactions. Under the general rule of the proposal, their allocations of nonrecourse deductions must be consistent with the partners' interests in the partnership, and it is anticipated that such partnerships will allocate nonrecourse deductions consistent with the most likely allocation of marginal profits (i.e., the last dollar of reasonably expected profits) unless such allocation is not reflective of the partners' interests in the partnership.

Nonrecourse liabilities excluded from outside basis

While the proposed modification to the safe harbor should be more effective than present law in requiring partners to allocate nonrecourse deductions in a manner consistent with their overall economic arrangement, it will not prevent all potential abuses. Thus, the exclusion of nonrecourse liabilities from partners' outside basis functions as a backstop which should prevent the most serious abuses, in which a partner with no economic risk at all is allocated nonrecourse deductions. Because a partner may not deduct allocated losses in excess of its outside basis, the proposal assures that partners benefit from the allocation of nonrecourse deductions only to the extent that they bear economic risk with respect to capital contributions, recourse liabilities, or undistributed partnership income. As under present law, any nonrecourse deductions allocated to a partner with insufficient outside basis are suspended and become deductible only when the partner's outside basis is increased to a sufficient amount.

In addition to its role in preventing abuses, this proposal brings the tax treatment of partners closer to the tax treatment of S corporation shareholders. In an S corporation, liabilities of the S corporation to persons other than the S corporation shareholders usually have no effect on the shareholders' adjusted bases for their stock or debt claims against the S corporation.[388] Under the proposal, a similar result is achieved for partners in a partnership with respect to nonrecourse liabilities. A partner is still able to include in its outside basis its share of a recourse liability, defined as a partnership liability for which one or more partners bear the economic risk of loss.[389] A partner's share of a recourse liability equals that portion of the liability for which

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[388] Secs. 1366 and 1367.

[389] Treas. Reg. sec. 1.752-1(a)(1).

that partner bears the economic risk of loss.[390] A liability may be part recourse and part nonrecourse in which case only the recourse portion may be included in a partner's outside basis to the extent the partner bears the economic risk of loss for the liability.

The proposal has the additional benefit of allowing recourse liabilities to be included in a partner's outside basis without regard to whether the recourse liability is treated as such because a partner loaned the money to the partnership or whether a partner guaranteed the partnership liability. In the S corporation context, there has been much confusion and litigation with respect to the distinction between a liability of the S corporation guaranteed by a shareholder and a liability of the S corporation to a shareholder. In the former case, the liability is not included as part of a shareholder's debt claim against the corporation while in the latter case the shareholder includes the liability as part of its debt claim. The advantage of inclusion in debt claim is that the shareholder is able to deduct a greater amount of losses flowing through the S corporation to the shareholder.

Under the proposal, no distinction is made between a liability of the partnership guaranteed by a partner and a liability of the partnership to a partner. To the extent a partner bears the economic risk of loss for the liability, however arising, then the partner includes the recourse liability in its outside basis. As a result, the proposal has some similarity to the rules for S corporations (i.e., no inclusion of nonrecourse liabilities in outside basis) while eliminating a perceived weakness of the S corporation regime (i.e., distinguishing between guaranteed debt and shareholder debt).

The proposal is consistent with the holding of the Supreme Court in *Crane v. Commissioner*[391] while at the same time acknowledging the increasing adoption of the entity theory of partnership law. A partnership that purchases property using nonrecourse financing includes the nonrecourse debt in its basis in the property. The partnership will compute its depreciation deductions using a basis that includes the nonrecourse debt. The partners are, however, treated as separate from the partnership for purposes of the nonrecourse liability, which represents economic reality. The nonrecourse creditor's remedy in the event of partnership default is limited solely to one or more assets of the partnership, and the partners are not personally liable for the liability under State law or under the contractual terms of the debt (or both). The proposal serves to minimize the flexibility partners may have to allocate deductions relating to debt for which no partner bears the economic risk of loss.

Finally, if the outside basis restrictions prove effective in preventing abuses, it may eventually be possible to modify or replace the existing allocation restrictions, resulting in significant simplification benefits for partners and partnerships.

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[390] Treas. Reg. sec. 1.752-2(a).

[391] 331 U.S. 1 (1947).

F. Modify Adjustment Rules for Basis of Undistributed Partnership Property (sec. 734)

Present Law

Present law provides that the basis of partnership property is to be adjusted as the result of a distribution of property if the partnership has so elected under section 754, or if there is a substantial basis reduction with respect to the property distributed (i.e., a basis reduction in excess of $250,000).[392] If adjustments are made, the basis of partnership property is to be increased by any gain recognized to the distributee partner, and also to the extent the distributed property had an adjusted basis to the partnership greater than the basis attributed to the property in the hands of the distributee. The basis of partnership property is decreased by any loss recognized to the distributee partner, and also to the extent the distributed property had an adjusted basis to the partnership that is less than the basis attributed to the property in the hands of the distributee.

Reasons for Change

The measurement of the basis adjustment is inaccurate in some cases under present law. The amount of the adjustment does not consistently keep the amount of unrealized partnership gain or loss unchanged with respect to the remaining partnership interests in a partnership, following a distribution of property when basis adjustments are made to partnership property. The adjustment should reflect the difference between the partnership's adjusted basis in the property distributed, and the reduction in the distributee partner's share of the adjusted basis of partnership property. This would more accurately adjust for basis that is shifted to or away from the partnership (and remaining partners) as a result of the property distribution.

Description of Proposal

The method of making the adjustment to remaining partnership property after a distribution of property, when the adjustments are made under section 734, is changed to reflect the difference between the basis to the partnership of the distributed property and the reduction which occurs in the distributee partner's proportionate share of the adjusted basis of the partnership property.[393]

Effective Date

The proposal applies to distributions made after the date of enactment.

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[392] Sec. 734.

[393] This proposal has been recommended by the Advisory Group on Subchapter K of the Internal Revenue Code of 1954 to the Subcommittee on Internal Revenue Taxation of the House Ways and Means Committee (December 30, 1957); the Section of Taxation of the American Bar Association (Recommendation #1974-11, 27 Tax Lawyer 876 (1974); and Professor William D. Andrews, *Inside Basis Adjustments and Hot Asset Exchanges in Partnership Distributions*, 47 Tax Law Rev. 3 (1991).

Discussion

The rules contained in section 734(b) are intended to permit a partnership to maintain the same adjusted basis for partnership property in the aggregate, as is represented by the aggregate of the adjusted bases of all the partnership interests. However, because this relationship may already have become distorted before the partnership made the election under section 754 (or makes a distribution involving a substantial basis reduction), increasing the basis of partnership property by the amount of gain recognized to the distributee partner or the excess of the basis of the partnership property over the amount of the basis assigned to it in the hands of the distributee may not give the correct result, if upward adjustments are required. Similarly, adjustments for losses or the excess of the basis of a property in the hands of the distributee over the basis to the partnership may not give the correct result, if downward adjustments in the basis of partnership property are required. A more accurate result can be obtained by making an adjustment in the manner recommended by the proposal. Further, the proposal would conform the operation of section 734(b) to that of the similar provision in section 743(b), which provides for an adjustment to the basis of partnership property following the transfer of a partnership interest.

The problem involved can be illustrated by the following examples.

Example 1.–Assume that the assets of the equal partnership ABD had a basis of $9,000 and a fair market value of $15,000. D, who recently purchased his interest in the partnership from C for $5,000 has a $5,000 basis for his partnership interest. A and B each has a basis for his partnership interest of $3,000. Under present law, if a $5,000 cash distribution is made by the partnership to either A or B in liquidation of its partnership interest, the partnership would be entitled to an upward adjustment of $2,000 to the basis of the remaining partnership assets. However, a similar distribution to D would result in no adjustment. Under the proposal, there would be a $2,000 upward adjustment regardless of which partner received the distribution.

Example 2.–Assume that the assets of the equal partnership ABD had a basis of $9,000 and a fair market value of $6,000. D, who recently purchased his interest in the partnership from C for $2,000 has a $2,000 basis for his partnership interest. A and B each has a basis for his partnership interest of $3,000. Under present law, if a $2,000 cash distribution is made by the partnership to either A or B in liquidation of its partnership interest, the partnership would be required to make a downward adjustment of $1,000 to the basis of the remaining partnership assets. However, a similar distribution to D would result in no adjustment. Under the proposal, there would by a $1,000 downward adjustment regardless of which partner received the distribution.

G. Treat Guaranteed Payments to Partners as Payments to Nonpartners (sec. 707)

Present Law

In general

Under present law, a partner's treatment of items of income, gain, loss, deduction, and credit arising in respect of the partnership depends on several factors.

In general, a partner includes on its own Federal income tax return its distributive share of items of partnership income, gain, loss, deduction, or credit. A partner's distributive share of an item is determined under the partnership agreement. The allocations provided in the partnership agreement will be respected if the allocations have substantial economic effect or are in accordance with the economic interests of the partners. Generally, allocations of partnership tax items are treated as having substantial economic effect if the partnership maintains capital accounts for its partners in accordance with regulations, distributions are made in accordance with the capital accounts, and any partners with a deficit balance in its capital account must make a capital contribution upon liquidation of its interest in the partnership.

Generally, under timing rules applicable to partnership items, the items are included in income for the taxable year of the partner in which the partnership's taxable year ends.[394]

Guaranteed payments

If a partner receives a payment that is determined without regard to the income of the partnership, the payment is considered a guaranteed payment rather than a distributive share of partnership income.[395] This provision was adopted in 1954 to clarify the situation in which the amount of the payment exceeded the net income of the partnership and would have resulted in the payment being out of the capital of the partners rather than from partnership income.[396] The

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[394] Sec. 706(a).

[395] Sec. 707(c).

[396] In 1954, House bill section 707(c) provided a rule with respect to "guaranteed salaries" of a partner. The Ways and Means Committee Report stated, "[a] partner who renders services to the partnership for a fixed salary, payable without regard to partnership income, shall be treated to the extent of such amount like any other employee who is not a partner, and the partnership shall be allowed a deduction for salary expense. The amount ... shall not be considered a distributive share of partnership income or gain." H.R. Rep. No. 1337, 83d Cong., 2d Sess., A226-A227. The provision was modified in the Senate to apply to guaranteed payments for capital as well as for services. S. Rep. No. 1622, 83d Cong., 2d Sess. The evolution of this rule as included in the law in 1954 has been described this way: "To summarize, the genesis of section 707(c) was a desire on the part of the House to obviate the complexity caused under prior law when compensatory payments to partners exceed partnership income. As the provision emerged from the Senate, its scope was limited to that necessary to

1954 treatment of guaranteed payments as different from a distributive share of partnership income provided the relatively narrow clarification that such payments are includable in the partner's income (not treated as a return of capital).

The rules for guaranteed payments provide that a partner receiving a guaranteed payment is treated as a third party (rather than as a partner), but only for purposes of income inclusion by the partner (sec. 61) and deduction of the payment by the partnership (sec. 162(a), subject to capitalization requirements of section 263).[397]

The partnership deducts guaranteed payments in determining partnership income. Present law provides a specific rule that matches the timing of inclusion of guaranteed payments and the deduction of such payments by the partnership. The timing rule is that guaranteed payments are included in gross 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.[398]

Payments made to a partner in a nonpartner capacity

A partner who engages in a transaction with a partnership, other than in its capacity as a partner, is treated as if it was not a member of the partnership with respect to the transaction. This rule applies both to performance of services for a partnership by a partner, and transfers (including indirect transfers) of property between the partnership and the partner.[399] Thus, the partnership and the partner are treated in the same manner as if the transaction were between the partnership and a third party.

The partnership is allowed a deduction with respect to a nonpartner payment in accordance with its method of accounting (provided capitalization rules do not apply); the partnership may deduct such a payment to a cash-basis partner no earlier than the day that the amount is includible in the partner's income.[400] The partner includes the payment in income in accordance with its own method of accounting (provided exclusion rules do not apply). For example, a cash method partner generally includes the payment upon receipt; an accrual method partner generally includes the amount when the right to the payment accrues. These timing rules differ from the timing rule for inclusion and deduction of guaranteed payments.

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accomplish this narrow purpose, as redefined by the Senate, and was expanded to include payments for the use of capital." McKee, Nelson & Whitmire, *Federal Taxation of Partnerships and Partners*, 13-40, 3d ed. 2004.

[397] Sec. 707(c).

[398] Sec. 706(a); Treas. Reg. sec. 1.707-1(c).

[399] Sec. 707(a).

[400] Sec. 267(a)(2).

Reasons for Change

The statutory distinction between guaranteed payments and nonpartner payments may have little continuing purpose. Eliminating the distinction between the two sets of rules would conform the income and deduction timing rules applicable to all payments to partners that are not based on partnership net income to the more generally applicable timing rules applicable to other taxpayers, and would eliminate opportunities for manipulation of the tax rules and provide simplification benefits.

Description of Proposal

Under the proposal, all compensation for services or use of capital that is not based on the net income (or an item of net income) of the partnership is treated as arising from a transaction between a partnership and a nonpartner. Under the proposal, the income and deduction timing rule for guaranteed payments is repealed and such payments are subject to the income and deduction timing rules for nonpartner payments. In determining whether an amount is a nonpartner payment, the proposal applies a standard of whether the amount is determined by reference to net income (or an item of net income) of the partnership, in lieu of the present-law standard of whether the partner is acting in its capacity as a partner. Thus, the proposal clarifies the treatment of all payments made to a partner that are not determined by reference to the net income of the partnership.

Effective Date

The proposal applies to taxable years beginning after the date of enactment.

Discussion

The present-law rules relating to guaranteed payments and nonpartner payments give rise to confusion, uncertainty and needless complexity in several respects. The treatment of guaranteed payments as nonpartner payments only for income inclusion and deduction purposes, but not for other tax purposes, has given rise to conflicting regulatory and judicial interpretations. The difference in the timing rules for deduction and income inclusion with respect to the two types of payments is confusing and may create opportunities for manipulation of the tax law. Further, there is uncertainty as to the scope of the application of the nonpartner payment rules of section 707(a) because it may be unclear whether a partner is acting in its capacity as a partner. Both guaranteed payments for capital, and guaranteed payments for services, have counterparts in the section 707(a) rules for nonpartner payments. Several commentators have questioned the continued viability of a concept of guaranteed payments separate from the concept of payments treated as made to a partner in a nonpartner capacity.[401]

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[401] See, e.g., L. Steinberg, "Fun and Games with Guaranteed Payments," 57 *Tax Lawyer* 533 (Winter 2004); S. Banoff, "Guaranteed Payments for the Use of Capital: Schizophrenia in Subchapter K," 70 *Taxes* 820 (1992); P. Postlewaite and D. Cameron, "Twisting Slowly in the Wind: Guaranteed Payments After the Tax Reform Act of 1984," 40 *Tax Lawyer* 649 (1986). Several commentators have advocated an approach like that of the proposal, stating that the "better approach would be to eliminate section 707(c) totally and provide that any payment to a

Eliminating the guaranteed payment rules would eliminate the confusion resulting from third-party status for some purposes and distributive share status for other purposes, as well as the confusion arising from the application of two sets of income and deduction timing rules to payments to partners. Choosing the more generally applicable timing rules applicable to nonpartner payments, rather than the partnership-specific rule for guaranteed payments that is provided under present law, promotes neutrality in the tax law as between comparably situated taxpayers.

The proposal would apply to all payments made to a partner that are not determined by reference to the net income of the partnership, rather than requiring a factual inquiry as to whether a partner is acting in its capacity as a partner with respect to the payment. A net income test would in many circumstances require a simpler factual determination than would the present-law test relating to the partner's capacity as a partner.

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partner, not determined with regard to partnership income, constitutes a section 707(a) payment." P. Postlewaite and J. Pennell, "JCT's Partnership Tax Proposals – 'Houston, We Have a Problem,'" 76 *Tax Notes* 527, 538 (July 28, 1997); and see W. Brannan, "The Subchapter K Reform Act of 1997," 76 *Tax Notes* 121 (April 7, 1997).

VI. INTERNATIONAL PROVISIONS

A. Amend the Employer-Provided Housing Exclusion and Impose a Stacking Rule with Respect to Non-Excludable Income (sec. 911)

Present Law

In general

U.S. citizens generally are subject to U.S. income tax on all their income, whether derived in the United States or elsewhere. A U.S. citizen who earns income in a foreign country also may be taxed on such income by that foreign country. The United States generally cedes the primary right to tax income derived by a U.S. citizen from sources outside the United States to the foreign country where such income is derived. Accordingly, a credit against the U.S. income tax imposed on foreign source income is generally available for foreign taxes paid on that income, to the extent of the U.S. tax otherwise owed on such income. If the foreign income tax rate is lower than the U.S. income tax rate, then the United States generally provides a credit up to the amount of the foreign tax and imposes a residual tax to the extent of the difference.

U.S. citizens living abroad may be eligible to exclude from their income for U.S. tax purposes certain foreign earned income and foreign housing costs, in which case no residual U.S. tax is imposed to the extent of such exclusion, regardless of the foreign tax paid on such income (if any). In order to qualify for these exclusions, an individual must be either: (1) a U.S. citizen who is a bona fide resident of a foreign country for an uninterrupted period that includes an entire taxable year;[402] or (2) a U.S. citizen or resident present overseas for 330 days out of any 12-consecutive-month period. In addition, the individual must have his or her tax home in a foreign country.

Exclusion for compensation

The foreign earned income exclusion generally applies to income earned from sources outside the United States as compensation for personal services rendered by the taxpayer. The maximum exclusion amount for foreign earned income is $80,000 per taxable year for 2005 and thereafter. For taxable years beginning after 2007, the maximum exclusion amount is indexed for inflation.

Exclusion for housing costs

The amount of the employer-provided housing exclusion is equal to the excess of the taxpayer's "housing expenses" over a base housing amount. The term "housing expenses" means the reasonable expenses paid or incurred during the taxable year with respect to the

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[402] Only U.S. citizens may qualify under the bona fide residence test. However, resident aliens of the United States who are citizens of foreign countries that have a treaty with the United States may qualify for section 911 exclusions under the bona fide residence test by application of a nondiscrimination provision.

taxpayer's housing in the foreign country. The term includes expenses attributable to housing, such as utilities and insurance, but does not include interest and taxes, which are separately deductible. If the taxpayer maintains a second household outside the United States for a spouse or dependents who do not reside with the taxpayer because of adverse living conditions, then the housing expenses of the second household are also eligible for exclusion. Under present law, the base housing amount is 16 percent of the annual salary earned by a GS-14, Step 1, U.S. government employee. For 2005, this salary is $76,193 and thus the current base housing amount is $12,190.

In the case of housing costs that are not paid or reimbursed by the taxpayer's employer, the amount that would be excludible is treated instead as a deduction.

Exclusion limitation amounts

The combined foreign earned income exclusion and housing cost exclusion may not exceed the taxpayer's total foreign earned income for the taxable year. The taxpayer's foreign tax credit is reduced by the amount of such credit that is attributable to excluded income.

Reasons for Change

Under present law, an individual working abroad has the potential to exclude significant amounts of housing benefits. The employer-provided housing exclusion is equal to the excess of an individual's housing expenses over a base amount, but substantial amounts above the base may be excluded from income because the exclusion is limited to "reasonable housing expenses," which allows for generous interpretation by the taxpayer. The proposal would establish an objective cap to determine "reasonable housing expenses." The proposal would also tie the employer-provided housing exclusion to the foreign earned income cap to bring the two exclusions into conformity.

Under present law, individuals working abroad can also benefit from being subject to low income tax rates on their non-excludible income. The taxable income of section 911 beneficiaries is subject to rates that ordinarily are applicable to taxpayers with substantially less economic income. The proposal would impose a stacking rule that requires individuals with section 911 benefits to stack their taxable income after their section 911 exclusion amounts, thereby subjecting such individuals to the same rates applicable to individuals living and working in the United States who have the same amount of economic income.

Description of Proposal

Exclusion for compensation

The foreign earned income exclusion remains capped at $80,000 per annum, but is indexed for inflation every year instead of only taxable years after 2007.

Exclusion for housing costs

The employer-provided housing exclusion is modified by tying it to the foreign earned income cap and applying an objective standard to the term "reasonable housing expenses."

Under the proposal, the base housing amount used to calculate the employer-provided housing exclusion is set at 16 percent of the foreign earned income exclusion cap, instead of 16 percent of the GS-14, Step 1 amount. As under present law, amounts below the base housing amount would be subject to U.S. tax because the base housing amount represents an estimate of expenditures that taxpayers would incur on housing regardless of whether they were relocated abroad. For 2005, the proposed base housing amount is $12,800 (=$80,000 x .16).

Employer-provided housing amounts in excess of the base housing amount are excluded from U.S. tax, but under the proposal such amounts are limited to 30 percent of the $80,000 (indexed for inflation). The proposal applies an objective standard to determine "reasonable housing expenses." The Department of Housing and Urban Development ("HUD") considers maximum affordable housing to be 30 percent of an individual's annual income. For 2005, the proposed maximum housing exclusion is therefore $11,200 (= ($80,000 x .30) - ($80,000 x .16)).

Stacking rule

Under present law, a taxpayer with excludable income under section 911 is subject to tax on the taxpayer's other income, after deductions, starting in the lowest tax rate bracket. Under the proposal, the taxpayer's other income, after deductions, is stacked on top of the section 911 exclusion amounts to arrive at the appropriate tax bracket. Thus, the income exempt under section 911, while not taxed in the United States, is still considered in determining the section 911 beneficiary's appropriate tax rate bracket under the U.S. progressive rate schedule.

Effective Date

The proposal is effective for taxable years beginning after date of enactment.

Discussion

Housing allowance

As opposed to present law, the proposal establishes an objective standard for excludable housing costs. Under present law, the employer-provided housing exclusion is provided for expenses above the base amount and capped at "reasonable housing expenses." As the HUD standard for maximum affordable housing, the 30-percent cap imposes an objective upper-limit on what is considered "reasonable housing expenses." A criticism of this approach may be that the objective cap does not account for the possibility that housing expenses in some foreign locales may exceed costs of housing in the United States. Thus, it may be appropriate to include some type of cost-of-housing adjustment factor to take into account the disparate cost of housing around the world. While the proposal does not include a cost-of-housing adjustment factor, the $80,000 amount used to cap employer-provided housing is more beneficial than using the median wage and salary amount for a family of four. Median wages and salaries for a family of four (married filing jointly with two dependents) was $56,085, as reported by taxpayers on Form 1040, in 2002. Thus, using $80,000 for the employer-provided housing calculation is generous in comparison to using wages and salaries for the median family.

The employer-provided housing exclusion is also tied to the foreign earned income cap. Thus, the housing exclusion is calculated by taking $80,000, indexed per annum, and applying a

16 percent floor and 30 percent cap. The foreign earned income exclusion cap is the threshold set by Congress to determine the amount of foreign earnings exempt from U.S. tax. Tying the employer-provided housing exclusion to the foreign earned income exclusion cap brings the two exclusions into conformity.

The modifications to the exclusion for employer-provided housing costs may reduce the current tax benefit provided to certain individuals under section 911. Income not eligible for the housing exclusion under the proposal would be treated the same as income earned by U.S. citizens living in the United States; U.S. citizens living abroad would be taxed on their worldwide income and a foreign tax credit would be allowed for foreign taxes paid. U.S. citizens living in countries that have tax rates higher than those in the United States would generally still not owe U.S. tax on the portion of their foreign earned income no longer eligible for section 911, because such taxes would be covered by the foreign tax credit. U.S. citizens living in countries that have tax rates lower than the United States would generally be made worse off relative to present law because the United States would impose a residual tax on the portion of their foreign earned income no longer eligible for section 911.

Stacking rule

Under present law, taxpayers with excludable income as a result of section 911 are taxed on any taxable income at rates that ordinarily are applicable only to taxpayers with substantially less economic income. The proposed stacking rule corrects this situation by subjecting taxpayers with section 911 excludable income to the same rates applicable to taxpayers with the same amount of economic income but who live and work only in the United States. For example, consider a taxpayer who has an $80,000 foreign earned income exclusion under section 911, a $10,000 employer-provided housing exclusion under section 911, $35,000 of other gross income, and $20,000 in deductions (including standard or itemized deductions and/or personal exemptions). The taxpayer has $90,000 in exclusions under section 911 and $15,000 of other income (after deductions). Under present law, the $15,000 of other income is taxed starting in the lowest rate bracket. Under the proposal, the $15,000 of other income is stacked after the $90,000 section 911 exclusion amounts. Therefore, under the proposal, the $15,000 of other income is taxed in the rate bracket that corresponds with $105,000. The proposed stacking rule is also applicable for purposes of the alternative minimum tax.

In cases where the excludable foreign income is subject to foreign taxes, the stacking rule prevents taxpayers from benefiting twice from graduated rate structures, once in the foreign country in the determination of the foreign tax liability on their foreign income, and again in the United States in the determination of their U.S. tax liability on any other income. Under the proposal, taxpayers can avoid the stacking rule by forgoing utilization of section 911 altogether and simply claiming a foreign tax credit for any foreign taxes paid.

B. Amend Rules for Determining Corporate Residency (sec. 7701)

Present Law

The U.S. tax treatment of a multinational corporate group depends significantly on whether the top-tier "parent" corporation of the group is domestic or foreign. For purposes of U.S. tax law, a corporation is treated as domestic if it is incorporated under the laws of the United States or of any State.[403] All other corporations (i.e., those incorporated under the laws of foreign countries) are treated as foreign.[404] Thus, place of incorporation determines whether a corporation is treated as domestic or foreign for purposes of U.S. tax law, irrespective of other factors that might be thought to bear on a corporation's "nationality," such as the location of the corporation's management activities, employees, business assets, operations, revenue sources, the exchanges on which the corporation's stock is traded, or the residence of the corporation's shareholders. Only domestic corporations are subject to tax on a worldwide basis. Foreign corporations are taxed only on income that has sufficient nexus in the United States.

Until recently, a U.S. parent corporation could reincorporate in a foreign jurisdiction, and this reincorporation could be respected for U.S. tax purposes, even in cases in which the reincorporation had no significant non-tax purpose or effect, and the corporate group had no significant business presence in the new country of incorporation. These transactions were commonly referred to as "inversion" transactions, and they could produce a variety of tax benefits, including the removal of a group's foreign operations from U.S. taxing jurisdiction and the reduction of U.S. tax on U.S.-source income through earnings-stripping transactions (e.g., large payments of interest from a U.S. subsidiary to the new foreign parent).

The American Jobs Creation Act of 2004 ("AJCA")[405] included provisions designed to curtail inversion transactions. Most significantly, section 801 of AJCA added section 7874 to the Code, which denies the intended tax benefits of a typical inversion transaction by deeming the new top-tier foreign corporation to be a domestic corporation for all Federal tax purposes. This sanction generally applies to a transaction in which, pursuant to a plan or a series of related transactions: (1) a U.S. corporation becomes a subsidiary of a foreign-incorporated entity or otherwise transfers substantially all of its properties to such an entity in a transaction completed after March 4, 2003; (2) the former shareholders of the U.S. corporation hold (by reason of holding stock in the U.S. corporation) 80 percent or more (by vote or value) of the stock of the foreign-incorporated entity after the transaction; and (3) the foreign-incorporated entity, considered together with all companies connected to it by a chain of greater than 50-percent ownership (i.e., the "expanded affiliated group"), does not have substantial business activities in

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[403] Sec. 7701(a)(4).

[404] Sec. 7701(a)(5).

[405] Pub. L. No. 108-357.

the entity's country of incorporation, compared to the total worldwide business activities of the expanded affiliated group.[406]

While AJCA created an exception to the place-of-incorporation test for determining corporate residency in cases involving defined inversion transactions, AJCA left that test in place with respect to all other cases. Thus, newly incorporated businesses, as well as businesses that completed inversion transactions prior to the effective date of the AJCA rules, remain subject to the place-of-incorporation rule as before.

Reasons for Change

The present-law test of determining corporate residency based solely on where the company is incorporated is artificial, and allows certain foreign corporations that are economically similar or identical to U.S. corporations to avoid being taxed like U.S. corporations. Determining corporate residency based on the location of the corporation's management activities would be a more meaningful standard.

AJCA included provisions that should curtail inversion transactions. In passing these provisions, the Congress addressed the most glaring deficiencies of the present-law place-of-incorporation test. However, ACJA's effective date permanently grandfathered most known inverted structures already in place. AJCA also did not address newly incorporated entities that establish corporate charters in a foreign jurisdiction, fail to establish substantial presence overseas, and effectively manage their business from within the United States, thereby achieving tax results similar to those achieved by pre-existing companies via inversion. However, in fall 2004, the Senate ratified a U.S.-Netherlands tax treaty protocol (the "Dutch protocol"),[407] which included a substantial presence test that looks to primary place of management and control to determine corporate residency. Revising the general U.S. corporate residency rules to test for primary place of management and control would produce a more meaningful test than that of present law and would present a comprehensive response to the problem identified and addressed by the Congress in 2004.

Description of Proposal

The proposal would be an overlay on present law, as amended by AJCA. Under the proposal, if a company is incorporated in the United States, it is still considered a domestic corporation and does not have to look any further to determine its residence. For publicly traded

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[406] AJCA also provides for a lesser set of sanctions with respect to a transaction that would meet the definition of an inversion transaction described above, except that the 80-percent ownership threshold is not met. In such a case, if at least a 60-percent ownership threshold is met, then a second set of rules applies to the inversion. Under these rules, the inversion transaction is respected (i.e., the foreign corporation is treated as foreign), but any applicable corporate-level "toll charges" for establishing the inverted structure are not offset by tax attributes such as net operating losses or foreign tax credits. AJCA also subjects certain partnership transactions to the new inversions rules.

[407] Senate Treaty Doc. 108-25.

foreign-incorporated entities, however, the proposal adds new rules that look to a corporation's primary place of management and control.

Under the proposal, a company's residence is based on the location of its primary place of management and control. A corporation's primary place of management and control is where the executive officers and senior management of the corporation exercise day-to-day responsibility for the strategic, financial and operational policy decision making for the company (including direct and indirect subsidiaries).

In determining which individuals are considered executive officers and senior management employees, the decision-making activities of all executive officers and senior management employees are taken into account. Under a centralized management structure, these employees would generally be those individuals who have executive officer positions and report to the corporate headquarters office. However, some companies may operate under a more decentralized management structure, where many strategic policy decisions are delegated to individuals who are directors of subsidiary companies. In this situation, individuals who are not executive officers and senior management employees of the corporate headquarters may be carrying on the strategic, financial and operational policy decisions for the company. The decision-making activities of these individuals are taken into consideration in determining the company's residence.

Effective Date

The proposal is effective for taxable years beginning at least two years after the date of enactment, in order to allow affected companies sufficient time to complete any necessary restructuring.

Discussion

The proposal retains present law but adds new rules with respect to publicly traded foreign-incorporated companies that are managed and controlled in the United States. Under present law, corporate residency is determined by place of incorporation. Thus, companies can avoid U.S. taxation on a worldwide basis by merely incorporating in a foreign jurisdiction. The proposal applies a more meaningful corporate residency test by requiring that a publicly traded foreign-incorporated company be treated as resident in the United States if it is managed and controlled in the United States.

The proposal determines corporate residence based on the location of the company's primary place of management and control. The proposal differs from the traditional management and control concept, defined by other countries as the location where the board of directors meets. The weakness in adopting the traditional management and control concept is that the board of directors is generally required to meet no more than a few times a year. Thus, a company could operate the majority of its business from the United States and meet the traditional management and control requirement simply by holding its board meetings in the foreign country a couple times a year.

The day-to-day management of a business is more difficult to manipulate. Moving the management of a company generally requires the physical relocation of top executives and their

families to an office in a foreign jurisdiction. It also requires the movement of support staff and administrative functions that are normally performed at the corporate headquarters office.

The concept of primary place of management and control is similar to the substantial presence test included in the recently ratified Dutch protocol. The substantial presence test in the Dutch protocol tests for corporate residence based on the location of the headquarters offices and senior management employees. The proposal does not adopt all aspects of the substantial presence test used in the Dutch protocol because some aspects lack relevance outside the treaty context.

Under present law, the corporate residency rules are easy to administer because determining residency is a bright line test. Under the proposal, corporate residency is based on a facts and circumstances test. The new rules would require the IRS to gather data on foreign incorporated entities to ascertain whether they have a substantial presence in the United States. Not only does this require an increase in the IRS's resources, but it also raises issues for foreign incorporated entities with respect to how they conduct business in the United States.

While the argument can be made that the new rules compromise the clarity and consistency of current law, the benefits related to preserving the U.S. tax base may offset these concerns. The new rules provide objective standards for companies that incorporate in the United States, but when a foreign company takes the position that it is not incorporated here, these rules allow the United States to test for management and control by looking at where the executive decision-making of the company is being conducted. In view of the high threshold of activity required under the proposal, only publicly traded foreign-incorporated companies that are effectively headquartered in the United States will need to contend with the new rules. Close cases should be few, thus limiting the scope of any problems relating to uncertainty and administrability.

C. Modify Entity Classification Rules to Reduce Opportunities for Tax Avoidance (sec. 7701)

Present Law

In order to apply the various substantive rules of the Code to transactions involving business entities, the entities first must be classified, typically as corporations, partnerships, or branches. The classification of a business entity carries significant Federal tax consequences. For example, corporations generally are subject to tax at the entity level, whereas partnerships and branches generally are not. Transactions between a branch and its owner generally are disregarded for Federal tax purposes (including the anti-deferral rules of subpart F), subject to several important exceptions.[408]

Prior to 1997, entity classification for Federal tax purposes was determined on the basis of a multi-factor test provided in regulations issued under section 7701 of the Code. In distinguishing between a corporation and a partnership, these regulations set forth four characteristics indicative of status as a corporation: continuity of life, centralization of management, limited liability, and free transferability of interests. If a business entity possessed three or more of these characteristics, then it was treated as a corporation; if it possessed two or fewer, then it was treated as a partnership.[409] Thus, in order to achieve characterization as a partnership under this system, taxpayers needed to arrange the governing instruments of an entity in such a way as to eliminate two of these corporate characteristics. For example, a taxpayer desiring partnership classification for an entity might include transferability restrictions and dissolution provisions in order to eliminate the corporate characteristics of free transferability and continuity of life. Partnerships also needed to have at least two members, as the term suggests.

Since January 1, 1997, new entity classification regulations have been in effect that generally allow taxpayers simply to elect the desired classification for many types of entities, including certain limited-liability entities that are available under the laws of many foreign jurisdictions.[410] These regulations are commonly referred to as the "check the box" regulations. The "check the box" regulations generally eliminate the need for modifications to the terms of governing documents in order to secure a particular entity classification, and they make it possible for a taxpayer to elect branch treatment for a single-member limited-liability entity, thus enabling the taxpayer to achieve both flow-through taxation and limited liability with respect to a foreign entity without adding a second member. These entities are often referred to as "disregarded entities," or "tax nothings."

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[408] One such exception is the so-called "branch rule" of section 954(d)(2), which effectively treats branches of controlled foreign corporations as separate corporations for purposes of the foreign base company sales income rules, under certain circumstances. No similar "branch rule" applies for other purposes of subpart F.

[409] Treas. Reg. sec. 301.7701-2, as in effect prior to 1997.

[410] Treas. Reg. sec. 301.7701-1, *et seq.*

Reasons for Change

It has been widely observed that the "check the box" regulations, while producing some simplification benefits with respect to both domestic and foreign entities, also have created some unintended tax-avoidance opportunities as applied to foreign entities. In particular, it appears that the availability of single-member disregarded entities has rendered it easy in many cases to avoid current taxation under subpart F.

Description of Proposal

Under the proposal, an organization must be treated as a corporation for Federal tax purposes if the organization: (1) is a separate business entity organized under foreign law; and (2) has only a single member. This proposal overrides any contrary result that may have been obtained under the current entity classification regulations. In all other respects, those regulations remain in force.

If a branch, local office, or other organization does not rise to the level of a separate business entity (e.g., if it is not established as a separate legal entity under the relevant local law), then the branch, office, or organization is not subject to this proposal, and thus is not treated as a corporation for Federal tax purposes.

Domestic business entities and non-single-member foreign business entities are generally not subject to the proposal and thus remain eligible for elective entity classification to the extent so eligible under the current regulations. However, the Treasury Secretary may issue regulations extending the application of this provision to: (1) a non-single-member foreign business entity, in cases in which a membership interest is issued to a person related to another member, with a principal purpose of preventing the entity from being classified as a corporation under the provision;[411] or (2) a domestic business entity that has a CFC as its sole member.

Effective Date

The provision applies to taxable years beginning one year or more after the date of enactment.

Discussion

As noted above, although the "check the box" regulations have produced some simplification benefits with respect to both domestic and foreign entities, the regulations also have created some unintended tax-avoidance opportunities as applied to foreign entities. In particular, it appears that the availability of single-member disregarded entities has facilitated the avoidance of current taxation under subpart F in situations in which subpart F normally would apply.

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[411] Persons are considered related for this purpose if they meet a greater-than-50-percent common-control standard under rules similar to those of section 954(d)(3).

For example, payments of interest, dividends, rent, and royalties between CFCs often generate subpart F income, but similar payments between a disregarded entity and a CFC do not, even if the disregarded entity is treated as a separate corporation under applicable foreign tax law, and thus may be deducting the payment for foreign tax purposes. In these cases, commonly referred to as "hybrid branch arrangements," the ability to avoid subpart F may combine with favorable results under foreign tax law to distort investment decisions, arguably making it more attractive in some cases to locate investments abroad than in the United States. Ensuring that these transactions are taxed under subpart F could both correct the misallocation of capital away from the United States and raise additional revenue. On the other hand, some would argue that this sort of inconsistent treatment of a transaction by the countries concerned is an inevitable result of cross-border activity in a world with diverse tax systems, that the appropriate U.S. tax treatment of a transaction should not depend on the results that a taxpayer might be able to achieve under foreign tax law, and that capital import neutrality is promoted by allowing these transactions to avoid taxation under subpart F.[412] Regardless of whether these particular tax results are viewed with approval or disapproval, hybrid branch arrangements illustrate well how a "check the box" election may be used to secure tax results that would have appeared difficult or impossible to achieve under the current statutory subpart F rules.

While hybrid branch arrangements are perhaps the first and best-known example of how a "check the box" election can be used to circumvent subpart F, other similar uses for the election have been found. For example, the sale of stock of an operating company by a CFC generally would give rise to subpart F income, but if an election to disregard the company is in effect, then the transaction may be treated as a sale of operating assets, thus avoiding the creation of subpart F income.[413] As in the case of hybrid branch arrangements, a mere election, with no non-tax economic effect, may transform what would have been subpart F income into an item exempt from subpart F.[414]

While a certain degree of electivity already prevailed as a practical matter under the pre-1997 entity classification rules, and tax results similar to those described above may have been attainable under some circumstances before 1997, the expressly elective approach of the current

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[412] In 1998 the IRS proposed, and then withdrew, regulations that sought to prevent this particular use of the "check the box" regulations. See Notice 98-11, 1998-1 C.B. 433; former Temp. Treas. Reg. sec. 1.954-9T, adopted in T.D. 8767, 1998-1 C.B. 875; Notice 98-35, 1998-2 C.B. 34. More recently, both the House- and Senate-passed versions of AJCA included a provision that would have allowed taxpayers to achieve tax results similar to those achieved via hybrid branch arrangements in connection with payments between two CFCs, thus obviating the need to establish a hybrid branch, but this provision was not adopted in the final version of AJCA.

[413] See, e.g., *Dover Corp. v. Commissioner*, 122 T.C. 324 (2004).

[414] Under section 412 of AJCA, certain sales of partnership interests by controlled foreign corporations no longer give rise to subpart F income. AJCA did not extend a similar approach to the sale of stock by a controlled foreign corporation, which still gives rise to subpart F income.

regulations has removed some frictions that may have acted as a brake on some of the tax planning involving the classification of entities. In particular, the ability to disregard single-member foreign business entities may have impaired the intended functioning of subpart F in some respects.

The proposal strikes a balance between the goal of simplification and the policies reflected in the substantive provisions of the Code by generally retaining the elective approach of the current entity classification regulations, but providing that single-member business entities organized under foreign law must be treated as corporations for Federal tax purposes. This approach will not prevent every arrangement that might be thought to be abusive, as not all abuses require the use of a separate disregarded entity, but the approach will render it considerably more difficult in many cases for taxpayers to use the entity classification rules to frustrate the intent of the international tax provisions of the Code. A wide range of potentially abusive transactions that are currently disregarded for purposes of the substantive rules of the Code would be "regarded" under the proposal, thereby providing a greater opportunity to apply and adjust those rules in an appropriate manner, whether that be to allow or to disallow a particular tax result.

While the overall structuring flexibility available to taxpayers under this approach is considerably less than what prevails under the current entity classification regulations, it is generally still greater than the flexibility that prevailed before 1997. Because this approach would have the effect of upsetting taxpayer expectations that have developed over the last several years of experience with the current regulations, the proposal includes a delayed effective date, in order to enable taxpayers to restructure arrangements that were established in reliance on the current regulations.

D. Adopt a Dividend Exemption System for Foreign Business Income

Present Law

"Worldwide" vs. "territorial" taxation of business income

The tax systems of the world generally reflect two basic approaches to the taxation of cross-border business income, often referred to as "worldwide" and "territorial" approaches. Under a pure worldwide tax system, resident corporations are taxable on their worldwide income, regardless of source, and the potential double taxation arising from overlapping source-country and residence-country taxing jurisdiction is mitigated by allowing a foreign tax credit. In contrast, under a pure territorial tax system, a country taxes only income derived within its borders, irrespective of the residence of the taxpayer. Thus, foreign-source income earned by a resident corporation is exempt from tax under a pure territorial tax system.

Each type of system may be said to promote a particular conception of economic efficiency. A pure worldwide tax system promotes capital export neutrality, a norm that holds that tax considerations should not influence a taxpayer's decision of whether to invest at home or abroad. Under a pure worldwide tax system, the after-tax return to an otherwise equivalent investment does not depend on whether the investment is made at home or abroad, since in either case the income from the investment generally will be subject to tax at the residence-country rate. Thus, investment-location decisions are governed by business considerations, instead of by tax law. A pure territorial system, on the other hand, promotes capital import neutrality, a norm that holds that all investment within a particular source country should be treated the same, regardless of the residence of the investor. Thus, if a residence country adopts a pure territorial system, residents of that country, when investing abroad in a particular source jurisdiction, will not receive a lower after-tax return than other investors by virtue of their country of residence.

In a world with diverse tax systems and rates, it is impossible fully to achieve both capital import neutrality and capital export neutrality at the same time. For example, suppose a source country offers a lower tax rate on a particular investment than the U.S. rate on a similar investment in the United States. Capital export neutrality would dictate that the United States impose a residual residence-based tax on the foreign investment at a level sufficient to make a U.S. investor indifferent on an after-tax basis between the two investment locations; however, doing so would violate capital import neutrality, as a U.S. investor in the source country would earn a lower after-tax rate of return compared to non-U.S. investors in the same source country, to the extent that such investors' residence countries did not assert a similar residual tax on the income. As long as different countries maintain different tax systems and rates, the two goals will remain in tension with each other.

The tax systems of all large, industrialized countries may be said to reflect varying compromises between these competing goals. Accordingly, no large, industrialized country employs a pure worldwide or pure territorial system. Existing systems may be accurately characterized as predominantly worldwide or territorial, but all systems share at least some features of both the worldwide and territorial approaches. Thus, systems commonly described as "worldwide" in fact include many territorial-type elements that promote capital import neutrality, such as indefinite deferral of tax on most types of foreign business income earned through

foreign subsidiaries in the case of the United States. Similarly, systems commonly described as "territorial" include many worldwide-type features that promote capital export neutrality, such as residence-country taxation of passive income earned through foreign subsidiaries in lower-tax countries.

Many countries tax resident corporations on a predominantly territorial basis by exempting dividends received from foreign subsidiaries from residence-country tax.[415] This exemption typically applies only where the parent company's ownership in the subsidiary exceeds a certain threshold (commonly five to 10 percent), and the exemption may be total or partial (e.g., only 95 percent, or 60 percent, of qualifying dividends might be exempted, as a proxy for disallowing expenses allocable to exempt income). A number of restrictions generally apply, in order to limit the exemption to certain categories of income (e.g., active business income) and to address concerns about shifting income to lower-tax countries in order to avoid tax. These exemption systems generally do impose tax on foreign-source royalties and portfolio-type income.

The U.S. system: worldwide, deferral-based taxation of foreign business income

The United States employs a "worldwide" tax system, under which domestic corporations generally are taxed on all income, whether derived in the United States or abroad. Income earned by a domestic parent corporation from foreign operations conducted by foreign corporate subsidiaries generally is subject to U.S. tax when the income is distributed as a dividend to the domestic corporation. Until such repatriation, the U.S. tax on such income generally is deferred, and U.S. tax is imposed on such income when repatriated.

However, under anti-deferral rules, the domestic parent corporation may be taxed on a current basis in the United States with respect to certain categories of passive or highly mobile income earned by its foreign subsidiaries, regardless of whether the income has been distributed as a dividend to the domestic parent corporation. The main anti-deferral provisions in this context are the controlled foreign corporation ("CFC") rules of subpart F[416] and the passive foreign investment company ("PFIC") rules.[417]

A foreign tax credit generally is available to offset, in whole or in part, the U.S. tax owed on foreign-source income, whether earned directly by the domestic corporation, repatriated as a dividend from a foreign subsidiary, or included in income under the anti-deferral rules.[418] The foreign tax credit generally is limited to the U.S. tax liability on a taxpayer's foreign-source

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[415] These systems are often referred to as "participation exemption" systems.

[416] Secs. 951-964.

[417] Secs. 1291-1298.

[418] Secs. 901, 902, 960, and 1291(g).

income, in order to ensure that the credit serves its purpose of mitigating double taxation of foreign-source income without offsetting the U.S. tax on U.S.-source income.[419]

The foreign tax credit limitation is applied separately to different types of foreign-source income, in order to reduce the extent to which excess foreign taxes paid in a high-tax foreign jurisdiction can be "cross-credited" against the residual U.S. tax on low-taxed foreign-source income. For example, if a taxpayer pays foreign tax at an effective rate of 40 percent on certain active income earned in a high-tax jurisdiction, and pays little or no foreign tax on certain passive income earned in a low-tax jurisdiction, then the earning of the untaxed (or low-tax) passive income could expand the taxpayer's ability to claim a credit for the otherwise uncreditable excess foreign taxes paid to the high-tax jurisdiction, by increasing the foreign tax credit limitation without increasing the amount of foreign taxes paid. This sort of cross-crediting is constrained by rules that require the computation of the foreign tax credit limitation on a category-by-category basis.[420] Thus, in the example above, the rules would place the passive income and the active income into separate limitation categories, and the low-tax passive income would not be allowed to increase the foreign tax credit limitation applicable to the credits arising from the high-tax active income. A significant degree of cross-crediting may be achieved within a single limitation category, however. For example, a high-tax dividend from a CFC and a low-tax royalty from another CFC may both fall into the general limitation category,[421] with the result that potential excess credits associated with the dividend effectively may reduce the residual U.S. tax owed with respect to the royalty.

Reasons for Change

It has long been recognized that the worldwide, deferral-based system of present law distorts business decisions in a number of ways. By establishing repatriation as the system's principal taxable event, the worldwide, deferral-based system creates incentives in many cases to redeploy foreign earnings abroad instead of in the United States, thereby distorting corporate cash-management and financing decisions. At the same time, basing the system on repatriation renders the payment of U.S. tax on foreign-source business income substantially elective in many cases, because repatriation itself is elective. By maintaining deferral indefinitely, a taxpayer may achieve a result that is economically equivalent to 100-percent exemption of income, with no corresponding disallowance of expenses allocable to the exempt income, provided that the taxpayer does not repatriate the earnings or run afoul of subpart F or other anti-

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[419] Secs. 901 and 904.

[420] Sec. 904(d). The American Jobs Creation Act of 2004 ("AJCA") generally reduced the number of these categories from nine to two, effective in 2007. A number of other provisions of the Code and treaties have the effect of creating additional separate limitation categories in specific circumstances.

[421] See sec. 904(d)(3) (providing for look-through treatment of dividends, interest, rents, and royalties received from CFCs).

deferral rules.[422] In addition, taxpayers that repatriate high-tax earnings may be able to use excess foreign tax credits arising from these repatriations to offset the U.S. tax on lower-tax items of foreign-source income, such as royalties received for the use of intangible property in a low-tax country.

For these reasons, in many cases, the present-law "worldwide" system actually may yield results that are more favorable to the taxpayer than the results available in similar circumstances under the "territorial" exemption systems used by many U.S. trading partners, as these systems generally fully tax foreign-source royalties and portfolio-type income, and often exempt less than 100 percent of a dividend received from a subsidiary, as a proxy for disallowing expenses allocable to the exempt income. At the same time, however, the potential for taxation under the U.S. system by reason of either repatriation or application of the highly complex U.S. anti-deferral rules arguably forces U.S.-based multinationals to contend with a greater degree of complexity, and to engage in a greater degree of tax-distorted business planning, than many of their foreign-based counterparts resident in countries with exemption systems.

The present-law system thus creates a sort of paradox of defects: on the one hand, the system allows tax results so favorable to taxpayers in many instances as to call into question whether it adequately serves the purposes of promoting capital export neutrality or raising revenue; on the other hand, even as it allows these results, the system arguably imposes on taxpayers a greater degree of complexity and distortion of economic decision making than that faced by taxpayers based in countries with exemption systems, arguably impairing capital import neutrality in some cases.

The Congress recognized and addressed some of these problems in AJCA, but significant problems remain. Replacing the worldwide, deferral-based system with a dividend exemption system arguably would mitigate many of these remaining problems, while generally moving the system further in the direction charted by the Congress in 2004.

Description of Proposal

Overview

Under the proposed dividend exemption system, income earned abroad by foreign subsidiaries of U.S. parent corporations would fall into one of two categories: (1) passive and other highly mobile income, which would be taxed to the U.S. parent on a current basis under subpart F; or (2) all other income--i.e., active, less-mobile income not subject to subpart F--which would be exempt from U.S. tax and thus could be repatriated free of any tax impediment. The deferral and repatriation tax at the heart of the present-law system would be eliminated, and the foreign tax credit system would serve a more limited function than it does under present law.

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[422] In addition, in some cases taxpayers may enter into transactions that are substantially equivalent to repatriations economically, but that are intended to escape taxation as such. Section 956 imposes limits on this practice with respect to many of the nearest repatriation equivalents.

CFC-parent dividends exempt from tax

A U.S. corporation that holds 10 percent or more of the stock of a CFC would exclude from income 100 percent of the dividends received from the CFC. This exclusion would be mandatory, and no foreign tax credits would arise with respect to foreign taxes attributable to the excluded dividend income (including both corporate-level income taxes and dividend withholding taxes). In addition, a special rule would provide that no subpart F inclusions would be created as a dividend moves up a chain of CFCs, to the extent that the dividend is attributable to a 10 percent or greater direct or indirect interest in the dividend-paying CFC owned by the U.S. parent. This rule would ensure that dividends could be repatriated from lower-tier CFCs without losing the benefit of dividend exemption, and it also would make it easier to redeploy CFC earnings in different foreign jurisdictions without triggering subpart F, thus promoting neutrality as to the decision of how to dispose of CFC earnings.

Under the dividend exemption system, CFC earnings would constitute a predominantly tax-exempt stream of income for the U.S. parent corporation. Accordingly, deductions for interest and certain other expenses incurred by the U.S. corporation would be disallowed to the extent allocable to exempt (non-subpart-F) CFC earnings. These allocations would be made as the earnings are generated, as opposed to when they are distributed. Thus, for expense allocation purposes, CFC earnings would be treated as giving rise to foreign-source income as they are earned.

Interest expense would first be allocated between U.S. and foreign-source income under rules similar to those of present law, including the interest allocation changes made by AJCA.[423] The amount of interest expense allocated to foreign-source income under these rules then would be further allocated between exempt CFC earnings and other foreign-source income on a pro rata basis, based on assets. Research and experimentation expenses would first be allocated between U.S. and foreign-source income under rules similar to those of present law.[424] The amount of research and experimentation expenses allocated to foreign-source income then would be further allocated first to taxable royalties and similar payments (e.g., cost-sharing or royalty-like sale payments) to the extent thereof, then to CFC earnings to the extent thereof (with this amount divided on a pro rata basis between exempt CFC earnings and non-exempt CFC earnings), and then finally to other foreign-source income. General and administrative expenses would be allocated to exempt CFC earnings in the same proportion that exempt CFC earnings of the group bears to overall earnings of the group. Other expenses, such as stewardship expenses, may be directly allocable to exempt CFC earnings in some cases. With respect to all of these categories of expenses, as under present law, it will be necessary for the Treasury Department to provide detailed expense allocation rules by regulation.

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[423] Sec. 401 of AJCA.

[424] Sec. 864(f).

Other foreign-source income fully taxed

Non-dividend payments from the CFC to the U.S. corporation (e.g., interest, royalties, service fees, income from intercompany sales) would be fully subject to tax, and this tax generally would not be offset by cross-crediting as it often is under present law. In addition, dividends from non-CFCs, or from CFCs with respect to which the U.S. corporation is not at least a 10-percent shareholder, would be fully subject to tax.

Anti-avoidance rules retained

Subpart F would be retained in its current form. Thus, notwithstanding the general rule of dividend exemption, a U.S. corporation that holds a 10-percent or greater stake in a CFC would still face current income inclusion when the CFC earns certain types of passive or highly mobile income. As under present law, a subpart F inclusion would carry with it a credit for any foreign taxes associated with the subpart F income. The PFIC rules also would be retained in their current form.

Treatment of gain or loss on sale of CFC stock

A U.S. corporation's gain on the sale of CFC stock would be excluded from income to the extent of undistributed exempt earnings. Any excess of gain over this amount would be taxable, even though some of this gain may relate to appreciation of assets that would have generated exempt income.[425] Deductions for losses on the sale of CFC stock would be disallowed.

Foreign branches

Foreign branch income would be exempt to the same extent as it would be if earned by a CFC, under rules that would treat foreign trades or businesses conducted directly by a U.S. corporation as CFCs for all Federal tax purposes. Thus, subpart F would apply to branch operations, branch losses would not flow directly onto a U.S. corporation's tax return, and transactions between the U.S. corporation and the foreign branch would be subject to the full range of rules dealing with intercompany transactions. Except as provided in regulations, all trades or businesses conducted predominantly within the same country would be treated as a single CFC for this purpose. The Treasury Secretary would be given regulatory authority to issue the rules necessary to place branches and CFCs on an equal footing for these purposes.

Transition and collateral issues

Transition

The exemption system would apply only with respect to CFC earnings generated after the effective date, thus requiring ongoing separate tracking of earnings pools. With respect to pre-

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[425] Allocating gain between appreciation of assets that produce exempt income and those that produce non-exempt income, while perhaps attractive in theory, would be highly complex and would introduce difficult issues of valuation into the system.

effective-date earnings, the present-law system would continue to apply in all respects. Dividends would be treated as coming first from exempt, post-effective-date earnings and then from pre-effective-date earnings.

Collateral change to subpart F

The deemed-repatriation rules of section 956 would be repealed, as these rules are merely a backstop to the present-law repatriation tax, which would be eliminated under the proposed system. (However, as indicated above, these and all other relevant rules of present law would continue to apply to pre-effective-date earnings.)

Collateral changes to the foreign tax credit

The foreign tax credit would remain in place with respect to: (1) income that is included on a current basis under the subpart F or PFIC rules; and (2) other foreign-source income that is not eligible for exemption (e.g., dividends received on a portfolio investment in a foreign corporation, foreign-source royalty income earned directly by the U.S. corporation).

The indirect foreign tax credit of section 902 would be repealed, except insofar as it applies to subpart F inclusions. This rule would eliminate the indirect foreign tax credit for noncontrolled section 902 corporations ("10-50 companies"). A foreign tax credit generally would remain available with respect to withholding taxes imposed on dividends received from 10-50 companies, as these dividends generally would remain subject to U.S. tax under the proposal. However, a U.S. corporation would be allowed to elect to treat its investment in a 10-50 company as an investment in a CFC for Federal tax purposes, thus rendering the investment both eligible for dividend exemption and subject to subpart F. Thus, the U.S. corporation effectively would choose between treating the 10-50 investment as a portfolio-type investment or as a direct, CFC-type investment.

The separate limitation categories of section 904 would be repealed, and thus the foreign tax credit limitation would apply on an overall basis. By removing most foreign business income from the foreign tax credit system altogether, most high-tax foreign-source income would be removed from the computation, greatly reducing the potential for cross-crediting relative to present law. Under these conditions, it would no longer be necessary to apply the limitation on a separate-category basis.

No change would be made to the export source rule under section 863(b), but the benefits of this rule would be significantly reduced or eliminated in most cases, in view of the narrowed scope of the foreign tax credit and the likelihood that most taxpayers will be in excess-limitation positions under the new system (because most high-tax foreign income will be exempted, leaving mostly low-tax or untaxed foreign-source income in the foreign tax credit system).

Treaties

The proposed system would require the renegotiation of existing income tax treaties, which are premised on the assumption that the United States will continue to operate a worldwide tax system. For example, existing treaties generally require the United States to allow foreign tax credits for foreign corporate income taxes and dividend withholding taxes under

certain circumstances. These treaties would have to be revised to reflect the conversion from a credit mechanism to an exemption mechanism.

Effective Date

The proposal is generally effective for taxable years of foreign corporations beginning after the date of enactment, and for taxable years of U.S. shareholders with or within which such taxable years of such foreign corporations end. The rules dealing with foreign branches are effective for taxable years of U.S. corporations beginning after the date of enactment.

Discussion

As described above, the present-law deferral system arguably imposes on taxpayers a greater degree of complexity and distortion of economic decision making than that faced by taxpayers based in countries with exemption systems, arguably impairing capital import neutrality in some cases. At the same time, the system allows tax results so favorable to taxpayers in many instances as to call into question whether it adequately serves the purposes of promoting capital export neutrality or raising revenue. Although the Congress recognized and addressed some of these problems in AJCA, significant problems remain. Replacing the worldwide, deferral-based system with a dividend exemption system arguably would mitigate many of these remaining problems, while generally moving the system further in the direction charted by the Congress in 2004.

For example, recognizing that deferral-based taxation created an impediment to repatriating certain foreign earnings, the Congress in 2004 provided a temporary window during which foreign earnings could be repatriated at a reduced rate of tax. This legislation reduced the tax impediment to repatriating existing earnings, but as a temporary provision, it left this impediment in place with respect to future earnings. Indeed, to the extent that taxpayers may expect the provision to be adopted again as a fiscal stimulus response to a future downturn, they may be even less likely to repatriate earnings at full tax cost after the temporary window than they were before the window. Adopting a dividend exemption system would remove the repatriation disincentive permanently, in a manner generally consistent with steps that the Congress has already taken on a temporary basis.

More broadly, the Congress made a number of changes to the international tax provisions of the Code that will promote greater capital import neutrality. Most significantly in this regard, the foreign tax credit rules were amended in a number of ways in order to reduce the burden on U.S. taxpayers of the foreign tax credit limitation.[426] More limited changes were made outside

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[426] See AJCA secs. 401 (interest allocation), 402 (overall domestic loss), 403 (noncontrolled sec. 902 corporations), 404 (reduction of number of separate limitation categories), 406 (treatment of deemed royalties), and 417 (extension of carryover period). These changes promote capital import neutrality in the long run, as they reduce the U.S. residence-country tax burden imposed on the cross-border income of U.S. taxpayers. More directly, these changes also may be viewed as promoting capital export neutrality, because they reduce the impact of the foreign tax credit limitation. The foreign tax credit limitation, while necessary to preserve full U.S. taxing jurisdiction with respect to U.S.-source income, impairs capital export

the foreign tax credit area, but these changes also generally moved the system in the direction of greater capital import neutrality.[427] Adopting a dividend exemption system would further promote capital import neutrality in many cases, as U.S. corporations no longer would need to contend with the possibility of residual U.S. taxation with respect to most types of foreign business income. Adopting a dividend exemption system also would specifically promote the Congress's demonstrated goal of further simplifying the foreign tax credit regime, as the regime would be rendered inapplicable to most foreign business income, which would simply be exempt from U.S. tax under the system. Application of the foreign tax credit regime on a more limited basis would reduce the amount of income and activity subject to these complex rules, and would allow further simplifying changes to be made to them, including the elimination of separate limitation categories.

While the Congress made sweeping changes to the foreign tax credit regime in 2004, the Congress made no similarly sweeping changes with respect to the anti-deferral regimes. The complexity of these regimes, the distortions that they produce, and their diminishing effectiveness in promoting capital export neutrality are all problems that remain to be solved. The seriousness of these problems, and the appropriateness of various possible solutions, are not significantly affected by moving to a dividend exemption system. Under either type of system, effective regimes are needed to prevent the avoidance of tax through shifting income into low-tax jurisdictions, without unduly interfering with the operation of nontax-motivated business structures. Accordingly, the desirability of various proposals that the Congress may wish to consider in this area is largely independent of the question of whether to adopt a dividend exemption system or to retain the present-law worldwide, deferral-based system--in either case, certain categories of passive or highly mobile foreign income must be defined and subjected to immediate U.S. tax.[428]

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neutrality by allowing investments in high-tax foreign jurisdictions to be subjected to a greater aggregate tax burden than comparable investments in the United States.

[427] See, e.g., AJCA secs. 407 (dealer exceptions to deemed repatriation rules), 412 (subpart F treatment of CFC sales of partnership interests), 414 (subpart F treatment of commodities transactions), 415 (subpart F treatment of aircraft leasing and shipping income), and 416 (subpart F active financing exception).

[428] There are several proposals dealing with subpart F that the Congress may wish to consider, either in conjunction with this proposal or as freestanding proposals. One such proposal would be to limit taxpayers' ability to use disregarded entities to avoid what would traditionally have been subpart F income, as described in Part VI.C. of this Report. Other possible proposals include repeal of the foreign base company sales and services income rules, which arguably are outmoded and distort business decision making, and yet appear to be ineffective as a practical matter in promoting capital export neutrality and reinforcing the transfer pricing rules. Another possible proposal would be to make permanent the active financing exception of sections 954(h) and (i) and 953(e), in order to promote greater certainty and stability in the tax law.

Although moving from the present-law system to a dividend exemption system broadly promotes capital import neutrality, such a move also should serve to promote capital export neutrality in a few respects. For example, in cases in which indefinite deferral and cross-crediting of high-tax dividends with low-tax royalties may produce results more advantageous to a taxpayer than the results available under a typical dividend exemption system, capital export neutrality may be improved by shifting to dividend exemption. In addition, the disallowance of deductions for interest and overhead expenses allocable to exempt income may have the effect of promoting capital export neutrality, although this effect would be offset to some extent by exemption itself.[429]

Thus, like any other system, the proposed system would result in a compromise between these two efficiency norms, but arguably a better compromise, involving less complexity and fewer distortions than the present-law system. On the other hand, the continued need for provisions like subpart F and the inter-company pricing rules means that significant complexity will remain, and the transition from the present-law system to the proposed system will create significant complexities of its own.[430]

Some have expressed a concern that switching from a deferral system to an exemption system might cause U.S. investment to flow out of the United States and into lower-tax countries, because permanent exemption is thought to be significantly more attractive than the deferral available under present law. While such an incentive may arise in certain circumstances, there is little evidence that this would generally be the case. First, as discussed above, the indefinite deferral available under present law is in many cases no worse a tax result for taxpayers than the tax results available under a dividend exemption system. Second, as long as the exemption system maintains anti-avoidance provisions of present law, such as subpart F and the transfer pricing rules of sections 482 and 367(d), problems of tax avoidance should be similar under both types of system.[431] Third, the disallowance of deductions for expenses allocable to exempt income should serve as a brake on any incentive to move investments and activities offshore, as the exemption achieved by such a shift may come at a cost of greater deduction disallowance.

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[429] Even if a dividend exemption system is not adopted, some would favor allocating certain expenses to CFC earnings and deferring deductions for the expenses so allocable during the period that the U.S. tax on the CFC earnings is deferred.

[430] See, e.g., Michael J. Graetz and Paul W. Oosterhuis, "Structuring an Exemption System for Foreign Income of U.S. Corporations," *National Tax Journal*, Vol. LIV, No. 4, (December 2001) (illustrating that moving to a dividend exemption system could provide an opportunity for simplification, but that many of the sources of complexity encountered under present law would remain).

[431] To the extent that permanent exemption is more favorable than the indefinite-but-restricted deferral available under present law, an exemption system may place somewhat more pressure on some of these rules, thus making it somewhat more important to remedy existing defects in the design and administration of those rules.

Economists who have studied how moving to a dividend exemption system might affect the location incentives of U.S. corporations find no definitive evidence that incentives would be significantly changed. Two recent studies examine how the incentive to invest in low-tax locations abroad would be affected if the United States were to move to a dividend exemption system similar to the one described here.[432] In both studies, the authors consider dividend exemption systems that impose allocation rules similar to those of present law so that some portion of deductions for interest and overhead expenses incurred by the U.S. parent company and allocated to exempt foreign income are disallowed as deductions from U.S. taxable income. One study concludes that under dividend exemption, the effective tax rate on U.S. investment in low-tax locations would actually increase relative to the system in place prior to AJCA.[433] Although active foreign business income would avoid U.S. residual taxation, the loss of the ability to shield U.S. tax on foreign royalties through cross-crediting and to claim deductions for overhead and interest expense at home (or in other high-tax locations) results in higher tax burdens in low-tax locations. The second study presents hypothetical effective tax rates for incremental investment by a U.S. taxpayer in a low-tax subsidiary abroad under the U.S. tax system in place prior to AJCA and under dividend exemption with expense allocation rules.[434] This study also finds that the tax burden of investing in low-tax countries may increase under dividend exemption. In addition, the study uses two other approaches to investigate how location decisions may change under dividend exemption: a comparison of foreign direct investment patterns for the United States and for two countries which exempt dividends received from foreign affiliates resident in countries with which they have tax treaties (Germany and Canada) and an empirical analysis of the extent to which residual U.S. taxes on low-tax foreign earnings impact the location decisions of U.S. corporations. Neither approach yielded results that would suggest that location decisions would be significantly altered if the United States were to exempt dividends from residence country taxation.[435]

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[432] Harry Grubert and John Mutti, *Taxing International Business Income: Dividend Exemption versus the Current System*, Washington, D.C., American Enterprise Institute (2001) ("Grubert and Mutti"); and Rosanne Altshuler and Harry Grubert, "Where Will They Go if We Go Territorial? Dividend Exemption and the Location Decisions of U.S. Multinational Corporations," *National Tax Journal*, Vol. LIV, No. 4 (December 2001) ("Altshuler and Grubert").

[433] Grubert and Mutti.

[434] Altshuler and Grubert.

[435] Some economic research has focused on the impact of home country tax systems on foreign direct investment in the United States. The conclusions from this literature are mixed. Joel Slemrod uses time-series data to compare the responsiveness to U.S. corporate tax rates of foreign direct investment from exemption and "worldwide" countries. Joel Slemrod, "Tax Effects on Foreign Direct Investment: Evidence from a Cross-Country Comparison," in *Taxation in the Global Economy*, edited by Assaf Razin and Joel Slemrod, Chicago, University of Chicago Press, 1990. The study does not uncover a difference between the two groups of countries. James R. Hines, Jr. examines whether the sensitivity of manufacturing foreign direct investment to State income tax rates varies across exemption and "worldwide" countries. James R. Hines,

Jr., "Altered States: Taxes and the Location of Foreign Direct Investment in America," *American Economic Review*, 86, No. 5, December, 1996. The study finds that foreign direct investment from exemption countries is more responsive to differences in State income tax rates. Although relevant, these papers do not examine the experience of U.S. corporations and how location incentives may change under the dividend exemption proposal described here and the current system.

VII. OTHER BUSINESS PROVISIONS

A. Disallow Deduction for Interest on Indebtedness Allocable to Tax-Exempt Obligations (sec. 265)

Present Law

In general

Present law disallows a deduction for interest on indebtedness incurred or continued to purchase or carry obligations the interest on which is exempt from tax (tax-exempt obligations).[436] This rule applies to tax-exempt obligations held by individual and corporate taxpayers. The rule also applies to certain cases in which a taxpayer incurs or carries indebtedness and a related person acquires or holds tax-exempt obligations.[437] There are two methods for determining the amount of the disallowance. One method, which applies to all taxpayers other than financial corporations or dealers in tax-exempt obligations, asks whether a taxpayer's borrowing can be traced to its holding of exempt obligations. A second method, which applies to financial corporations and dealers in exempt obligations, disallows interest deductions based on the percentage of a taxpayer's assets comprised of exempt obligations.

The interest expense disallowance rules are intended to prevent taxpayers from engaging in tax arbitrage by deducting interest on indebtedness that is used to purchase tax-exempt obligations.

Rules for nonfinancial corporations

General rules

Under IRS rules,[438] for every taxpayer other than a financial corporation or a dealer in tax-exempt obligations, an interest deduction generally is disallowed only if the taxpayer has a purpose of using borrowed funds to purchase or carry tax-exempt obligations (the "tracing rule"). This purpose may be established by direct or circumstantial evidence.

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[436] Sec. 265.

[437] Section 7701(f) provides that the Secretary of the Treasury will prescribe regulations necessary or appropriate to prevent the avoidance of any income tax rules that deal with the use of related persons, pass-through entities, or other intermediaries in (1) the linking of borrowing to investment or (2) diminishing risks. See *H Enterprises Int'l, Inc. v. Commissioner,* T.C.M. 1998-97, *aff'd.* 183 F.3d 907 (8th Cir. 1999) (Code section 265(a)(2) applied where a subsidiary borrowed funds on behalf of a parent and the parent used the funds to buy, among other investments, tax-exempt securities).

[438] Rev. Proc. 72-18, 1972-1 C.B. 740.

Direct evidence of a purpose to purchase tax-exempt obligations exists if the proceeds of indebtedness are used for and are directly traceable to the purchase of tax-exempt obligations. Direct evidence of a purpose to carry tax-exempt obligations exists if tax-exempt obligations are used as collateral for indebtedness. In the absence of direct evidence, the interest disallowance rule applies only if the totality of facts and circumstances supports a reasonable inference that the purpose to purchase or carry tax-exempt obligations exists. In general terms, the tracing rule applies only if the facts and circumstances establish a sufficiently direct relationship between the borrowing and the investment in tax-exempt obligations.

Two-percent de minimis exception

Under IRS rules, an interest deduction generally is not disallowed to an individual if during the taxable year the average adjusted basis of the individual's tax-exempt obligations is two percent or less of the average adjusted basis of the individual's portfolio investments and trade or business assets. For a corporation an interest deduction generally is not disallowed if the average adjusted basis of the corporation's tax-exempt obligations is two percent or less of the average adjusted basis of all assets held in the active conduct of the corporation's trade or business. These two-percent safe harbors do not apply to dealers in tax-exempt obligations or to financial institutions.

Interest on installment sales to State and local governments

If a corporation holds tax-exempt obligations (installment obligations, for example) acquired in the ordinary course of its business in payment for services performed for, or goods supplied to, State or local governments, and if those obligations are nonsalable, the interest deduction disallowance rule generally does not apply.[439] The theory underlying this rule is that a corporation holding tax-exempt obligations in these circumstances has not incurred or carried indebtedness for the purpose of acquiring those obligations.

Rules for financial corporations and dealers in tax-exempt obligations

A financial institution generally is denied a deduction for that portion of its interest expense (not otherwise allocable to tax-exempt obligations) that equals the ratio of the financial institution's average adjusted basis of tax-exempt obligations acquired after August 7, 1986 to the average adjusted basis of all the taxpayer's assets (the "pro-rata rule").[440] In the case of an obligation of an issuer that reasonably expects not to issue more than $10 million in tax-exempt obligations within a calendar year (a "qualified small issuer"), the general pro-rata rule does not apply. Instead, only 20 percent of the interest allocable to the tax-exempt obligations of a qualified small issuer is disallowed.[441] The special rule for qualified small issuers also applies to

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[439] Rev. Proc. 72-18, as modified by Rev. Proc. 87-53, 1987-2 C.B. 669.

[440] Sec. 265(b).

[441] Secs. 265(b)(3) and 291(a)(3).

certain aggregated issuances of tax-exempt obligations in which more than one governmental entity receives benefits.[442]

A rule similar to the pro-rata rule applies to dealers in tax-exempt obligations, but there is no exception for qualified small issuers, and the 20-percent disallowance rule does not apply.[443]

Reasons for Change

The tracing rule requires an inquiry into a taxpayer's intent in borrowing. A taxpayer's deduction for the interest expense of borrowing is subject to the tracing rule only if the taxpayer intends to use the proceeds of the borrowing to buy or carry tax-exempt obligations. Because intent is difficult to determine, and because a firm's funds are fungible, the tracing rule has proven difficult to administer and easy to avoid. In particular, related corporations have avoided the tracing rule by engaging in borrowing through one corporation and the holding of exempt obligations by another corporation. Moreover, the two-percent de minimis exception provides a safe harbor for a certain amount of tax arbitrage.

Description of Proposal

The proposal extends to all corporations (other than insurance companies) the pro-rata rule applicable to financial institutions under present law. Accordingly, except in limited circumstances (described below), the proposal repeals the tracing rule, and it repeals the two-percent de minimis exception provided by IRS guidance. The proposal retains the present-law scope of the qualified small issuer exception. The proposal retains the present-law exception for interest on installment sales to State and local governments and extends the exception to taxpayers that become subject to the pro-rata rule under this proposal.

The proposal applies the pro-rata rule to related persons by treating (1) all members of the same affiliated group as one taxpayer[444] and (2) any interest in a partnership held by the taxpayer as a direct ownership interest by the taxpayer in its allocable share of partnership assets and liabilities. In addition, the proposal applies the present-law tracing rule to all other related persons by treating those persons and the taxpayer as a single entity.[445] For example, if one taxpayer borrows with the purpose that a related person will hold tax-exempt obligations (and the taxpayer and related person are not members of an affiliated group),[446] the tracing rule applies to the taxpayer's borrowing.

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[442] Sec. 265(b)(3)(C)(iii).

[443] Rev. Proc. 72-18, sec. 5.

[444] The proposal adopts the definition of affiliated group found in present law section 1563(a).

[445] The proposal defines related persons by reference to section 267(f)(1).

[446] If the taxpayer and the related person are members of an affiliated group, they are treated as a single taxpayer under the proposal, and the pro-rata rule applies.

Effective Date

The proposal is effective for taxable years beginning on or after the date of enactment.

Discussion

The proposal reflects the fact that money is fungible and, therefore, all debt of the taxpayer finances its proportionate share of all of the taxpayer's assets, including tax-exempt obligations. The proposal offers at least two specific advantages over present law. First, because the proposal replaces a subjective inquiry into the taxpayer's purpose for borrowing (that is, the tracing rule) with an objective formulary rule (that is, the pro-rata rule), the proposal is easier than present law for the IRS and taxpayers to apply. Second, the proposal more effectively prevents taxpayers from avoiding interest deduction disallowance through the use of related parties.[447]

As a general matter, curtailing the amount of debt capital available for the purchase of tax-exempt obligations requires issuers of those obligations to pay higher yields to attract purchasers -- in particular, purchasers for whom the tax exemption is less valuable than it is to taxpayers subject to the highest marginal tax rate. Consequently, disallowing interest expense deductions for leveraged purchases of tax-exempt obligations may erode the subsidy to State and local governments provided by tax-exempt obligations, and strengthening the rules could further reduce the subsidy by increasing those governments' borrowing costs.

There are three related responses to this argument. First, without the interest disallowance rules, tax arbitrage would be permitted. Analysts note that unrestricted arbitrage opportunities should make the implicit subsidy of tax-exempt bond finance fully efficient in the sense that the revenue loss of the Federal government would exactly equal the reduced interest cost of the State or local issuer. However, given the uniqueness of many tax-exempt bond issues, the practice of private placement without competitive bidding, and several other factors, some doubt that full efficiency of the subsidy to interest cost would ever be achieved. If full efficiency is not attained, opportunities for tax arbitrage remain. Many observers view arbitrage transactions in which tax deductions support the earning of wholly or partially exempt income by

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[447] In recent guidance, the IRS and Treasury Department have expressed concern over multi-party financing arrangements that avoid the application of section 265. See Rev. Rul. 2004-47, 2004-21 I.R.B. 941 (borrowing and investing by dealer and non-dealer members of affiliated group); Priv. Ltr. Rul. 200428027 (March 26, 2004) (borrowing and investing by subsidiary of bank); Announcement 2004-44, 2004-21 I.R.B. 957 (request for comments regarding the scope of possible proposed regulations under section 7701(f) to address the application of section 265(a)(2) (and section 246A) in transactions involving related parties); 69 F.R. 25535 (May 7, 2004) (proposed amendments to Treas. Reg. secs. 1.265-2 and 1.1502-13 addressing situations in which one member of a consolidated group borrows funds that another member had borrowed from a nonmember and uses those funds to purchase tax-exempt obligations). For recent guidance involving ownership of tax-exempt obligations by investment subsidiaries of banks, see Tech. Adv. Mem. 200434021 (March 12, 2004) and Tech. Adv. Mem. 200434029 (March 26, 2004).

profitable corporations and high-income individual taxpayers (both high marginal tax rate taxpayers) as corrosive to voluntary compliance and respect for the fairness of the Code, even if those taxpayers, at the margin, are not materially better off than if they had not engaged in tax arbitrage transactions. Any such arbitrage creates revenue loss to the Federal government. Second, although arbitrage intended to be curbed by the proposal exists under present law, strengthening the interest expense disallowance rule might not raise borrowing costs significantly. At least one study suggests that most non-financial corporations do not hold debt and tax-exempt bonds simultaneously or do so at a level below the two-percent de minimis exception described above.[448] Thus, any change in demand for tax-exempt bonds that results from the proposal may have little (if any) effect on the price and yields of tax-exempt bonds. Third, if the impact on State and local governments is minimal, this impact might be outweighed by the advantages of replacing a subjective rule (that is, the tracing rule) that has proven avoidable and difficult to apply with an objective rule (that is, the pro-rata rule) that is less avoidable and easier to apply.

Extending the pro-rata rule to all corporations may increase the compliance burden by forcing corporations, including firms with small holdings of tax-exempt bonds, to engage in annual calculations of the proportion of their assets represented by exempt obligations. On the other hand, the two-percent de minimis exception and the difficulty of applying the tracing rule permit corporations under present law to engage in tax arbitrage, albeit on a limited scale. The pro-rata rule will prevent this arbitrage.

The proposal neither extends to non-financial corporations nor repeals the qualified small issuer exception.[449] The present law exception is intended to ensure that small borrowers do not face additional obstacles to debt financing due to the insignificant volume of their issuances. The exception allows qualified small issuers, which may not have access to State bond banks, to borrow funds directly from financial institutions without the application of the interest disallowance rule. Nonfinancial corporations do not participate in small issuances to the same extent as financial institutions.

The proposal retains the present-law exception for interest on installment sales to State and local governments and extends it to taxpayers that become subject to the pro-rata rule under this proposal. A taxpayer that makes an installment sale to a State or local government might have outstanding borrowings and therefore may be engaged in the arbitrage that the pro rata rule generally is intended to prevent. The taxpayer in this situation, however, is holding an installment obligation as payment for services, not for investment. Although the pro-rata rule

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[448] Merle Erickson, Austan Goolsbee, and Edward Maydew, "How Prevalent is Tax Arbitrage? Evidence from the Market for Municipal Bonds," *National Tax Journal*, 56 (June 2003).

[449] The Joint Committee staff previously recommended that the qualified small issuer exception should be eliminated. See 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 Federal Tax System* (JCS-3-01), April 2001. For the reasons described in the accompanying text, this proposal does not include that recommendation.

generally does not inquire into a taxpayer's purposes in borrowing and in holding exempt obligations, lack of investment intent makes the installment sale context fundamentally different from the ordinary holding of exempt obligations. Consequently, an exception from the pro-rata rule is appropriate.

B. Modify Recapture of Section 197 Amortization (sec. 1245)

Present Law

Taxpayers are entitled to recover the cost of amortizable section 197 intangibles using the straight-line method of amortization over a uniform life of fifteen years.[450] With certain exceptions, amortizable section 197 intangibles generally are purchased intangibles held by a taxpayer in the conduct of a business.[451]

Gain on the sale of depreciable property must be recaptured as ordinary income to the extent of depreciation deductions previously claimed,[452] and the recapture amount is computed separately for each item of property. Section 197 intangibles, because they are treated as property of a character subject to the allowance for depreciation,[453] are subject to these recapture rules.

Reasons for Change

Under present law, it is difficult for the IRS to ensure that taxpayers recognize the appropriate amount of ordinary income recapture when multiple intangible assets are sold as part of a single transaction. Because ordinary income is recaptured only to the extent of ordinary deductions previously claimed with respect to each individual asset, taxpayers have an incentive to allocate less of the sales proceeds to intangible assets with respect to which significant amortization deductions have been claimed. Congress enacted section 197 to reduce controversies between taxpayers and the IRS with respect to acquisition of intangible assets,[454] but the potential for controversy remains with respect to the subsequent disposition of section 197 intangibles.

Description of Proposal

Under the proposal, if multiple section 197 intangibles are sold (or otherwise disposed of) in a single transaction or series of transactions, the seller must calculate recapture as if all of the section 197 intangibles were a single asset. Thus, any gain on the sale (or other disposition) of the intangibles is recaptured as ordinary income to the extent of ordinary depreciation deductions previously claimed on any of the section 197 intangibles. The proposal applies regardless of whether the intangibles were acquired as part of the same acquisition.

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[450] Sec. 197(a).

[451] Sec. 197(c).

[452] Sec. 1245.

[453] Sec. 197(f)(7).

[454] See H.R. Rep. No. 103-111 at 760 (1993).

If the sale transaction includes an intangible whose adjusted basis exceeds its fair market value, such intangible is not subject to recapture and is excluded from this aggregate calculation. The loss on such intangible continues to be permitted to the extent it is permitted under present law.[455]

Effective Date

The proposal is effective for dispositions of property after the date of enactment.

Discussion

Section 197 was enacted in 1993 to minimize disputes regarding the proper treatment of acquired intangible assets by creating a uniform method and period for cost recovery. Where a taxpayer acquires multiple intangible assets as part of a single acquisition of a trade or business, the uniform 15-year amortization period minimizes the incentive for taxpayers or the IRS to manipulate or challenge the valuation of (or allocation of basis among) the various intangible assets. However, upon disposition of multiple intangible assets, the sales price allocation affects the amount of recapture. Because income is recaptured only to the extent of deductions previously claimed with respect to each individual asset, taxpayers have an incentive under present law to allocate less sales proceeds to intangible assets with respect to which significant amortization deductions have been claimed.

The following example illustrates present law and the proposal:

Example.–In year 1, a taxpayer acquires two section 197 intangible assets for a total of $45. Asset A is assigned a cost basis of $15 and asset B is assigned a cost basis of $30. The allocation is irrelevant for amortization purposes, as the taxpayer will be entitled to a total of $3 per year ($45 divided by 15 years).

In year 6, the basis of A is $10 and the basis of B is $20. Taxpayer sells the assets for an aggregate sale price of $45, resulting in gain of $15. The character of this gain depends on the recapture amount, which depends in turn on the relative sales prices of the individual assets. Taxpayer has claimed $5 of amortization, and therefore has $5 of recapture potential, with respect to A. Taxpayer has claimed $10 of amortization, and therefore has $10 of recapture potential, with respect to B.

Under present law, if the sale proceeds are allocated $15 to A and $30 to B, the gain on assets A and B will be $5 and $10, respectively. These amounts match the recapture potential for each asset, so the full amount of the gain will be recaptured as ordinary income. However, if the sale proceeds instead are allocated $25 to A and $20 to B, the full $15 gain will be recognized with respect to A, and only $5 (full recapture potential with respect to A) will be recaptured as ordinary income. The remaining $10 of gain attributable to A will be treated as capital gain. No gain (and thus no recapture) will be recognized with respect to

[455] See sec. 197(f)(1), which disallows the loss if any other section 197 intangibles acquired as part of the same acquisition are retained.

Asset B, and only $5 of the $15 recapture potential is recognized. This distinction creates an incentive to manipulate the sales price allocation and increases the potential for disputes, which is the specific circumstance Congress sought to eliminate with the enactment of section 197.

Under the proposal, the taxpayer calculates recapture as if assets A and B were a single asset. For purposes of the calculation, the proceeds are $45 and the gain is $15. Because a total of $15 of amortization has been claimed with respect to assets A and B, the full $15 gain is recaptured as ordinary income.

This issue is similar to the one addressed by present-law section 197(f)(1), which disallows a loss on any section 197 intangible if any other section 197 intangible acquired as part of the same acquisition is retained. While section 197(f)(1) can sometimes operate to defer real economic losses, it eliminates the potential for disputes over valuation issues. Similarly, the policy of section 197 is best served by eliminating the significance of the allocation of basis (and sale proceeds) among individual intangible assets with respect to recapture.

Like section 197 itself, the proposal will not entirely eliminate the controversies in this area. Specifically, valuation of intangible assets could still be controversial (as it is under present law) with respect to whether an individual intangible asset is sold at a loss and, therefore, not subject to the recapture provisions. However, applying the proposal to intangibles sold at a loss would create an opportunity for taxpayers to circumvent the recapture rules by combining gain and loss properties in a single transaction to avoid recapture on the gain intangibles. The proposal serves to eliminate controversies in situations where it is clear that all assets have appreciated in value relative to their adjusted bases.

A possible alternative approach would require taxpayers to calculate recapture as if the sale proceeds were allocated such that the gain on each asset was proportional to each asset's recapture potential. Thus, for recapture purposes only, intangibles with respect to which the taxpayer had taken the most amortization deductions would be allocated an amount of proceeds resulting in the greatest gain. The primary benefit of this alternative approach is that it is more effective in eliminating disputes between the IRS and taxpayers because it applies to all intangibles, regardless of whether sold at a gain or a loss. However, the proposal is simpler, is consistent with present-law section 197(f)(1), and does not require taxpayers to calculate recapture on the basis of an allocation which may be different from the one agreed to by the parties to the transaction.

C. Modify Application of Income Forecast Method of Depreciation (sec. 167)

Present Law

The cost of motion picture films, sound recordings, copyrights, books, and patents are eligible to be recovered using the income forecast method of depreciation. Under the income forecast method, a property's depreciation deduction for a taxable year is determined by multiplying the adjusted basis of the property by a fraction, the numerator of which is the gross income generated by the property during the year, and the denominator of which is the total forecasted or estimated gross income expected to be generated prior to the close of the tenth taxable year after the year the property was placed in service. Any costs that are not recovered by the end of the tenth taxable year after the property was placed in service may be taken into account as depreciation in such year. In general, the adjusted basis of property that may be taken into account under the income forecast method only includes amounts that satisfy the economic performance standard of section 461(h). An exception to this rule applies to participations and residuals.

Under the American Jobs Creation Act of 2004 ("AJCA"), solely for purposes of computing the allowable deduction for property under the income forecast method of depreciation, participations and residuals may be included in the adjusted basis of the property beginning in the year such property is placed in service (even if economic performance has not yet occurred) if such participations and residuals relate to income to be derived from the property before the close of the tenth taxable year following the year the property is placed in service.[456] For this purpose, participations and residuals are defined as costs the amount of which, by contract, varies with the amount of income earned in connection with such property.

Alternatively, rather than accounting for participations and residuals as a cost of the property under the income forecast method of depreciation, the taxpayer may deduct those payments as they are paid, consistent with the *Associated Patentees*[457] decision. This may be done on a property-by-property basis and must be applied consistently with respect to a given property thereafter.

The inclusion of participations and residuals in adjusted basis beginning in the year the property is placed in service applies only for purposes of calculating the allowable depreciation deduction under the income forecast method. For all other purposes, the general basis rules of sections 1011 and 1016 apply. Thus, in calculating the adjusted basis for determining gain or loss on the sale of an income forecast property, participations and residuals are treated as

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[456] AJCA also grants authority to the Treasury Department to prescribe appropriate adjustments to the basis of property (and the look-back method) to reflect the treatment of participations and residuals under the provision.

[457] *Associated Patentees, Inc. v. Commissioner*, 4 T.C. 979 (1945).

increasing the taxpayer's basis only when such items are properly taken into account under the taxpayer's method of accounting.[458]

Reasons for Change

In some cases, the present-law rule relating to participations and residuals allows taxpayers to deduct costs before they have been paid or incurred. This is because the basis used for calculating the income forecast deduction can differ from the property's actual adjusted basis. Taxpayers should not be permitted to deduct costs prior to the time such costs are paid or incurred, under principles of economic performance that are generally applicable in determining the timing of deductions.

Description of Proposal

Under the proposal, depreciation deductions under the income forecast method would be disallowed to the extent that they would cause the adjusted basis for purposes of determining gain or loss on sale to become negative.[459] Any disallowed deductions will effectively be carried over by operation of the income forecast formula in subsequent years.

Effective Date

The proposal is effective for property placed in service after the date of enactment.

Discussion

The present-law rule permitting the inclusion of participations and residuals in basis when the property is placed in service generally is appropriate because the income to which the participations and residuals relate is included in the denominator of the formula. Effectively, one must use this "hypothetical basis" rather than the actual basis (for gain or loss purposes) in order for the formula to work correctly. However, the result becomes inappropriate when the income forecast depreciation deductions exceed the actual adjusted basis of the property (used to determine gain or loss) because taxpayers should not be permitted to deduct costs prior to the time the costs are paid or incurred by the taxpayer. The proposal attempts to prevent this result.

The operation of the proposal is illustrated in the following example:

> Example.–A taxpayer creates a film with negative costs (i.e., production costs) of $100. The expected revenue stream over each of the next five years is: $300, $40, $40, $10, and $10, respectively, for a total of $400 expected revenue. The taxpayer is contractually obligated to pay participations equal to 80 percent of all

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[458] For example, in the case of participations or residuals to which section 404(a)(5) or section 404(b)(1) applies, such participations or residuals would not increase the taxpayer's basis until the amount is included in the gross income of the participant.

[459] It is possible that Treasury may address this issue when regulations are issued under AJCA. See sec. 167(g)(7)(E).

revenue from the film in excess of $350. Thus, the taxpayer expects to pay a total of $40 of participations over the course of years three through five. Accordingly, the taxpayer uses a basis of $140 for purposes of its income forecast calculation.

For year one, under present law, the taxpayer's income forecast calculation is $140 multiplied by (300/400), which equals $105. However, under the proposal the deductible amount is limited to $100 of deductions in year one because economic performance has occurred only with respect to the first $100 of "hypothetical basis" used in the calculation. Because the taxpayer's adjusted basis in the film is reduced only by the $100 allowable deduction, the disallowed $5 is carried over by operation of the income forecast formula to subsequent years.

The proposal allows taxpayers to use the "hypothetical basis" to determine their tentative income forecast deduction as under present law, but disallows the tentative deduction to the extent it would cause the taxpayer's true adjusted basis in the property to go below zero. The disallowed amount is allowed in a future year when the true adjusted basis would not be reduced below zero, when the taxpayer has paid or incurred the costs and included them in basis, consistent with principles of economic performance.

D. Apply Luxury Automobile Limitations to Sport Utility Vehicles (sec. 280F)

Present Law

A taxpayer is allowed to recover, through annual depreciation deductions, the cost of certain property used in a trade or business or for the production of income. The amount of the depreciation deduction allowed with respect to tangible property for a taxable year is determined under the modified accelerated cost recovery system ("MACRS"). Under MACRS, passenger automobiles generally are recovered over five years.

In lieu of depreciation, a taxpayer with a sufficiently small amount of annual investment may elect to expense such investment under section 179. The Jobs and Growth Tax Relief Reconciliation Act of 2003 ("JGTRRA")[460] increased the amount a taxpayer may deduct, for taxable years beginning in 2003 through 2005, to $100,000 of the cost of qualifying property placed in service for the taxable year. In general, qualifying property is defined as depreciable tangible personal property that is purchased for use in the active conduct of a trade or business. The $100,000 amount is reduced (but not below zero) by the amount by which the cost of qualifying property placed in service during the taxable year exceeds $400,000. The American Jobs Creation Act of 2004 ("AJCA")[461] extends the temporary $100,000/$400,000 modifications to section 179 through 2007. Prior to the enactment of JGTRRA (and for taxable years beginning in 2008 and thereafter) a taxpayer with a sufficiently small amount of annual investment may elect to deduct up to $25,000 of the cost of qualifying property placed in service for the taxable year. The $25,000 amount is reduced (but not below zero) by the amount by which the cost of qualifying property placed in service during the taxable year exceeds $200,000.

However, section 280F(a) limits the annual cost recovery deduction with respect to certain passenger automobiles. This limitation is commonly referred to as the "luxury automobile depreciation limitation." For passenger automobiles placed in service in 2004 and for which the additional first-year depreciation deduction under section 168(k) is not claimed, the maximum amount of allowable depreciation is $2,960 for the year in which the vehicle is placed in service, $4,800 for the second year, $2,850 for the third year, and $1,675 for the fourth and later years.[462] This limitation applies to the aggregate deduction provided under present law for depreciation and section 179 expensing.

In general, if a taxpayer does not elect the additional first-year depreciation deduction under 168(k), the calculated MACRS depreciation deductions for a vehicle placed in service in 2004 are less than the luxury automobile depreciation limitations if the vehicle costs less than $14,540. Thus, the limitations reduce the taxpayer's cost recovery deduction for such a vehicle

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[460] Pub. L. No. 108-27, sec. 202 (2003).

[461] Pub. L. No. 108-357, sec. 910 (2004).

[462] Rev. Proc. 2004-20, 2004-13 I.R.B. 642. The 2005 amounts have not yet been released by the IRS.

only if the taxpayer is eligible for section 179 expensing of the cost of the vehicle. Whether a taxpayer purchasing a car for more than $14,540 is limited under present law depends upon the taxpayer's percentage of business use of the vehicle.

For purposes of the luxury automobile depreciation limitation, passenger automobiles are defined broadly to include any 4-wheeled vehicles that are manufactured primarily for use on public streets, roads, and highways and which are rated at 6,000 pounds unloaded gross vehicle weight or less.[463] In the case of a truck or a van, the luxury automobile depreciation limitation applies to vehicles that are rated at 6,000 pounds gross vehicle weight or less. Under regulatory authority, certain trucks and vans are exempted as "qualified nonpersonal use vehicles." These vehicles are exempted by reason that the design of the vehicle suggests such vehicle is not likely to be used more than a de minimis amount for personal uses.[464] Sport utility vehicles ("SUVs") are treated as trucks for the purpose of applying the section 280F(a) limitation.

In addition to extending the increased expensing limits of JGTRRA, the AJCA limits the deduction under section 179 for certain vehicles not subject to section 280F to $25,000 (the "section 179 expensing limitation"). This provision applies generally to sport utility vehicles rated between 6,000 pounds and 14,000 pounds gross vehicle weight, but does not apply to any vehicle which has seating for nine individuals behind the driver's seat or a cargo area that is at least six feet long.

Reasons for Change

As Congress acknowledged in enacting AJCA, certain vehicles not subject to the luxury automobile depreciation limitations contain features which are not necessary for purposes of conducting business.[465] While Congress restricted the ability of certain sport utility vehicles to qualify for the expanded expensing provisions of section 179, such vehicles remain exempt from the luxury automobile depreciation limitation and are therefore accorded more favorable treatment than are luxury sedans, sport utility vehicles, and pickup trucks weighing less than 6,000 pounds. Because the luxury automobile depreciation limitation and the section 179 expensing limitation appear to have the same rationale, it is appropriate to apply the luxury automobile depreciation limitation to the class of vehicles targeted by the section 179 expensing limitation.

When the luxury automobile limits were enacted, new car sales included far fewer trucks and vans than today, and those vehicles were more likely to be used in the operation of a business. Now, nearly half of all new vehicle sales are not automobiles, and many more of the larger vehicles are purchased as personal-use vehicles than they were previously. For these

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[463] Sec. 280F(d)(5). Exceptions are provided for any ambulance, hearse, or any vehicle used by the taxpayer directly in the trade or business of transporting persons or property for compensation or hire.

[464] Temp. Treas. Reg. sec. 1.274-5T(k). Examples of exempted trucks include flatbed trucks, refrigerated trucks, and delivery trucks with seating only for the driver.

[465] See S. Rep. No. 108-192, at 195 (2004).

reasons, it is no longer appropriate to assume that the purchase of these larger vehicles is a likely indicator of 100 percent business use. Thus, an extension of the luxury automobile limits to these larger vehicles is appropriate.

Description of Proposal

Under the proposal, all vehicles subject to either the present-law luxury automobile depreciation limitation or to the present-law section 179 expensing limitation for certain sport utility vehicles are made subject to the luxury automobile limitation. Because the luxury automobile depreciation limitation is more restrictive than the treatment under the present-law section 179 expensing limitation for sport utility vehicles, the expensing limitation is repealed.

Effective Date

The proposal is effective for property placed in service after the date of enactment.

Discussion

The Congress has identified two classes of business-use vehicles that have characteristics and features that are not necessary for the conduct of a taxpayer's business. However, under present law, the more stringent luxury automobile depreciation limitation is applied to one class (e.g., an expensive luxury sedan) and the less stringent section 179 expensing limitation is applied to the other class (e.g., an expensive large SUV). Because the two limitations appear to have the same rationale, tax neutrality calls for applying the same rule to both classes of vehicles. To apply different rules to the different classes would favor the purchase of one vehicle over another. The non-neutrality also may influence producers to design certain vehicles to be heavier, thereby sacrificing some fuel economy, compared to a design they might have chosen in the absence of the disparate tax treatment.

Because it favors certain vehicles over others, some may view present law as unfair. If one taxpayer purchases an SUV weighing 5,700 pounds while another taxpayer purchases an SUV weighing 6,200 pounds, they presently receive disparate treatment under the income tax. On the other hand, these two taxpayers may not be equally situated if one taxpayer truly needed the heavier vehicle, perhaps because the taxpayer requires a heavier suspension for his vehicle.

Because section 280F(a) provides slower cost recovery, the proposal would increase the user cost of heavier SUVs, even if used 100 percent for business purposes, compared to present law. This likely would reduce the sale of heavier SUVs; however, if a vehicle is necessary for the taxpayer's business, the taxpayer may still choose to purchase a heavy SUV or another vehicle. Aggregate vehicle sales may be only modestly reduced.

The proposal, like present law, may suffer from taking a broad view of what constitutes a "luxury" vehicle. The MACRS cost recovery generally allows an investment in cars and light trucks to be recovered over five years. The calculated MACRS depreciation deductions will exceed the luxury automobile depreciation limitations for any 100 percent business use passenger automobile whose cost exceeds $14,540. One can interpret section 280F(a) as implying that $14,540 constitutes the maximum pure-business investment element of a vehicle, with any excess cost reflecting a luxury element which provides personal comfort and utility but

is not necessary for business use. Some may deem the $14,540 price as not indicative of "luxury" in today's vehicle market. However, such an observation would argue for broader reform, but would not argue for including some vehicles above the specified price threshold while excluding other vehicles above that threshold. A broader revenue neutral reform could increase the price threshold while subjecting all vehicles costing greater than the threshold to section 280F(a).

Under the proposal, the luxury automobile depreciation limitation continues to apply to any vehicle that is currently subject to the limitation under present law. In addition, the limitation is expanded to apply to sport utility vehicles rated at 14,000 pounds gross vehicle weight or less. The present-law exceptions (currently in section 179) continue to be provided for any vehicle which has seating for nine individuals behind the driver's seat or a cargo area that is at least six feet long. This design-based exception is consistent with the reasoning behind the exceptions for certain trucks and vans from section 280F(a) granted by the Secretary under present law.[466]

[466] Temp. Treas. Reg. sec. 1.274-5T(k) grants the exemption to "any vehicle which, by reason of its nature (i.e., design), is not likely to be used more than a de minimis amount for personal purposes."

E. Disallow Deduction for Interest on Debt Allocable to Tax-Exempt Income of Insurance Companies (secs. 265 and 832)

Present Law

In general

No deduction is allowed for interest on debt incurred or continued to purchase or carry obligations, the interest on which is exempt from tax (sec. 265(a)(2)). This rule applies to both individuals and corporations, and incorporates a tracing notion.

In the case of financial institutions, a pro-rata interest deduction disallowance rule applies. Under that rule, no deduction is allowed for the portion of the taxpayer's interest expense that is allocable to tax-exempt interest, based on the ratio of the adjusted basis of the taxpayer's tax-exempt obligations to the adjusted basis of all its assets (sec. 265(b)). An exception to the pro-rata disallowance rule applies in the case of tax-exempt obligations of a qualified small issuer.

Insurance companies

In general

The rules of subchapter L determine the income of life insurance companies (sec. 801 et seq.) and property and casualty insurance companies (sec. 831 et seq.) Under these rules, different pro-rata interest deduction disallowance rules apply to life insurance companies and to property and casualty companies.

Life insurance companies

A life insurance company is subject to tax on its life insurance company taxable income ("LICTI"). LICTI is life insurance gross income reduced by life insurance deductions. A life insurance company includes in gross income any net decrease in reserves, and deducts a net increase in reserves. Methods for determining reserves for tax purposes generally are based on reserves prescribed by the National Association of Insurance Commissioners for purposes of financial reporting under State regulatory rules.

Because deductible reserves might be viewed as being funded proportionately out of taxable and tax-exempt income, the net increase and net decrease in reserves are computed by reducing the ending balance of the reserve items by a portion[467] of tax-exempt interest (sec.

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[467] The portion is referred to in the statute as the "policyholders' share" of tax-exempt interest; this term originates with the notion that a share of the assets of the company really belongs to the policyholders. The policyholders' share is the excess of 100 percent over the portion determined as the "company's share" under section 812. In general, the company's share is that percentage that reflects the investment income of the company for the taxable year, reduced by policyholder dividends, policy interest credited to policyholders, and a portion of investment expenses.

807(b)(2)(B) and (b)(1)(B)). Similarly, a life insurance company is allowed a dividends-received deduction for intercorporate dividends from nonaffiliates only in proportion to the company's share of such dividends (secs. 805(a)(4), 812). Fully deductible dividends from affiliates are excluded from the application of this proration formula (so long as such dividends are not themselves distributions from tax-exempt interest or from dividend income that would not be fully deductible if received directly by the taxpayer). In addition, the proration rule includes in prorated amounts the increase for the taxable year in policy cash values of life insurance policies and annuity and endowment contracts owned by the company (the inside buildup on which is not taxed).

In recent years, life insurers have not owned significant amounts of tax-exempt obligations.

Property and casualty insurance companies

The taxable income of a property and casualty insurance company is determined as the sum of its underwriting income and investment income (as well as gains and other income items), reduced by allowable deductions (sec. 832). Underwriting income means premiums earned during the taxable year less losses incurred and expenses incurred.

In calculating its reserve for losses incurred, a property and casualty insurance company must reduce the amount of losses incurred by 15 percent of: (1) the insurer's tax-exempt interest, (2) the deductible portion of dividends received (with special rules for dividends from affiliates), and (3) the increase for the taxable year in the cash value of life insurance, endowment or annuity contracts the company owns (sec. 832(b)(5)).

This 15-percent proration requirement was enacted in 1986. The reason the provision was adopted was Congress' belief that "it is not appropriate to fund loss reserves on a fully deductible basis out of income which may be, in whole or in part, exempt from tax. The amount of the reserves that is deductible should be reduced by a portion of such tax-exempt income to reflect the fact that reserves are generally funded in part from tax-exempt interest or from wholly or partially deductible dividends."[468]

In recent years, property and casualty insurers have owned about 10-14 percent of outstanding tax-exempt obligations.

Reasons for Change

The 15-percent proration rule applicable to untaxed income of property and casualty insurance companies does not effectively limit the companies' ability to engage in tax arbitrage. Applying a rule similar to the rule for other types of financial intermediaries would improve neutrality of the tax law by treating more financial intermediaries similarly, and would more effectively limit tax arbitrage.

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[468] H.R. Rep. No. 99-426, 670.

Description of Proposal

The proposal extends to property and casualty insurers the pro-rata interest disallowance rule that applies to financial institutions under present law section 265(b). As under the present-law rules for insurers, however, the proposal applies not only with respect to tax-exempt interest, but also with respect to the untaxed portion of dividends received and insurance inside buildup. Thus, in lieu of the current 15-percent proration rule, a property and casualty insurer would be allowed no deduction for the portion of its interest expense that is allocable to: (1) the insurer's tax-exempt interest, (2) the deductible portion of dividends received (with special rules for dividends from affiliates), and (3) the increase for the taxable year in the cash value of life insurance, endowment or annuity contracts the company owns. The portion of the deduction for interest expense that is subject to the proposal is determined by the ratio of the adjusted basis of the taxpayer's tax-exempt obligations, dividend-paying stock and unborrowed policy cash values to the adjusted basis of all its assets. The proposal does not change the tax treatment of life insurers.

Effective Date

The proposal is effective for investments acquired on or after the date of enactment.

Discussion

The premise of the proposal is that interest deduction limitation rules based on fungibility of money should be applied to all corporate taxpayers in a similar manner, to the extent practical. In particular, the arbitrary 15-percent rule currently applicable to property and casualty insurers should be replaced by the more accurate allocation rule of section 265(b) that uses the taxpayer's asset bases to determine the portion of interest costs that finance untaxed income. Because life insurers already are subject to an interest limitation rule (based on investment income) that is specific to life insurance products that pay policyholder dividends and interest (which property and casualty insurance products generally do not), extending the 265(b) rule to life insurers may not be necessary.

The proposal arguably imposes a greater administrative and recordkeeping burden on property and casualty insurers by substituting a percentage based on the ratio of adjusted bases of assets for the present-law flat 15-percent rate. However, business taxpayers usually know the adjusted bases of their assets. Further, the proposal simplifies tax administration by applying the same rules to all (or most) taxpayers, and provides a more accurate measurement of taxable income by the use of relative asset basis for determining what portion of interest costs are financing untaxed income in lieu of a flat percentage.

A narrower proposal could be limited to interest on tax-exempt obligations as under section 265(b), both for conformity with other taxpayers subject to 265(b), and to facilitate the application of the interest deduction limitation in the case of related parties (some of which might not be property and casualty insurers). However, there may be little difference among types of untaxed income for purposes of applying an interest deduction limitation based on fungibility, particularly when no such distinction among types of untaxed income is made for property and casualty insurers under their present-law interest limitation rule.

Because it would be less attractive under the proposal than under current law for property and casualty insurance companies to hold tax-exempt debt, the borrowing costs to State and local governments may rise. As described previously in this report,[469] unrestricted arbitrage opportunities should make the subsidy of tax-exempt bond financing more efficient. That subsidy, however, may never be fully efficient, and arbitrage opportunities may remain. This arbitrage may harm voluntary compliance and creates revenue loss to the Federal government.

[469] See Part VII.A. of this Report, "*Disallow Deduction for Interest on Indebtedness Allocable to Tax-Exempt Obligations*."

F. Eliminate Double Deduction of Mining Exploration and Development Costs Under the Minimum Tax (sec. 57)

Present Law

Under present law, mining development costs are expensed in computing taxable income, unless either the deferred expense method is elected under section 616(b) or 10-year amortization is elected under section 59(e). In addition, a taxpayer may elect to expense mining exploration costs under section 617 or amortize the costs over a 10-year period under section 59(e). Also, a deduction for depletion is allowed with respect to mines. One method of computing the allowance for depletion is the percentage method that is based on the income of the mining property and is not limited by the adjusted basis of the property.

In determining alternative minimum taxable income ("AMTI") mining exploration and development costs with respect to a mine are required to be capitalized and amortized over a 10-year period, unless the deferred expense method is elected under section 616(b).[470] In addition, the deduction for percentage depletion is limited to the adjusted basis of the property at the end of the taxable year (without regard to the depletion deduction for the year).[471]

Under the rules, notwithstanding the adjusted basis limitation on percentage depletion, a taxpayer may deduct more than 100 percent of its exploration and development costs in computing AMTI. For example, assume a taxpayer incurs $1 million in development costs in 2005 with respect to a mine that has a zero basis and that the deferred expense method is not elected. Also, assume that the deduction for percentage depletion (without regard to the basis limitation) for 2005 is $900,000. Under present law, in computing AMTI, the taxpayer is allowed to deduct $100,000 per year in development costs for each of the 10 taxable years beginning in 2005, and, in addition, is allowed to deduct percentage depletion of $900,000 in 2005, for a total of $1.9 million in deductions.

Reasons for Change

The double deduction of the same expenses in computing alternative minimum taxable income should not be permitted.

Description of Proposal

The deduction for depletion under the alternative minimum tax is amended by excluding from the adjusted basis of any mining property, the amount of mining exploration and development costs that may be allowed as a deduction to the taxpayer in computing AMTI in a future taxable year.

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[470] Sec. 56(a)(2).

[471] Sec. 57(a)(1).

In the example described above, the $1 million development costs will be amortized over a 10-year period and no amount will be allowed as a deduction for depletion in computing AMTI.[472]

Effective Date

The proposal applies to taxable years beginning after the date of enactment.

Discussion

The 10-year amortization requirement was enacted in 1986 to better measure the economic income from mineral properties. However, because percentage depletion (not in excess of adjusted basis) is also allowed in computing AMTI, the failure to coordinate the two provisions improperly allows a deduction in excess of costs incurred.

[472] If the taxpayer elects the deferred expense method under section 616(b) or 10-year amortization under section 59(e), the deduction for depletion will remain zero.

VIII. EXEMPT ORGANIZATIONS

A. Require Five-Year Review of Exempt Status of Public Charities and Private Foundations and Annual Notice by Organizations Not Required to File Information Returns (sec. 508)

Present Law

Application for tax exemption

Section 501(c)(3) organizations (with certain exceptions) are required to seek formal recognition of tax-exempt status by filing an application with the IRS (Form 1023). In response to the application, the IRS issues a determination letter or ruling either recognizing the applicant as tax-exempt or not. Certain organizations are not required to apply for recognition of tax-exempt status in order to qualify as tax-exempt under section 501(c)(3) but may do so. These organizations include churches, certain church-related organizations, organizations (other than private foundations) the gross receipts of which in each taxable year are normally not more than $5,000, and organizations (other than private foundations) subordinate to another tax-exempt organization that are covered by a group exemption letter.

A favorable determination by the IRS on an application for recognition of tax-exempt status will be retroactive to the date that the section 501(c)(3) organization was created if it files a completed Form 1023 within 15 months from the end of the month it was formed.[473] If the organization does not file Form 1023 or files a late application, it will not be treated as tax-exempt under section 501(c)(3) for any period prior to the filing of an application for recognition of tax exemption.[474] Contributions to section 501(c)(3) organizations that are subject to the requirement that the organization apply for recognition of tax-exempt status generally are not deductible from income, gift, or estate tax until the organization receives a determination letter from the IRS.[475]

Information required on Form 1023 includes, but is not limited to: (1) a detailed statement of actual and proposed activities; (2) compensation and financial information

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[473] Pursuant to Treas. Reg. sec. 301.9100-2(a)(2)(iv), organizations are allowed an automatic 12-month extension as long as the application for recognition of tax exemption is filed within the extended, i.e., 27-month, period. The IRS also may grant an extension beyond the 27-month period if the organization is able to establish that it acted reasonably and in good faith and that granting relief will not prejudice the interests of the government. Treas. Reg. secs. 301.9100-1 and 301.9100-3.

[474] Treas. Reg. sec. 1.508-1(a)(1).

[475] Sec. 508(d)(2)(B). Contributions made prior to receipt of a favorable determination letter may be deductible prior to the organization's receipt of such favorable determination letter if the organization has timely filed its application to be recognized as tax-exempt. Treas. Reg. secs. 1.508-1(a) and 1.508-2(b)(1)(i)(b).

regarding officers, directors, trustees, employees, and independent contractors; (3) a statement of revenues and expenses for the current year and the three preceding years (or for the years of the organization's existence, if less than four years); (4) a balance sheet for the current year; (5) a description of anticipated receipts and contemplated expenditures; (6) a copy of the articles of incorporation, trust document, or other organizational or enabling document; (7) organization bylaws (if any); and (8) information about previously filed Federal income tax and exempt organization returns, if applicable. The IRS revised the Form 1023 in October 2004.

A favorable determination letter issued by the IRS will state that the application for recognition of tax exemption and supporting documents establish that the organization submitting the application meets the requirements of section 501(c)(3) and will classify (as either an adverse or definitive ruling) the organization as either a public charity or a private foundation.

Review of exempt status

An organization that has received a favorable tax-exemption determination from the IRS generally may continue to rely on the determination as long as "there are no substantial changes in the organization's character, purposes or methods of operation."[476] There is no mandated, periodic procedure to review an organization's continuing qualification for exemption.

Organizations that are classified as public charities (or as private operating foundations) and not as private nonoperating foundations may cease to satisfy the conditions that entitled the organization to such status. The IRS makes an initial determination of public charity or private foundation status (either a definitive ruling, or an advance ruling generally effective for five years and then reviewed again by the IRS) that is subsequently monitored by the IRS through annual return filings. The IRS periodically announces in the Internal Revenue Bulletin a list of organizations that have failed to establish, or have been unable to maintain, their status as public charities or as private operating foundations, and that become private nonoperating foundations.

If the IRS denies an organization's application for recognition of exemption under section 501(c)(3), the organization may seek a declaratory judgment regarding its tax status.[477] Prior to utilizing the declaratory judgment procedure, the organization must have exhausted all administrative remedies available to it within the IRS.

Revocation (and suspension) of exempt status

A ruling or determination letter concluding that an organization is exempt from tax may be revoked or modified by: (1) notice from the IRS to the organization to which the ruling or determination letter was originally issued; (2) enactment of legislation or ratification of a tax treaty; (3) a decision of the United States Supreme Court; (4) issuance of temporary or final Regulations by the Treasury Department; or (5) issuance of a revenue ruling, a revenue

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[476] Treas. Reg. sec. 1.501(a)-1(a)(2).

[477] Sec. 7428.

procedure, or other statement in the Internal Revenue Bulletin.[478] An organization's tax exemption will not be terminated if it becomes inactive for a time so long as the organization does not cease to be a legal entity under the laws of the State in which it is organized.

The IRS generally issues a letter revoking recognition of an organization's tax-exempt status only after: (1) conducting an examination of the organization; (2) issuing a letter to the organization proposing revocation; and (3) allowing the organization to exhaust the administrative appeal rights that follow the issuance of the proposed revocation letter. In the case of a section 501(c)(3) organization, the revocation letter immediately is subject to judicial review under the declaratory judgment procedures of section 7428. To sustain a revocation of tax-exempt status under section 7428, the IRS must demonstrate that the organization no longer is entitled to exemption.

Upon revocation of tax-exemption or change in the classification of an organization (e.g., from public charity to private foundation status), the IRS publishes an announcement of such revocation or change in the Internal Revenue Bulletin.[479] Contributions made to organizations by donors who are unaware of the revocation or change in status ordinarily will be deductible if made on or before the date of publication of the announcement.

The IRS may suspend the tax-exempt status of an organization for any period during which an organization is designated or identified by U.S. authorities as a terrorist organization or supporter of terrorism.[480] Such an organization also is ineligible to apply for tax exemption. The period of suspension runs from the date the organization is first designated or identified to the date when all designations or identifications with respect to the organization have been rescinded pursuant to the law or Executive order under which the designation or identification was made. During the period of suspension, no deduction is allowed for any contribution to a terrorist organization.

Information returns

In general, organizations exempt from Federal income tax under section 501(a) are required to file an annual information return with the IRS.[481] Under present law, the information

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[478] Rev. Proc. 90-27, 1990-1 C.B. 514; IRS Pub. No. 557, Tax-Exempt Status for Your Organization (May 2003) at 4-5.

[479] Rev. Proc. 82-39, 1982-2 C.B. 759.

[480] Sec. 501(p) (enacted by Pub. L. No. 108-121, sec. 108(a), effective for designations made before, on, or after November 11, 2003).

[481] Sec. 6033(a)(1). Temporary Treasury Regulations effective January 12, 2005, require that exempt organizations that file at least 250 returns (of any type, including Forms 1099) a calendar year and with assets of at least $100 million file the Form 990 electronically for taxable years ending on or after December 31, 2005, reduced to $10 million in assets for taxable years ending on or after December 31, 2006. Private foundations and charitable trusts meeting the 250 return requirement are required to file the Form 990-PF electronically for taxable years ending on or after December 31, 2006. Temp. Treas. Reg. sec. 301.6033-4T.

return requirement does not apply to several categories of exempt organizations. Organizations exempt from the filing requirement include organizations (other than private foundations), the gross receipts of which in each taxable year normally are not more than $25,000.[482] Also exempt from the requirement are churches, their integrated auxiliaries, and conventions or associations of churches; the exclusively religious activities of any religious order; section 501(c)(1) instrumentalities of the United States; section 501(c)(21) trusts; an interchurch organization of local units of a church; certain mission societies; certain church-affiliated elementary and high schools; certain State institutions whose income is excluded from gross income under section 115; certain governmental units and affiliates of governmental units; and other organizations that the IRS has relieved from the filing requirement pursuant to its statutory discretionary authority.

Reasons for Change

Five-year review

Organizations determined by the Secretary to be described in section 501(c)(3) generally are exempt from taxation and are eligible to receive tax-deductible contributions. These twin benefits are provided on the condition that the organization at all times is organized and operated exclusively for exempt purposes. In general, because these benefits can be substantial, exemption often is granted based on scant evidence of an organization's actual operations, and organizations change over time, it is appropriate periodically to review the exempt status of section 501(c)(3) organizations.

Under present law, tax exemption initially is granted to an organization, often newly formed, based on information provided by the organization regarding its plans for future operations, including detailed information about planned activities, future fundraising expectations, compensation arrangements with insiders, estimated budgets, and relationships with other entities. Though such information is highly relevant to making a determination of whether an organization is described in section 501(c)(3), the exemption application typically is a document based on an organization's aspirations and intentions, and not measured by an organization's experience. Despite these limitations, however, the exemption application forms the basis of an organization's claim to exempt status, and once exemption is granted, it rarely is reviewed or revoked.

As a practical matter, the initial exemption application has become the only procedure through which an organization must justify its claim to tax exemption. Although many section 501(c)(3) organizations are required to report annually to the IRS regarding the organization's activities for the year, the annual information return is designed more to provide data and less to

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[482] Sec. 6033(a)(2); Treas. Reg. sec. 1.6033-2(a)(2)(i); Treas. Reg. sec. 1.6033-2(g)(1). Sec. 6033(a)(2)(A)(ii) provides a $5,000 annual gross receipts exception from the annual reporting requirements for certain exempt organizations. In Announcement 82-88, 1982-25 I.R.B. 23, the IRS exercised its discretionary authority under section 6033 to increase the gross receipts exception to $25,000, and enlarge the category of exempt organizations that are not required to file Form 990.

explore the seminal question of whether the organization remains exempt. No established mechanism exists to hold an organization to account for statements made in the initial exemption application, or gives an organization the opportunity to explain how promises have been kept, how aspirations have been adjusted (often appropriately) to reflect changes in plans and expectations, or how goals have been met as the organization develops. In addition, because the risk of loss of exemption is remote and in general the level of enforcement by the IRS and State officials is low, organizations do not have the threat of a significant sanction to encourage accurate information reporting or overall compliance.

Annual notice for organizations not filing information returns

The present-law exemption from the annual information return filing requirement for small organizations serves two main purposes. Generally, the exemption is intended to relieve small organizations of the burden of a detailed annual filing and to lessen the administrative burden on the Secretary of collecting and maintaining data for such small organizations when the potential benefit of doing so, compared to the resources required, is slight. As a result, however, the Secretary is not able to maintain a record of the continuing existence of such organizations and the public is unable easily to obtain basic information about the organization, such as the organization's current address. The absence of a record is especially problematic for charitable organizations. Although the Secretary publishes the names of organizations to which charitable contributions may be made, if an organization is not required to file with the Secretary and alert the Secretary of its termination, the Secretary does not know when to omit the organization from its list of names.

Description of Proposal

Five-year review

The proposal requires that every five years, each organization described in section 501(c)(3), other than churches, must file with the Secretary such information as would enable the Secretary to determine whether the organization continues to be organized and operated exclusively for exempt purposes and whether the original determination letter should remain in effect (or be modified or revoked).[483] The five-year review filing is required to be made publicly available and to be filed electronically. Failure to satisfy the five-year review filing requirement results in loss of tax-exempt status, effective as of the first day of the taxable period beginning after expiration of the five-year review filing deadline.[484]

The Secretary is not required to take action or make any determination with respect to a five-year review filing. Similar to the filing of a Form 990, under the proposal the Secretary has discretion to review any filing and is permitted to revoke tax-exempt status retroactively or

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[483] The proposal does apply to integrated auxiliaries and conventions or associations of churches.

[484] An exception could be made for failure due to reasonable cause and not to willful neglect. Revocation due to failure to satisfy the five-year review filing requirement is not subject to the declaratory judgment provisions of section 7428.

prospectively, as warranted by the facts and circumstances, if a review undertaken by the Secretary concludes that the organization is not entitled to exemption. The Secretary also may determine based on an examination of the filing that certain activities of an organization are subject to the unrelated business income tax or that excise taxes should apply to certain transactions or activities. If the Secretary conducts an examination of a five-year review filing and determines that the organization continues to be organized and operated for purposes described in section 501(c)(3), the Secretary is not required to issue a new determination letter. Organizations that file the five-year review may continue to rely on their existing determination letter unless informed otherwise by the Secretary.

Information to be filed as part of a five-year review filing include the organization's current articles of incorporation and by-laws or governing instruments; a description of related party transactions entered into by the organization over the previous five-year period (and expected to be entered into over the subsequent five-year period); a detailed narrative about the organization's prior, current, and contemplated operations and practices and how such operations and practices differ from those described in the initial application for exemption (or most recent five-year filing); a description of the prior, current, and contemplated trade or business activities of the organization and whether and how such activities are related to the organization's exempt purposes; a summary of the organization's compensation of management and senior employees for the previous five-year period; the organization's financial statements; a description of the organization's material changes during the prior five-year period; and such additional information as the Secretary may require. Private nonoperating foundations are required to show the percentage over five years of qualifying distributions that are administrative expenses for purposes of meeting the payout requirement of section 4942 and to compare for each year in the five-year period the amount expended on grant-related administrative costs and the amounts expended to recipients as grants for exempt purposes.

Annual notice for organizations not filing information returns

The proposal requires that organizations that are excused from filing an information return by reason of normally having gross receipts below a certain specified amount (generally, under $25,000) [485] shall furnish to the Secretary annually a notice containing the legal name of the organization, any name under which the organization operates or does business, the organization's mailing address and Internet web site address (if any), the organization's taxpayer identification number, the name and address of a principal officer, and evidence of the organization's continuing basis for its exemption from the generally applicable information

[485] The annual notice proposal does not apply to organizations exempted from the filing requirement on other grounds, for example, churches, their integrated auxiliaries, and conventions or associations of churches; the exclusively religious activities of any religious order; section 501(c)(1) instrumentalities of the United States; section 501(c)(21) trusts; an interchurch organization of local units of a church; certain mission societies; certain church-affiliated elementary and high schools; certain state institutions whose income is excluded from gross income under section 115; certain governmental units and affiliates of governmental units; and other organizations that the IRS has relieved from the filing requirement pursuant to its statutory discretionary authority.

return filing requirements. Upon such organization's termination of existence, the organization is required to furnish notice of such termination. Notices would be required to be made publicly available by the Secretary and by the organization.

Under the proposal, if an organization fails to provide the required annual notice for three consecutive years, the organization's tax-exempt status is automatically revoked. In addition, if an organization that is required to file an annual information return under section 6033(a) (e.g., a Form 990) fails to file such an information return for three consecutive years, the organization's tax-exempt status is automatically revoked. If an organization fails to meet its filing obligation to the IRS for three consecutive years in cases where the organization is subject to the information return filing requirement in one or more years during a three-year period and also is subject to the notice requirement for one or more years during the same three-year period, the organization's tax-exempt status is automatically revoked. An organization may not challenge under the Code's declaratory judgment procedures[486] a revocation of tax-exemption made pursuant to the provision. There is no monetary penalty for failure to file the notice. The proposal does not affect an organization's obligation under present law to file required information returns or existing penalties for failure to file such returns.

A revocation of exempt status under the proposal is effective from the date that the Secretary determines was the last day the organization could have timely filed the third required information return or notice. To again be recognized as tax-exempt, the organization must apply to the Secretary for recognition of tax exemption, irrespective of whether the organization was required to make an application for recognition of tax-exemption in order to gain tax exemption originally.

If upon application for tax-exempt status after a revocation under the proposal, the organization shows to the satisfaction of the Secretary reasonable cause for failing to file each of the required annual notices or returns, the organization's tax-exempt status may, in the discretion of the Secretary, be reinstated retroactive to the date of revocation.

Effective Date

Five-year review

The proposal is effective for organizations receiving favorable exempt status determinations within the ten years prior to, on, or after the date of enactment. The first five-year review filings would commence in calendar year 2007. The Secretary has the discretion to determine the due date for the first five-year review of all organizations subject to the proposal.

Annual notice for small organizations not filing information returns

The proposal is effective for notices and returns with respect to annual periods beginning after the date of enactment.

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[486] Sec. 7428.

Discussion

Five-year review

The purpose of the five-year review filing is to convert the initial exemption application from a one-time review of an organization's exempt purposes to the first installment in an ongoing process whereby an organization described in section 501(c)(3) describes its current and planned activities every five years and explains why such activities are consistent with the goals and requirements of section 501(c)(3). Like other filings of section 501(c)(3) organizations, e.g., the original exemption application and annual information returns, the five-year review filing would be publicly available. In general, public availability enables oversight by the public and by State officials of whether an organization meets its exempt purposes, whether contributions are being spent appropriately, and whether State laws, such as charitable solicitation laws, are being observed.

A systematic five-year review process would provide the Secretary and the public with updated information regarding the basis for an organization's exemption, and the ongoing organizational structure and operations of an organization. The proposal recognizes that the Secretary does not have the resources to make a new determination with respect to every organization, or even necessarily to review a high percentage of five-year filings. Thus, the proposal does not require that the Secretary take any action with respect to a five-year review filing. However, the five-year review filing will be a public document subject to public scrutiny and oversight, the Secretary has the discretion to conduct an audit of exempt status based on the information provided in a five-year review filing, and the process of submitting a five-year review filing should have a salutary effect on an organization's annual compliance efforts and also would require an organization to articulate and reveal for scrutiny the basis for its continued exemption from tax.

Certain information required in the five-year review should be of particular use for enforcement purposes, including enforcement by State officials. Five-year summaries of compensation data of senior officers and directors should provide the Secretary, the States, and the public with an easy reference to the compensation practices of the organization over time. A five-year review of related-party transactions should highlight whether an organization has a history of entering into transactions with insiders and whether such transactions should be subject to greater scrutiny, including intermediate sanctions or self-dealing excise taxes. A description every five years of an organization's trade and business activities should provide the Secretary, the States, and the public with a clearer sense of the extent of commercial activity engaged in by an organization and provide a better ability for assessment of whether such activity is related to exempt purposes or subject to the unrelated business income tax. Regarding private nonoperating foundations, five-year reports regarding administrative expenses as a percentage of qualifying distributions and comparative data regarding grant-related administrative expenses and grants made for exempt purposes should help identify foundations that may not be operating efficiently, or that are claiming as qualifying distributions unreasonable and unnecessary administrative expenses.

Once successfully implemented, the five-year review should provide a new source of data for information about types of charitable organizations as well as the overall charitable sector.

Because the filings are publicly available, it will be easier for nongovernmental oversight organizations (as well as the IRS) to collect, analyze, and disseminate data about charitable organizations. Public oversight will not be solely dependent on a year-by-year analysis and comparison of the Form 990 or 990-PF, but would be enhanced by the ability to look to five-year review filings to assess an organization's performance and activities over time.

In general, the Secretary has the discretion to determine the manner of filing the five-year review. For example, the review could take the form of a special "Form 990-5 Year," which would include the information regularly required by the annual information return plus an additional schedule of information relevant to the five-year review. The form is required to be filed electronically in order to facilitate access for the Secretary, State officials, and the public. If the five-year filing were made as a separate schedule to the Form 990, the five-year review would not result in new forms being filed with the Secretary, although the Form 990 would be longer in years when the five-year filing was required.

The five-year review need not be overly burdensome on organizations. Although it requires filing of additional information, such a filing is infrequent and the information required should be readily available to the organization. Small organizations that are exempted from annual return filing requirements are subject to the five-year review filing and so would have to provide additional information of a nature not currently provided. However, in general, the smaller the organization the easier the form should be to complete, and any burden should be minimized by the filing's infrequency. Irrespective of any relative burden on the organization, the information is fundamental to the organization's status as an organization exempt from tax and to which deductible contributions can be made. Some might argue that the Secretary and the public have a right to know such information and that a five-year filing is a reasonable burden to impose for the privilege of tax exemption as a charity.

The proposal is effective for organizations that receive favorable determinations of exempt status within the ten-year period prior to, on, or after the date of enactment. Some might argue that the proposal should apply beyond ten years and cover all existing organizations that have favorable determinations. However, a five-year review filing for all organizations could entail significant additional costs on the IRS as compared to review of organizations recognized as exempt over the past ten years. Some might argue that any such additional cost is largely transitional, however, and that once the process for five-year review is successfully implemented, the IRS will be in a better position than presently to enhance compliance and efficiency through its data collection and reporting. Arguably, however, the need for a five-year review filing is most important for more recently formed organizations and less important for organizations with a more established existence. In addition, covering organizations recognized as exempt over the past ten years captures much of the recent significant growth of section 501(c)(3) organizations (and the exempt sector). For example, in fiscal year 1995, the IRS listed 626,226 section 501(c)(3) organizations. For fiscal year 2003, the number had grown to 964,418, or an increase of 338,192, and a growth rate of 54 percent over nine years.[487]

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[487] Tax-Exempt Organizations and Other Entities Listed on the Exempt Organization Business Master File, by Type of Organization and Internal Revenue Code Section, Fiscal Years

Annual notice for small organizations not filing information returns

The proposal requires that exempt organizations that do not have to file an annual information return by virtue of the amount of their gross receipts file with the Secretary a simple, short annual notice. Under the proposal, the list presently maintained by the Secretary of active organizations to which charitable deductions could be made could regularly be updated, omitting the names of organizations that cease to file a notice or that notify the Secretary of their termination. The proposal thus addresses the problem under present law of taxpayers relying on an incomplete and inaccurate list.

The annual notice need be no longer than a single page. The burden and cost are intended to be modest. No monetary penalty applies for failure to file the notice and so would not place a financial burden on small organizations. The public availability of the notice also would enable the public to know how to contact an organization and would inform the public that the organization was active and in compliance with a basic filing obligation. The sanction of loss of exempt status for failure to file the notice for three consecutive years is also applied to organizations that fail to file an information return for three consecutive years to ensure equitable treatment among exempt organizations.[488]

2000-2003 and Fiscal Years 1995-1998, 2003 IRS Data Book, Excel ver. 4, March 2004 and 1998 IRS Data Book, Excel ver. 4, September 2000.

[488] A similar proposal was passed by the Senate on April 9, 2003, as section 207 of S. 476. The staff of the Joint Committee on Taxation recommended the adoption of a similar proposal. 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, at 98.

B. Impose Termination Tax on Conversions of Assets of Charities (secs. 501, 507, 4941, and 4958)

Present Law

In general

Nonprofit organizations described in section 501(c), including charitable and educational organizations, may seek to convert their assets for use by a taxable entity that is organized and operated for profit. Such a conversion may take one of many forms, including a sale of assets, a joint venture, or a reorganization of the entity for Federal tax or State law purposes. In recent years, the conversion of public charities, especially of hospitals and other health care providers, has resulted in significant amounts of charitable assets being converted to for-profit uses.[489]

Many conversion transactions are subject to State nonprofit corporation or charitable trust laws, as well as Federal tax laws applicable to charitable organizations. Provided that the converting charity receives fair market value for its assets, pays no more than reasonable compensation for services rendered in connection with the transaction, and takes appropriate steps to assure that its assets (including conversion transaction proceeds) remain dedicated to charitable purposes, conversion transactions may be completed in a manner that is consistent with the organization's charitable mission and the tax subsidies provided by the Federal government. In general, no Federal income tax is collected with respect to conversion transactions, either because they are structured to constitute tax-free reorganizations or joint ventures involving the charity, or as taxable transactions the gain from which is not subject to the unrelated business income tax.

Exemption requirements and related provisions

Exemption requirements for charities

Organizations described in section 501(c)(3) (generally "charitable organizations" or "charities") generally are exempt from Federal income tax and are eligible to receive tax-deductible contributions. A charitable organization must be organized and operate exclusively to further one or more tax-exempt purposes constituting the basis of its tax exemption. Section 501(c)(3) organizations are classified either as "public charities" or "private foundations."[490] A

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[489] Conversion transactions are sometimes used to provide organizations access to equity markets, and advocates of conversion transactions claim additional advantages of: (1) cost reduction due to efficiency and enhanced bargaining power with respect to providers of services or goods to the organization; (2) greater accountability to consumers and enhancement of consumer choices; (3) providing a means to offer stock options, restricted stock, and other long-term incentives to management; and (4) avoiding the limiting effects of certain tax rules (such as the treatment of commercial-type insurance under section 501(m)) and fear of regulatory changes. Frances R. Hill and Douglas M. Mancino, "Taxation of Exempt Organizations," sec. 30.01 (2002).

[490] Sec. 509(a). The phrase "public charity" is not defined in the Code, but generally refers to a charitable organization described in section 501(c)(3) that is not a private foundation.

charitable organization may lose its exemption for a various reasons, including failure to operate exclusively for exempt purposes, impermissible private inurement or private benefit, political campaign activities, and substantial nonexempt business or lobbying activities.

Dedication of assets to charitable purposes

An organization is not organized exclusively for exempt purposes (and thus may be denied or lose exempt status) unless its assets are dedicated to an exempt purpose.[491] A charitable organization's assets will be considered dedicated to an exempt purpose if, upon dissolution, such assets would, by reason of a provision in the organization's articles or by operation of law, be distributed for one or more exempt purposes, or to the Federal government, or to a State or local government, for a public purpose, or would be distributed by a court to another organization to be used in such manner as in the judgment of the court will best accomplish the general purposes for which the dissolved organization was organized.[492] The IRS takes the position that a charitable organization's articles of organization must contain a dissolution clause that satisfies these requirements, unless the organization is organized under a State law that satisfies the dissolution provisions of Treasury Regulations section 1.501(c)(3)-1(b)(4).[493]

Intermediate sanctions (excess benefit transaction tax)

The Code imposes excise taxes on excess benefit transactions between disqualified persons and public charities.[494] An excess benefit transaction generally is a transaction in which an economic benefit is provided by a public charity directly or indirectly to or for the use of a disqualified person, if the value of the economic benefit provided exceeds the value of the

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In general, private foundations are subject to special rules (such as reporting requirements, excise tax rules, and charitable deduction limitations) that do not apply to public charities.

[491] Treas. Reg. sec. 1.501(c)(3)-1(b)(4).

[492] *Id.*

[493] Rev. Proc. 82-2, 1982-1 C.B. 367 (providing which State nonprofit corporation statutes satisfy the dissolution provision, and explaining the application of the provision to inter vivos charitable trusts, testamentary charitable trusts, and unincorporated nonprofit associations). See also Rev. Proc. 2003-12, 2003-1 C.B. 316. The IRS provided a sample dissolution provision that may be used by charitable organizations to satisfy this provision. It reads: "[u]pon dissolution of [this organization], assets shall be distributed for one or more exempt purposes within the meaning of section 501(c)(3) of the Internal Revenue Code, or corresponding section of any future Federal tax code, or shall be distributed to the Federal government, or to a state or local government, for a public purpose." Rev. Proc. 82-2, 1982-1 C.B. 367.

[494] Sec. 4958. The excess benefit transaction tax is commonly referred to as "intermediate sanctions," because it imposes penalties generally considered to be less punitive than revocation of the organization's exempt status. The tax also applies to transactions between disqualified persons and social welfare organizations (as described in section 501(c)(4)).

consideration (including the performance of services) received for providing such benefit. The tax generally does not apply to fixed payments made by a public charity to a disqualified person pursuant to a binding written contract between the organization and a person who was not a disqualified person immediately before entering into the contract (the "initial contract exception").[495]

Under present law, a disqualified person is any person in a position to exercise substantial influence over the affairs of the public charity at any time in the five-year period before the excess benefit transaction occurred.[496] Persons holding certain powers, responsibilities, or interests (e.g., officers, directors, or trustees) are considered to be in a position to exercise substantial influence over the affairs of the public charity.

An excess benefit transaction tax is imposed on the disqualified person and, in certain cases, on the organization managers, but is not imposed on the public charity. An initial tax of 25 percent of the excess benefit amount is imposed on the disqualified person that receives the excess benefit. An additional tax on the disqualified person of 200 percent of the excess benefit applies if the violation is not corrected within a specified period of time. A tax of 10 percent of the excess benefit (not to exceed $10,000 with respect to any excess benefit transaction) is imposed on an organization manager that knowingly participated in the excess benefit transaction, if the manager's participation was willful and not due to reasonable cause, and if the initial tax was imposed on the disqualified person.

Private foundation termination tax

In general, section 507 imposes a tax on the voluntary or involuntary termination of the status of an organization as a private foundation unless such organization transfers its net assets to, or begins to operate as, a public charity. Section 507 does not apply to the conversion or liquidation of public charities. The section 507 termination tax generally is equal to the aggregate tax benefit resulting from the organization's status as a charitable organization (including the entire period the organization was exempt as a charitable organization), not to exceed the value of the net assets of the foundation. The tax also applies in certain cases involving willful repeated acts or failures to act, or a willful and flagrant act or failure to act, that gives rise to liability for excise taxes under the private foundation rules.[497]

Under present law, the aggregate tax benefit equals the sum of: (1) aggregate increases in tax that would have been imposed with respect to all substantial contributors to the foundation if deductions for charitable contributions made by the substantial contributors to the foundation had been disallowed; (2) the aggregate increases in Federal income tax that would have been imposed with respect to the foundation if it had not been exempt; and (3) interest on such tax increases, determined from the dates on which the taxes would have been due and payable, to the

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[495] Treas. Reg. sec. 53.4958-4(a)(3).

[496] Sec. 4958(f)(1). A disqualified person also includes certain family members of such a person, and certain entities that satisfy a control test with respect to such persons.

[497] Sec. 507(a)(2).

date on which the organization ceases to be a private foundation. The value of the net assets of the foundation is determined as of the first day on which action is taken by the organization which culminates in its ceasing to be a private foundation, or the date on which it ceases to be a private foundation, whichever value is higher.

The Secretary may abate the unpaid portion of the tax if the private foundation distributes all of its net assets to one or more public charities or governmental units, or in certain cases if corrective action has been taken pursuant to State law to insure that the assets of the private foundation are preserved for charitable purposes.

In enacting section 507, "Congress concluded that foundations should not receive substantial and continuing tax benefits in exchange for the promise of the use of the assets involved for educational, charitable, religious, etc., purposes but avoid the carrying out of these responsibilities."[498] There is no indication whether the focus of the Congress in 1969 on private foundation abuses meant that applying the termination tax to public charities was not considered at that time.

Application of Federal tax law to conversion transactions

There are a variety of structures used to effect conversion transactions. If a conversion is structured as a sale, lease, or other transfer of assets, the transferring exempt organization may remain in existence and continue to use the transaction proceeds to further charitable purposes, or may form a new charity to use the proceeds for charitable purposes. If a conversion is structured as a merger or change in form of the corporation under State law, the charity ceases to exist as a nonprofit organization, and a new charity may be established to receive and hold the assets to be used to further charitable purposes.

Conversion transactions must be structured in a manner that is consistent with the organizational requirements of an exempt organization, including that the organization's assets are dedicated to an exempt purpose. Conversion transactions generally involve a realization event for Federal income tax purposes, although a converting charitable organization often does not recognize income on the conversion transaction.[499]

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[498] *Id.* at 56.

[499] Frances R. Hill and Douglas M. Mancino, "Taxation of Exempt Organizations," sec. 30.02[4][d] (2002) (change in form under State law might be treated as a tax-free recapitalization under section 368(a)(1)(E) or disregarded entirely; merger might be treated as a tax-free reorganization; other transfers might be viewed as a sale of assets by the charity, with exclusions of gain or loss from unrelated business income as a transaction that furthers the charity's exempt purpose, or as gain or loss from the sale, exchange, or other disposition of assets that is excludable under section 512(b)(5)). See, e.g., Priv. Ltr. Rul. 200434028 (charity that transfers all of its student loan notes to a taxable corporate subsidiary in exchange for stock in the subsidiary will not recognize unrelated business income on the transfer of the assets, upon receipt of dividends, or on a subsequent redemption or sale of the stock, as it constitutes "a one time sale of the principal asset").

The sale or other transfer by a public charity of its assets to a for-profit entity for less than fair market value may justify revocation of the charity's exempt status through the private inurement doctrine (for insider transactions), or through the private benefit doctrine (for non-insider transactions). However, "[i]n practice, revocation of tax-exempt status, with or without the imposition of [excess benefit transaction] excise taxes, would occur only when the organization no longer operates as a charitable organization."[500] Thus, under present law, an arrangement between a charity and its acquirer arguably would have to be found to be so unfair to the charity that the organization cannot be regarded as operating in a charitable manner in order to revoke exemption based on the particular transaction. In addition, a conversion agreement between a charity and an acquiring party might not be subject to the section 4958 excess benefit transaction tax, either because the transaction is not with insiders of the organization, or because the agreement fits within the initial contract exception.

If the circumstances of a transaction are determined to warrant revocation of exempt status of the participating charity, present law provides no clear rules to determine what the tax consequences of revocation are in a particular case. There is no provision in the tax law for the voluntary termination or conversion of exempt status,[501] and the tax consequences in the event an organization's exempt status is revoked can be unclear. The dedication of assets requirement "does not, in a literal sense, 'prevent' an individual from doing anything."[502]

Reasons for Change

Conversion transactions raise concerns that: (1) charitable assets may be transferred to for-profit companies for less than fair market value; (2) excessive compensation and severance amounts are paid to officers, directors, and employees of the charity or the acquiring for-profit entity; and (3) the charity's assets will not be used for their intended charitable purposes following the completion of the transaction.[503] Opportunities for such abuses are greatest in

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[500] H.R. Rep. No. 104-506, 59, n.15 (legislative history to the intermediate sanctions rules). See also *Caracci v. Commissioner*, 118 T.C. 379 (2002) (certain insider transactions warranted imposition of the section 4958 excise taxes but did not justify revocation of exempt status).

[501] Bruce R. Hopkins, "The Law of Tax-Exempt Organizations," sec. 33.3(b) (8th ed. 2003).

[502] *Id.* at sec. 33.3(b), note 71 (8th ed. 2003).

[503] Evelyn Brody, "Whose Public? Parochialism and Paternalism in State Charity Law Enforcement," 79 Indiana Law Journal 937, 962-63 (Fall 2004) ("[c]ommunities have been worrying about behind-closed-doors sales of nonprofit hospital assets: the community might be short-changed either in the amount paid for the assets (and hence the funds available for future charity) or in the quality and price of future for-profit hospital services. Some also suspect conflicts of interest on the part of the nonprofit's trustees and officers, who might receive positions either in the new hospital management or the resulting foundations."); Terry Roth Reicher, "Assuring Competent Oversight to Hospital Conversion Transactions", 52 Baylor Law Review 83, 91-92 (Winter 2000) (major objections to conversion transactions stemmed from

situations where officers, directors, and employees of the charity enter into relationships with the acquiring entity that put them in a position of influence over the affairs of the acquirer. Such conflicts of interest may make it difficult to ensure that the best interests of the charitable beneficiaries are protected, and that the charity's assets remain dedicated for charitable purposes. The large number of conversion transactions over recent years involving the conversion of charitable assets to for-profit uses raises serious questions about the ability of the IRS to enforce the Federal tax law requirement that a public charity's assets be perpetually dedicated to charitable purposes. Strict enforcement of this requirement may be accomplished through a termination tax, similar to the present-law termination tax on private foundations, imposed on all charitable organizations that liquidate or engage in certain major transactions without dedicating the entire value of their assets to charitable purposes.

Description of Proposal

Overview

The proposal modifies present law to improve the Federal Government's ability to enforce the requirement that a charitable organization's assets remain dedicated to charitable purposes by imposing a termination tax on the liquidation or conversion of a charitable organization. The termination tax equals the value of the organization's net assets that are not dedicated to charitable purposes after the liquidation or conversion transaction. No termination tax is due if following the transaction the entire pre-transaction value of the charity's net assets remains dedicated to charitable purposes. As is described below, the termination tax may not be collected from assets that are dedicated to charitable purposes.

The proposal applies to public charities and to private foundations, and thus eliminates the present-law aggregate tax benefit limit contained in section 507. In the case of private foundations, the proposed termination tax applies to voluntary or involuntary terminations (within the meaning of present-law section 507, including willful repeated acts or failures to act, or a willful and flagrant act or failure to act, that gives rise to liability for tax under Chapter 42),[504] as well as to conversion or liquidation transactions (as defined by this proposal). The proposed termination tax also applies to a public charity if there have been either willful repeated acts or failures to act, or a willful and flagrant act or failure to act, that gives rise to liability for Chapter 42 taxes, which includes sections 4955 (tax on political expenditures) and 4958 (tax on excess benefit transactions).

The proposal generally defines a conversion transaction by reference to present-law section 280G principles pertaining to changes in ownership or control of an organization or a substantial portion of its assets. In order to assure that fair consideration is paid in these transactions, the proposal extends the section 4958 excess benefit transaction tax rules (in the

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undervaluation of the nonprofit with the resultant underfunding of the charity, the channeling of sales proceeds back to the for-profit purchaser, restrictions on the surviving charity's ability to function as a charity after the transaction, and improper inducements to board members).

[504] Chapter 42 refers to the excise taxes imposed under sections 4940 through 4963.

case of a public charity) or section 4941 self-dealing rules (in the case of a private foundation) to an acquirer of the charity's assets in a conversion or liquidation transaction, if persons who are disqualified persons of the charitable organization are in a position to exercise substantial influence over the affairs of the acquirer at the time of or after the transaction, including as officers, directors, or employees of the acquirer. The proposal provides for enhanced disclosure and substantiation of liquidation and conversion transactions by requiring that the parties to such a transaction provide the IRS with written notice of a conversion or liquidation of the charity, and by implementing qualified appraiser and appraisal requirements for such transactions.

Definition of conversion and liquidation transactions

The proposal defines a conversion transaction as a change in the ownership or control of a charity, or in the ownership of a substantial portion of the assets of a charity, directly or indirectly, in either a single transaction or a series of transactions, in which a person or persons other than a charitable organization or governmental unit obtains ownership or control.[505] Forms of a conversion transaction include, for example, an asset sale, a merger, a transfer of assets to a subsidiary, a change in corporate form under State law, a transfer of assets to a joint venture, or a long-term lease or similar transaction pursuant to which the charity has transferred the benefits and burdens of ownership of its assets.

In general, the proposal uses present-law section 280G principles to determine if a conversion of the charity has occurred. Under the proposal, a change in ownership of a charitable corporation occurs on the date that: (1) any one person (other than a charitable organization or a government), or more than one person acting as a group, acquires ownership of stock or membership interests of the corporation that, together with stock or membership interests held by such person or group, causes the person or group to own 50 percent or more of the total fair market value or total voting power of the stock or membership interests of such corporation; or (2) the corporation ceases to be organized and operated as a nonprofit corporation under State law. In the case of a trust or unincorporated charity, a change of ownership is determined by reference to beneficial interests rather than to stock, and a change of ownership occurs if the trust or unincorporated entity ceases to be organized and operated for nonprofit purposes under State law.

Under the proposal, a change in the control of a corporation, trust, or unincorporated charity occurs on the date that: (1) any one person (other than a charitable organization or a government), or more than one person acting as a group, acquires the authority to appoint, elect, or replace at least 50 percent of the members of the corporation's board of directors or of the trustees; or (2) the organization amends its articles of organization or other governing instruments to eliminate the requirement that upon dissolution its assets be distributed to a charity or a government for charitable or public purposes.

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[505] For this purpose, a governmental unit is defined in the same manner as under section 507 (i.e., an organization described in section 170(b)(1)(A) (other than in clauses (vii) and (viii)). This includes the Federal government, State and local governments, and certain Indian tribal governments treated as a State or local government for this purpose. Secs. 507(b)(1)(A), 170(b)(1)(A)(v), 170(c)(1), and 7871(a).

A change in the ownership of a substantial portion of the assets of a charity (whether a corporation, trust, or unincorporated charity) occurs on the date that any one person (other than a charitable organization or a government), or more than one person acting as a group, acquires assets from the charity that have a total gross fair market value of at least one-third of the total gross fair market value of all of the assets of the charity immediately prior to such acquisition. For this purpose, gross fair market value means the value of the assets without regard to any liabilities associated with such assets. For example, a change in the ownership of a substantial portion of a charity's assets could be in the form of the acquisition of a subsidiary of the charity, a merger of the charity with and into another entity, or a sale of assets (whether exempt purpose, investment, or trade or business assets) by the charity.

Under the proposal, the term liquidation has the same meaning that it has under present law. In general, a status of liquidation exists when the corporation "ceases to be a going concern and its activities are merely for the purpose of winding up its affairs, paying its debts, and distributing any remaining balance to its shareholders."[506]

The proposal does not apply to liquidations or changes of ownership or control of taxable nonprofit organizations,[507] or organizations exempt from Federal income tax under a provision other than section 501(c)(3). Further, the proposal does not apply to a charity's change in status from a public charity to a private foundation, or from a private foundation to a public charity.

Imposition of termination tax on liquidations and conversions

The proposal imposes a termination tax on conversions and liquidations of public charities and private foundations, including the transfer of assets from a charity to an organization that is exempt other than as a charity (e.g., a social welfare organization described in section 501(c)(4)). Under the proposal, a charity is subject to a tax equal to the excess of the value of its net assets over the value of its net assets that remain dedicated to charitable purposes following the transaction. The value of the net assets of the organization is determined at whichever time such value is higher: (1) the first day on which action is taken by the organization that culminates in a conversion or liquidation of the organization; or (2) the date of the conversion or liquidation of the organization. If the amount of the termination tax exceeds the net asset value of the organization immediately after the transaction, the termination tax may not be collected from assets that are dedicated to charitable purposes. The proposal permits the tax to be abated to the extent that assets are subsequently dedicated to charitable purposes, through retention by or distribution to a charitable organization for charitable purposes, or by distribution to a government for public purposes. The proposal does not modify present law with

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[506] Treas. Reg. sec. 1.332-2(c).

[507] E.g., Blue Cross and Blue Shield organizations described in section 833. Congress addressed the treatment of such organizations in 1986 by treating them similar to taxable insurance companies and providing special rules for such organizations. Sec. 1012(c)(3) of the Tax Reform Act of 1986, Pub. L. No. 99-514.

respect to the transferee liability of a transferee of property of an organization subject to the termination tax.[508]

Expansion of intermediate sanctions and self-dealing rules

Treat acquirers as disqualified persons for excess benefit transaction and self-dealing taxes

To assure that an acquirer of a public charity's assets pays fair market value for the assets acquired pursuant to a conversion or liquidation in cases involving conflicts of interest between the charity and the acquirer, the proposal provides that an acquiring person other than a charitable organization or a governmental unit is a disqualified person for purposes of applying section 4958 to the transaction, if at any time during the five-year period beginning on the date of the transaction persons who were disqualified persons of the public charity (at the time of the conversion or liquidation transaction) are in a position to exercise substantial influence over the affairs of the acquirer, including as officers, directors, or employees of the acquirer.[509] The proposal provides that the present-law initial contract exception is not available to such an acquirer with respect to the acquisition.[510] Under the proposal, such an acquirer is subject to the present-law 25-percent excise tax on an excess benefit it receives from the transaction, and the additional 200-percent tax if the excess benefit transaction is not corrected. In addition, the charity's managers who participate in such a transaction are subject to the ten-percent excise tax on organization managers.

Under the proposal, whether disqualified persons of the public charity have substantial influence over the affairs of the acquirer is determined under present-law section 4958 principles. In general, this includes a person who has or shares authority to control or determine a substantial portion of the acquirer's capital expenditures, operating budget, or compensation for employees, or manages a discrete segment or activity of the acquirer that represents a substantial portion of the activities, assets, income, or expenses of the acquirer, as compared to the organization as a whole.[511]

Under the proposal, the present-law section 4941 self-dealing rules continue to apply to transactions involving a private foundation, and may prohibit certain types of conversion

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[508] Under section 6901 and the substantive doctrine of transferee liability, a transferee of property of a taxpayer may succeed to the transferor's Federal tax liability under certain circumstances. In general, however, a transferee of property is not liable for the tax liability of the transferor if the transferee pays adequate consideration for the transferred property.

[509] As is the case under present-law section 4958, a "person" includes an individual, trust, estate, partnership, association, company, or corporation. Sec. 7701(1).

[510] A separate proposal in this publication modifies the initial contract exception for more general purposes. See Part VIII.D. of this report, "Reform Intermediate Sanctions and Extend Certain Reforms to Private Foundations."

[511] Treas. Reg. sec. 53.4958-3(e).

transactions involving private foundations (e.g., if the acquirer is a disqualified person with respect to the foundation). The proposal extends the self-dealing rules to conversion or liquidation transactions if at any time during the five-year period beginning on the date of the conversion or liquidation, persons who were disqualified persons of the private foundation (at the time of the conversion or liquidation) are in a position to exercise substantial influence over the affairs of the acquirer (as described above).

Excess benefit transaction and self-dealing rules for disqualified persons of the charity who have a relationship with the acquirer

Under the proposal, the excess benefit transaction tax rules (in the case of a public charity) or the section 4941 self dealing rules (in the case of a private foundation) apply to compensation, severance arrangements, and other transactions involving disqualified persons of the charity (determined as of the time of the conversion or liquidation) who at any time during the five-year period beginning on the date of the conversion or liquidation transaction have a relationship with the acquirer that would cause the person to be a disqualified person if the acquirer were treated as a charity to which section 4958 or section 4941 applies. For example, a transaction between the acquirer and an officer or director of a public charity who becomes an officer or director of the acquirer at any time within five years following the transaction is subject to section 4958.[512]

Notice and reporting requirements

The proposal imposes notice and reporting requirements on the charity and the acquiring person with respect to certain events relating to the conversion or liquidation. These events include: (1) entering into a letter of intent or a definitive agreement to convert or liquidate the charity; (2) adoption of a conversion or liquidation plan by the charity; (3) adoption of or agreement to any material changes to such a letter, agreement or plan; and (4) filing or receipt of a filing relating to the commencement of State administrative or judicial proceedings with respect to a conversion or liquidation transaction involving the charity.

The required information, which must be reported to the IRS within 10 days of the relevant event, includes: (1) a description of the transaction and all minutes of the governing bodies of the organizations pertaining to the transaction; (2) a description of any consideration to be paid (cash, notes, property, stock of acquirer, assumption of liabilities, etc.) by or to the charity, and of any severance arrangements, stock and stock rights or other equity agreements, and officer and employee compensation arrangements entered into in connection with the transaction; (3) copies of any appraisals, fairness opinions (including with respect to any stock, stock rights, or other equity rights provided as consideration in the transaction), material transactional documents, severance arrangements, stock and stock rights or other equity

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[512] The officer or director also would be a disqualified person with respect to the public charity, and thus subject to section 4958 with respect to transactions between such person and the charity, during this five-year period. Sec. 4958(f)(1). Thus, under the proposal, the disqualified person would be required to deal fairly with both the charity and the acquirer to avoid excess benefit transaction tax liability.

agreements, and officer and employee compensation arrangements entered into in connection with the transaction; and (4) a summary of any Federal, State, or local regulatory review and approval processes applicable to the transaction. The proposal authorizes the IRS to recover its reasonable costs of reviewing the conversion or liquidation transaction.[513]

Tolling or extension of limitations period

Under the proposal, if the required notice and reporting requirements are not fulfilled within the required time frame, the statute of limitations period is suspended with respect to the assessment and collection of the termination tax and applicable excess benefit transaction and self dealing taxes, until the proposal's notice and reporting requirements are satisfied. In addition, the limitations period with respect to a conversion or liquidation transaction is extended for an additional five years to enforce the five-year lookback rules for purposes of determining whether disqualified persons who are in a position to exercise substantial influence over the acquirer subject the acquirer and such persons to section 4941 or section 4958 with respect to the conversion or liquidation and other transactions entered into during such five-year period.

Appraiser and appraisal requirements

The proposal establishes qualified appraiser and appraisal requirements for conversion and liquidation transactions. A charity is required to obtain a qualified appraisal of the fair market value of the charity's assets from an independent qualified appraiser, determined as of two dates: (1) the first day on which action is taken by the organization with respect to the conversion or liquidation transaction; and (2) the date of the conversion or liquidation transaction. Similarly, each party that acquires ownership or control of the charity, or all or a substantial portion of the assets of the charity, must obtain its own qualified appraisal from a different qualified appraiser that is not a related party to any other qualified appraiser with respect to the transaction of the fair market value of the assets or property it acquired pursuant to the transaction. Each qualified appraisal must state that the appraisal was performed with the understanding of the appraiser and the party for whom the appraisal was performed that the appraised values will be reviewed by the IRS for purposes of determining the applicability of the termination tax, section 4941 or section 4958 (whichever is applicable), and the private inurement and private benefit prohibitions.

Under the proposal, a qualified appraiser is an individual who affirms: (1) that the fair market value of the subject property has been determined in accordance with generally accepted appraisal standards; (2) with respect to the specific property and transaction type, that he or she: (a) has successfully completed educational coursework, including for continuing education credits, in generally accepted appraisal practices, principles, concepts, methodologies, and ethics from a recognized provider of such courses; or has earned an appraisal designation from a recognized organization that teaches, tests, and provides continuing education to its members in valuation; and (b) regularly performs appraisals for which he or she receives compensation and

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[513] An alternative to recovery of actual reasonable costs might be to require filing parties to pay a user fee to cover the costs of IRS review of conversion and liquidation transactions.

has a minimum of two years experience in doing so; and (3) has not been subject to disbarment from practice before the IRS by the Secretary pursuant to 31 U.S.C. section 330(c).[514]

Examples

Example 1.–Public charity (PC) enters into an agreement with several other public charities, pursuant to which each of the charities transfers a portion of its intellectual property to a partnership in exchange for a partnership interest. No persons other than public charities participate in the joint venture. The transfer of intellectual property by some of the charitable participants constitutes more than one-third of the gross value of the organization's assets. Each of the charities continues to dedicate its assets, including its partnership interest, to charitable purposes.

Under the proposal, the arrangement does not constitute a conversion transaction, because charitable organizations retain ownership and control of the joint venture. The result is the same whether the joint venture is treated for Federal tax purposes as an association taxed as a corporation, or as a partnership.

Example 2.–PC sells all of its assets with a value of $100 million to a for-profit entity (FP) for $100 million, and dedicates $100 million to charitable purposes.

Under the proposal, the sale of all of PC's assets to FP is a conversion transaction (change in ownership of assets) that PC and FP must report to the IRS. Each of PC and FP must obtain a qualified appraisal from qualified appraisers with respect to the value of PC's assets. Because PC receives fair market value for the asset transfer, and dedicates the entire fair market value to charitable purposes following the transaction, there is no termination tax imposed on PC. The results are the same if the transaction is structured as a State law merger of PC with and into FP (a change of ownership of assets), or a change in corporate form under State law (a change in ownership), and FP contributes $100 million to a newly formed charity.

Example 3.–PC sells all of its assets with a value of $100 million to FP for $100 million, but only dedicates $80 million of the sales proceeds to charitable purposes.

Under the proposal, the sale of all of PC's assets to FP is a conversion transaction (change in ownership of assets) that PC and FP must report to the IRS. Each of PC and FP must obtain a qualified appraisal from a qualified appraiser with respect to the value of PC's assets. Because PC failed to dedicate the entire fair market value of its assets for charitable purposes, there is a termination tax of $20 million imposed on the transaction, the portion of the value that was not dedicated to charitable purposes. The tax may not be recovered from PC's assets that are dedicated to charitable purposes, or from FP (which paid fair market value for the acquired

[514] 31 U.S.C. sec. 330(c) (after notice and opportunity for a hearing to any appraiser with respect to whom a penalty for aiding and abetting understatement of tax liability has been assessed, the Secretary may provide that appraisals by such appraiser shall not have any probative effect in any administrative proceeding before the Treasury or the IRS, and bar such appraiser from presenting evidence or testimony in any such proceeding).

assets). All or a portion of the termination tax may be recovered through enforcement of the excess benefit transaction tax provisions, however, if the $20 million not dedicated to charitable purposes was paid to disqualified persons and corrected by repayment of the excess benefit to PC. In addition, the termination tax may be recovered from a charity's claim under State law against its officers or directors for breach of duty as an officer or director, if proceeds awarded under the claim are not dedicated to charitable purposes.

Example 4.–PC sells all of its assets with a value of $100 million to FP for $80 million, and dedicates the $80 million proceeds to charitable purposes.

Under the proposal, the sale of all of PC's assets to FP is a conversion transaction (change in ownership of assets) that PC and FP must report to the IRS. Each of PC and FP must obtain a qualified appraisal from a qualified appraiser with respect to the value of PC's assets. PC is liable for a termination tax of $20 million (the value of the assets that was not dedicated to charitable purposes). However, the $20 million termination tax may not be recovered from the assets that remain dedicated to charitable purposes. If FP is a disqualified person as the acquirer of PC's assets (whether because of a relationship that existed prior to the transaction or by virtue of disqualified persons of PC being in a position to exercise substantial influence over the affairs of FP after the transaction), FP is subject to the section 4958 excess benefit transaction taxes, because PC did not receive fair market value for the asset transfer. The termination tax may be collected from PC as a result of a correction by FP of the excess benefit transaction, or from FP under transferee liability principles, if applicable.

Example 5.–PC transfers 40 percent of the gross fair market value of its assets to a joint venture (JV) in which PC and FP each owns a 50 percent ownership interest. The fair market value of PC's interest in JV equals the fair market value of the assets transferred by PC to JV. JV is a partnership for Federal income tax purposes.

PC's transfer of assets to JV constitutes a conversion (change in ownership of a substantial portion of assets) because more than one-third of PC's assets were transferred to an entity other than a charity or a government. (This would be the result whether PC owned a minority or a majority interest in JV.) PC and JV must satisfy the reporting requirements applicable to the transaction. Each of PC and JV must obtain a qualified appraisal from a qualified appraiser with respect to the value of PC's assets transferred to JV, and of PC's interest in JV. Because PC received fair market value in exchange for the transferred assets, neither JV nor FP is liable for a section 4958 excess benefit transaction tax. Provided that PC continues to dedicate all of its assets (including its interest in JV) to charitable purposes, the transaction is not subject to a termination tax.

Example 6.–PC is a nonstock, nonmembership, nonprofit corporation governed by a self-perpetuating board of directors. FP obtains the authority to elect, appoint, or remove 50 percent of the members of PC's board.

FP's obtaining authority to elect, appoint, or remove 50 percent of PC's board constitutes a conversion transaction (change in control) that PC and FP must report to the IRS. Each of PC and FP must obtain a qualified appraisal from a qualified appraiser with respect to the value of PC's assets, and FP must obtain a qualified appraisal of the value of FP's rights to alter PC's

board composition. Provided that all of PC's assets remain dedicated to charitable purposes, PC is not liable for a termination tax on the transaction.

Example 7.–PC amends its articles of organization to eliminate the requirement that, upon dissolution, its assets will be distributed to a charity or to a government for charitable or public purposes.

The amendment of PC's articles of organization to eliminate the dedication of assets requirement constitutes a conversion (change of control) of the organization that must be reported to the IRS. PC must obtain a qualified appraisal from an independent qualified appraiser with respect to the value of PC's assets. PC is subject to a termination tax equal to the entire value of its net assets if no assets are transferred to a charity or government.

Effective Date

The proposal is effective for liquidations or conversion transactions that occur after the date of enactment.

Discussion

Extending a termination tax to all charities to enforce the dedication of assets requirement

The proposal extends a modified version of the present-law section 507 tax on private foundation terminations to conversion and liquidation transactions. This approach strictly enforces the asset dedication requirement by imposing a tax on the net assets of the charity, even if greater in amount than the aggregate tax benefit, that do not remain dedicated to charitable purposes. The rationale for strictly enforcing the dedication of assets requirement is that strict enforcement is necessary to protect the public's interest in seeing that the entire value of its contributions is used for charitable purposes. The dedication of assets requirement is the linchpin of exempt status law for charities, with doctrines such as private inurement, private benefit, and intermediate sanctions and self-dealing providing additional mechanisms to buttress the requirement by protecting against misuse of charitable assets. A termination tax that strictly enforces the dedication of assets requirement is consistent with State charitable trust and nonprofit corporation statutes which contain similar requirements.

Some might argue that extension of a termination tax to public charities inappropriately interferes with the authority of State officials to oversee these transactions. Under this view, it might be argued that present-law private inurement and private benefit prohibitions adequately address the Federal tax law concerns applicable to these transactions, and that many States have adopted conversion statutes in recent years to give State officials additional enforcement authority. A number of practical limitations, however, impair the ability of the IRS and the States to ensure perpetual dedication of assets to charitable uses. First, the private inurement prohibition does not ensure that a public charity's assets will be used for charitable purposes in non-insider contexts. Second, the private benefit doctrine is not clearly defined and is difficult to administer. Third, the proliferation of conversion transactions and the varying State responses to such transactions demonstrate that there is no uniform national standard that is being applied to protect the charitable assets of the nation's public charities. A public charity in New York is subject to the same Federal dedication of assets requirement as a public charity in California, and

whether one or the other's assets remains dedicated to charitable purposes is both a Federal and a State concern. Under the present regime, however, the Federal government effectively has delegated enforcement of a Federal tax law requirement to the various States, resulting in non-uniform enforcement of this important basis for exemption as a public charity.[515]

The proposal modifies the termination tax with respect to private foundations to be consistent with that proposed for public charities. Some might argue that Congress enacted the section 507 tax to address a specific type of abuse, and determined at that time that this could be accomplished by taking away the tax benefits that were provided to those who formed the private foundation. However, the dedication of assets requirement applies to all charities, and the basic rationale for strictly enforcing the requirement (rather than limiting it to an aggregate tax benefit) applies equally to public charities and private foundations. As is the case under present law, the proposal imposes the termination tax on private foundations in certain cases involving willful and flagrant acts or failure to act, or willful repeated acts or failures to act, and extends the termination tax to public charities in similar circumstances.

Some commentators have advocated the imposition of an "exit tax" on conversion transactions, determined by applying a tax rate to the value of the assets involved in the transaction, without regard to whether fair market value is received by the converting nonprofit entity or the use of the proceeds.[516] This approach would not assure the dedication of the charity's assets to charitable purposes, and in some cases could divert assets from the charitable sector to the Federal government by imposing a tax even if the entire value of the charity's assets were dedicated to charitable purposes. Others might argue that a better approach would be to extend the section 507 tax on private foundation terminations to conversions or liquidations of public charities, and retain the present-law measure of the tax based on the aggregate tax benefit (not to exceed the net assets of the charity). However, if a charity becomes free to use its assets without regard to furthering charitable purposes merely by transferring its assets to another person and paying an exit tax or a termination tax equal to the tax benefits previously provided to the organization and its donors, the requirement that upon dissolution the charity's assets be distributed for charitable or public purposes arguably is nothing more than an unenforceable promise.

Expansion of intermediate sanctions rules

It is important that a charity receive fair market value in all conversion or liquidation transactions, whether the acquirer is related or unrelated to the charity. In general, the tax law

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[515] David Villar Patton, "The Queen, the Attorney General, and the Modern Charitable Fiduciary: A Historical Perspective on Charitable Enforcement Reform," 11 Journal of Law & Public Policy 131, 164-65 (Spring 2000) (stating that critics of charitable enforcement by State Attorneys General assert that they are politically influenced, suffer from a lack of funds and staff, and have an overwhelming case load resulting in insufficient and ineffective regulation of charitable fiduciaries).

[516] E.g., John D. Columbo, "A Proposal for an Exit Tax on Nonprofit Conversion Transactions," 23 Iowa Journal of Corporate Law 779 (Summer 1998).

assumes that unrelated persons (including charities) will bargain at arm's length and that each will adequately protect its own interests. If the charity and the acquirer are unrelated, and are free to engage in good faith negotiations to arrive at a fair market value consideration for the charity because the acquirer is not in a position to substantially influence the affairs of the charity, the doctrines of transferee liability (applicable to the transferee of assets) and State law breach of duty (applicable to the charity's officers and directors) should adequately protect against the risk that a charity will receive less than fair market value consideration from its unrelated acquirer, and there should be no need to treat the acquirer as a disqualified person under such circumstances.[517] However, in those instances that involve a financial or other relationship between the charity and the acquirer, or an overlap of officers, directors, or other employees of the charity and the acquirer, conflicts of interest may arise that make it difficult to assure that a charity's interests will be protected in the conversion or liquidation transaction. For this reason, the proposal treats certain acquirers as disqualified persons for purposes of the intermediate sanctions and self-dealing rules, even if the acquirer did not have a relationship with the charity prior to engaging in the conversion transaction. Acquirers treated as disqualified persons include those who are treated as such under present-law, and acquirers for which disqualified persons of the charity (determined at the time of the conversion or liquidation transaction) are at any time during the five-year period beginning on the date of the conversion in a position to exercise substantial influence over the affairs of the acquirer. Also, in such cases, transactions between either the acquirer or the charity and such disqualified persons with substantial influence over the affairs of the acquirer are subject to the excess benefits transaction tax or self-dealing provisions during such five year period.

Definition of conversion transactions

The definition of conversion must be broad enough to encompass the various kinds of transactions in which charitable assets cease to be dedicated to charitable purposes. For example, some have reported that nonprofit organizations have used leases and other structures that transfer beneficial (but not legal) ownership of their assets to for-profit entities in order to avoid running afoul of State laws prohibiting or limiting the disposition of assets to a non-charity.[518] Further, although the focus of many reports has been on the conversion of nonprofits into for-profit entities, the dedication of assets requirement should not be circumvented by converting into another nonprofit entity that is not subject to the requirement, such as an exempt social welfare organization or a taxable nonprofit corporation, or by liquidating and distributing

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[517] In those instances where the acquirer is not treated as a disqualified person with respect to the conversion transaction, the acquirer will not be subject to an excess benefits transaction tax, and generally will not be liable for any portion of a termination tax imposed on the charity unless the acquirer is liable as a transferee under transferee liability principles. If the charity's officers and directors did not uphold their State law duties as officers and directors to protect the charity's assets, in some cases the charity or the State Attorney General (on behalf of the charity) might be able to assert a claim for damages against the officers or directors who breached their duty.

[518] Terry Roth Reicher, "Assuring Competent Oversight to Hospital Conversion Transactions," 52 Baylor Law Review 83, note 21 (Winter 2000).

assets to such an entity.[519] Accordingly, the proposal defines conversion broadly to include any change in ownership or control pursuant to which charitable assets are no longer subject to a requirement that they be dedicated in perpetuity to charitable purposes, and extends the proposed rules to liquidations of charities.

Under the proposal, a conversion through an asset transfer occurs whenever at least one third of the gross fair market value of the charity's total assets has been transferred other than to another charity or a government. This is consistent with the one-third standard used for section 280G purposes.

Notice and reporting requirements

Under present law, an exempt organization generally does not notify the IRS of a liquidation or material transaction, such as a conversion, until it files its Form 990 for the year during which the liquidation or transaction occurred. This provides the IRS no opportunity to review the transaction before or soon after it is completed. Under the proposal, a charity is required to notify the IRS of certain events at various stages of the conversion or liquidation process. The notice requirements are intended to provide the IRS a meaningful opportunity to review the proposed transaction for compliance with Federal tax laws, including the proposed termination tax, and the modified intermediate sanctions and self-dealing rules. By suspending the statute of limitations with respect to imposition of these taxes until all notice and reporting requirements are satisfied, the IRS is provided a better opportunity to enforce the laws after completion of the transaction.

Appraisal requirements

Under the proposal, a proper determination of the fair market value of a charity's assets is critical in conversion and liquidation cases, including for purposes of determining the amounts of the potential termination and excess benefits transaction or self-dealing taxes. Accordingly, the proposal establishes qualified appraiser and qualified appraisal requirements that apply to both the charity and the acquirer of the charity's assets. The requirement of separate appraisals as of both the conversion or liquidation date and the first day on which action is taken by the organization with respect to the transaction might be viewed by some as onerous, but generally should not result in substantial additional costs unless there have been significant changes in the composition of assets during the interim, in which case they are justified to reflect such changes and to determine the potential termination tax amount (i.e., as is the case under present-law section 507, the greater of the values of net assets as of the two dates).

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[519] The proposal should prevent the use of multiple step conversions to achieve a conversion of charitable assets to for-profit uses, such as through a conversion to a social welfare organization followed by a sale by the social welfare organization of the formerly charitable assets to a for-profit entity.

C. Tax Involvement by Exempt Organizations in Tax-Shelter Transactions (secs. 6011 and 6707A)

Present Law

Disclosure of listed and other reportable transactions by taxpayers

Present law provides that a taxpayer that participates in a reportable transaction (including a listed transaction) and who is required to file a tax return must attach to its return a disclosure statement in the form prescribed by the Secretary.[520] For this purpose, the term taxpayer includes any person, including an individual, trust, estate, partnership, association, company, or corporation.[521]

Under existing regulations, a reportable transaction includes a listed transaction and five other categories of transactions: (1) confidential transactions, which are transactions offered to a taxpayer under conditions of confidentiality and for which the taxpayer has paid an advisor a minimum fee; (2) transactions with contractual protection, which include transactions for which the taxpayer or a related party has the right to a full or partial refund of fees if all or part of the intended tax consequences from the transaction are not sustained, or for which fees are contingent on the taxpayer's realization of tax benefits from the transaction; (3) loss transactions, which are transactions resulting in the taxpayer claiming a loss under section 165 that exceeds certain thresholds, depending upon the type of taxpayer; (4) transactions with a significant book-tax difference; and (5) transactions involving a brief asset holding period.[522] A listed transaction means a reportable transaction which is the same as, or substantially similar to, a transaction specifically identified by the Secretary as a tax avoidance transaction for purposes of section 6011 (relating to the filing of returns and statements), and identified by notice, regulation, or other form of published guidance as a listed transaction.[523] The fact that a transaction is a reportable transaction does not affect the legal determination of whether the taxpayer's treatment of the transaction is proper.[524] Present law authorizes the Secretary to define reportable transaction on the basis of such transaction being of a type which the Secretary determines as having a potential for tax avoidance or evasion.[525]

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[520] Treas. Reg. sec. 1.6011-4(a).

[521] Sec. 7701(a)(1); Treas. Reg. sec. 1.6011-4(c)(1).

[522] Treas. Reg. sec. 1.6011-4(b).

[523] Sec. 6707A(c)(2); Treas. Reg. sec. 1.6011-4(b)(2).

[524] Treas. Reg. sec. 1.6011-4(a).

[525] Sec. 6707A(c)(1).

Treasury regulations provide guidance regarding the determination of when a taxpayer participates in a transaction for these purposes.[526] A taxpayer has participated in a listed transaction if the taxpayer's tax return reflects tax consequences or a tax strategy described in the published guidance that lists the transaction, or if the taxpayer knows or has reason to know that the taxpayer's tax benefits are derived directly or indirectly from tax consequences or a tax strategy described in published guidance that lists a transaction. A taxpayer has participated in a confidential transaction if the taxpayer's tax return reflects a tax benefit from the transaction and the taxpayer's disclosure of the tax treatment or tax structure of the transaction is limited under conditions of confidentiality. A taxpayer has participated in a transaction with contractual protection if the taxpayer's tax return reflects a tax benefit from the transaction, and the taxpayer has the right to the full or partial refund of fees or the fees are contingent.

Present law provides a penalty for any person who fails to include on any return or statement any required information with respect to a reportable transaction.[527] The penalty applies without regard to whether the transaction ultimately results in an understatement of tax, and applies in addition to any other penalty that may be imposed.

The penalty for failing to disclose a reportable transaction is $10,000 in the case of a natural person and $50,000 in any other case. The amount is increased to $100,000 and $200,000, respectively, if the failure is with respect to a listed transaction. The penalty cannot be waived with respect to a listed transaction. As to reportable transactions, the IRS Commissioner may rescind all or a portion of the penalty if rescission would promote compliance with the tax laws and effective tax administration.

Disclosure of listed and other reportable transactions by material advisors

Present law requires each material advisor with respect to any reportable transaction (including any listed transaction) to timely file an information return with the Secretary (in such form and manner as the Secretary may prescribe).[528] The information return must include (1) information identifying and describing the transaction, (2) information describing any potential tax benefits expected to result from the transaction, and (3) such other information as the Secretary may prescribe. The return must be filed by the date specified by the Secretary.

A "material advisor" means any person (1) who provides material aid, assistance, or advice with respect to organizing, managing, promoting, selling, implementing, insuring, or carrying out any reportable transaction, and (2) who directly or indirectly derives gross income in excess of $250,000 ($50,000 in the case of a reportable transaction substantially all of the tax

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[526] Treas. Reg. sec. 1.6011-4(c)(3).

[527] Sec. 6707A, as added by the American Jobs Creation Act of 2004, Pub. L. No. 108-357, sec. 811(a).

[528] Sec. 6707(a), as added by the American Jobs Creation Act of 2004, Pub. L. No. 108-357, sec. 816(a).

benefits from which are provided to natural persons) or such other amount as may be prescribed by the Secretary for such advice or assistance.[529]

The Secretary may prescribe regulations which provide (1) that only one material advisor is required to file an information return in cases in which two or more material advisors would otherwise be required to file information returns with respect to a particular reportable transaction, (2) exemptions from the requirements of this section, and (3) other rules as may be necessary or appropriate to carry out the purposes of this section.[530]

Present law imposes a penalty on any material advisor who fails to timely file an information return, or who files a false or incomplete information return, with respect to a reportable transaction (including a listed transaction).[531] The amount of the penalty is $50,000. If the penalty is with respect to a listed transaction, the amount of the penalty is increased to the greater of (1) $200,000, or (2) 50 percent of the gross income derived by such person with respect to aid, assistance, or advice which is provided with respect to the transaction before the date the information return that includes the transaction is filed. An intentional failure or act by a material advisor with respect to the requirement to disclose a listed transaction increases the penalty to 75 percent of the gross income derived from the transaction.

The penalty cannot be waived with respect to a listed transaction. As to reportable transactions, the IRS Commissioner can rescind all or a portion of the penalty if rescission would promote compliance with the tax laws and effective tax administration.

Reasons for Change

Many tax exempt organizations are accorded special tax status because they are organized and operated to further public purposes or other policy objectives (e.g., charitable purposes, social welfare purposes, promotion of retirement savings). Certain others obtain exempt status because they are in effect conduits used to achieve the objectives of their members, and thus an entity level tax is not appropriate. Regardless of the policy rationale for providing exempt status to an organization, the exemption from tax generally is limited to income derived from those activities that substantially further the basis for exemption. Because tax exemption is a valuable financial benefit, exempt organizations have become attractive targets to serve as accommodation parties for taxpayers in various tax-motivated transactions. Such transactions involving exempt organizations contribute to the erosion of the tax base by improperly extending the benefit of exemption to other taxpayers, including with respect to transactions that serve no material purpose for the taxable party to the transaction other than to avoid tax. Although recent shelter legislation addressed many tax shelter abuses, such legislation does not prevent certain abuses that might be perpetrated by using exempt organizations as accommodation parties.

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[529] Sec. 6707(b)(1).

[530] Sec. 6707(c).

[531] Sec. 6707(b).

Description of Proposal

In general

In general, under the proposal, many tax-exempt entities are subject to penalties for participating in a prohibited tax shelter transaction as accommodation parties. A prohibited tax shelter transaction is a transaction that the Secretary determines is a listed transaction (as defined in section 6707A(c)(2)) or a reportable transaction that is a confidential transaction or a transaction with contractual protection (as defined by the Secretary in regulations). The proposal also provides that an exempt organization that participates in a reportable transaction (including a listed transaction) in order to shelter from tax the organization's own tax liability (e.g., the unrelated business income tax) is subject to the present-law rules (sec. 6707A and sec. 6011) pertaining to disclosure of such transactions.

The proposal generally applies to all tax-exempt organizations and entities, including charitable and other organizations described in section 501(c) (other than instrumentalities of the United States, i.e., section 501(c)(1) organizations), State and local governments, Indian tribal governments, and tax qualified pension plans, individual retirement arrangements ("IRAs"), and similar tax-favored savings arrangements (such as Coverdell education savings accounts, health savings accounts, and qualified tuition plans).

Entity level tax

Under the proposal, if a tax-exempt entity participates in a transaction, knowing or with reason to know that the transaction is a prohibited tax shelter transaction, the entity is subject to a tax of 100 percent of the entity's net income (after taking into account any income tax imposed with respect to the transaction) that is attributable to the entity's participation in the prohibited transaction. If the entity is eligible to receive deductible contributions, the Secretary may suspend such eligibility with respect to the income tax for one year. The entity level tax does not apply to tax qualified pension plans, IRAs, and similar tax-favored savings arrangements (such as Coverdell education savings accounts, health savings accounts, and qualified tuition plans).

In addition, if a transaction is not a tax shelter prohibited transaction at the time a tax-exempt entity participates in the transaction, but the transaction subsequently is determined by the Secretary to be a prohibited tax shelter transaction (a "subsequently prohibited tax shelter transaction"), the entity must pay an excise tax at the highest unrelated business taxable income rate on any income that is properly allocable to the transaction after the time the transaction becomes prohibited. The Secretary has the authority to provide guidance regarding the determination of the allocation of net income of a tax-exempt entity that is attributable to a transaction to various periods, including before and after the listing of the transaction.

Disclosure of participation in prohibited tax shelter transactions

A person who fails to include information with respect to a prohibited tax shelter transaction on any return or statement as required by the Secretary must pay a penalty of $10,000 in the case of a natural person or $50,000 in any other case. In addition, the proposal requires that a party to a prohibited tax shelter transaction that is not a tax-exempt entity disclose to the

tax-exempt entity that the transaction is a reportable transaction. Failure to make such disclosure is subject to the penalties described above.

The proposal requires disclosure by a tax-exempt entity to the IRS of its participation in a prohibited tax shelter transaction and disclosure of other known parties to the transaction if the tax-exempt entity knows that such transaction is a reportable transaction. The penalty for failure to disclose is imposed on the entity (or entity manager, in the case of qualified pension plans and similar tax favored retirement arrangements) at $100 per day the failure continues, not to exceed $50,000. If any person fails to comply with a demand for payment by the Secretary of such penalty, such person or persons shall pay a penalty of $10 per day (beginning on the date of the failure to comply) not to exceed $1,000 per reportable transaction.

Penalty on entity managers

A tax of $20,000 is imposed on each entity manager that approves a tax-exempt entity's participation in a prohibited tax shelter transaction, knowing or with reason to know that the transaction is a prohibited tax shelter transaction. No more than $200,000 of tax in the aggregate may be imposed with respect to a prohibited tax shelter transaction. An entity manager is defined as the person with authority or responsibility similar to that exercised by an officer, director, or trustee of an organization, except: (1) in the case of an entity described in section 501(c)(3) or (c)(4), an entity manager is an organization manager as defined in section 4958(f)(2), and (2) in the case of tax qualified pension plans, IRAs, and similar tax-favored savings arrangements (such as Coverdell education savings accounts, health savings accounts, and qualified tuition plans), an entity manager is the person responsible for causing the entity to participate in the prohibited tax shelter transaction.

Effective Date

The proposal generally is effective for transactions that are prohibited after the date of enactment, except that no tax applies with respect to income that is properly allocable to the period ending on the date that is 90 days after the date of enactment. The effective date for disclosure obligations and penalties for failure to disclose is returns and statements the due date of which is after the date of enactment.

Discussion

The proposal provides that exempt organizations and exempt organization managers are subject to tax for participation as an accommodation party in prohibited tax shelter transactions. The purpose of the proposal is not to collect the taxes imposed, but to provide a strong deterrent that will prevent exempt organizations from participating as accommodation parties in transactions known to be abusive, and to be cautious about entering into transactions that could be considered abusive. The proposal broadly defines exempt organization for this purpose to include organizations described in section 501(c) (other than instrumentalities of the Federal government), State and local governments, Indian tribal governments, qualified plans and trusts, and certain other entities exempt from Federal income tax. The proposal treats listed and substantially similar transactions, as well as two types of other reportable transactions generally

regarded as similar to a listed transaction (confidential transactions and contractual protection transactions) equally.

Some argue that it is inappropriate to impose substantive sanctions with respect to transactions that have not yet been tested in court. However, listed transactions are now being used (or considered for use) in other contexts to impose substantive standards, such as determining whether an auditing firm is independent with respect to a client for which it provided an opinion regarding a listed or certain reportable transactions,[532] or for limited Circular 230 purposes to determine whether an opinion is a "covered opinion."[533] Some might argue that the proposal should not provide the IRS and the Treasury with the discretion to determine which transactions will result in a tax on an exempt organization and its managers. Indeed, the Treasury has delisted certain transactions after it determined that the potential for abuse was less than first thought. Others might argue, however, that the listing process is sufficiently rigorous to identify only those transactions that have the greatest potential to erode the tax base, that the Treasury and IRS will not abuse its discretion, and that it is appropriate to compel a participating exempt organization to disgorge its profits from such transactions.

The proposal distinguishes between cases where the transaction was listed or reportable at the time it was entered into, and transactions that subsequently become listed or reportable, by providing for a lesser rate of tax in the case of subsequently prohibited tax shelter transactions. Some argue, however, that an organization should not pay any tax for participating in a transaction that was not a prohibited tax shelter transaction at the time of the organization's initial participation because the organization managers would have no way of knowing that participation in the transaction would subject the organization to tax, and may raise questions regarding due process issues. Others argue that the tax is a necessary deterrent to discourage organization managers from entering into potentially suspect transactions. Others also argue that it is appropriate to impose a tax on the income attributable to the time after the transaction is

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[532] On December 14, 2004, the Public Company Accounting Oversight Board ("PCAOB") unanimously approved proposed ethics and auditor independence rules to limit the ability of accounting firms to provide certain aggressive tax planning services to their public clients. Proposed Rule 3522 provides that a public accounting firm will lose its independence from an audit client if the accounting firm provides services related to planning or opining on the tax consequences of a listed or confidential transaction under Treasury Regulations. In addition, the proposed rule provides that a firm is not independent if it provides its client services regarding planning or opining on transactions based on an aggressive interpretation of applicable tax laws and regulations.

[533] 31 C.F.R. Part 10, sec. 10.35(b)(2)(i) (a covered opinion includes written advice by a practitioner concerning one or more Federal tax issues arising from "a transaction that is the same as or substantially similar to a transaction that, at the time the advice is rendered, the Internal Revenue Service has determined to be a tax avoidance transaction and identified by published guidance as a listed transaction" under Treas. Reg. sec. 1.6011-4(b)(2)). A practitioner who provides a covered opinion must comply with standards of practice of Circular 230, including certain requirements with respect to factual matters, relating the law to the facts, and evaluating significant Federal tax issues.

determined to be a prohibited tax shelter transaction because, once such a determination is made, the income should not be considered as related to the organization's exempt purposes and should be taxed as unrelated business income, regardless of whether the organization regularly engages in such types of transactions.

Some argue that the proposal should apply more broadly to all tax-motivated transactions which serve no business or exempt purpose of the participating exempt organization. However, extending the proposal to cover such tax-motivated transactions would introduce substantial uncertainty regarding which transactions ultimately would be subject to the proposal. Using listed and certain reportable transactions as the standard provides a clear line to delineate which transactions are subject to the proposed sanctions, without having to examine the subjective motivations and intentions of the parties to the transaction.

Some argue that determining net income may be difficult for some of these transactions, and that organizations will have an incentive to allocate exempt function expenses to such activities, or offset such income by unrelated business losses, to reduce the amount of tax. In many cases, the income of the organization should be relatively easy to determine (the gross accommodation fee less transaction costs, such as legal fees). In addition, the proposal could be modified to disallow the use of other losses to offset such income (similar to the separate proposal regarding exempt organizations that hold stock in an S corporation).[534]

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[534] See Part V.D. of this report, "Modify Application of Unrelated Business Income Tax to S Corporation Shareholders."

D. Reform Intermediate Sanctions and Extend Certain Reforms to Private Foundations (secs. 4941 and 4958)

Present Law

In general

The Code imposes excise taxes on excess benefit transactions between disqualified persons and charitable organizations (other than private foundations) or social welfare organizations (as described in section 501(c)(4)).[535] An excess benefit transaction generally is a transaction in which an economic benefit is provided by a charitable or social welfare organization directly or indirectly to or for the use of a disqualified person if the value of the economic benefit provided exceeds the value of the consideration (including the performance of services) received for providing such benefit. The excise tax is imposed on any such excess.

The Code also imposes excise taxes on acts of self-dealing between a disqualified person and a private foundation. In general, self-dealing transactions between a private foundation and a disqualified person include: (1) a sale or exchange, or leasing, of property; (2) lending of money or other extension of credit; (3) the furnishing of goods, services, or facilities between a private foundation and a disqualified person,; (4) the transfer to, or use by or for the benefit of, a disqualified person of the income or assets of the private foundation; and (5) certain payments of money or property to a government official.[536] Taxes are imposed on the very act of self-dealing, irrespective of whether fair market value is paid (except for the payment of compensation, which is permitted at fair market value). The tax is imposed on the entire amount involved in the transaction (except for the payment of compensation, with respect to which the tax is imposed on the excess compensation).

The intermediate sanctions regime is modeled on the present-law self-dealing excise tax regime applicable to private foundations, though the two regimes have significant differences. The primary difference is that the intermediate sanctions regime permits insider transactions to occur so long as fair market value is paid, whereas the private foundation self-dealing regime generally prohibits self-dealing transactions altogether. Thus, the intermediate sanctions regime is much more permissive than the self-dealing regime.

Legislative background

Prior to enactment of the current private foundation self-dealing rules in 1969, foundations generally were permitted to engage in certain self-dealing transactions so long as arm's length standards were followed by the foundation and the insider. Sanctions were imposed if arm's length standards were not followed. However, Congress significantly tightened the rules

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[535] Sec. 4958. The excess benefit transaction tax commonly is referred to as "intermediate sanctions."

[536] Sec. 4941.

in 1969 in part because arm's length standards proved difficult to enforce.[537] The pre-1969 self-dealing regime is similar in approach to today's excess benefit transaction rules for public charities, i.e., self-dealing transactions are permitted so long as fair market value is received by the public charity.

The excess benefit transaction rules were enacted in 1996 to provide a sanction short of revocation of tax exemption, an "intermediate" sanction, for abusive self-dealing transactions (i.e., private inurement) between an organization insider and the organization. Prior to enactment of the excess benefit transaction rules, there was no sanction in the Code on organization insiders or disqualified persons for engaging in self-dealing transactions with respect to a public charity. Congress determined that under prior law the chances of the IRS finding cases of private inurement and of revoking the organization's exemption because of the bad actions of a few were slim, and that an intermediate sanction was appropriate. The Secretary issued proposed regulations with respect to excess benefit transactions in January 2001 and final regulations in January 2002.

Intermediate sanctions regime

Rebuttable presumption of reasonableness

Under the intermediate sanctions rules, in certain cases, an exempt organization may avail itself of a rebuttable presumption with respect to compensation arrangements and property transfers. Payments under a compensation arrangement are presumed to be reasonable, and a transfer of property, or the right to use property, is presumed to be at fair market value, if: (1) the arrangement or terms of transfer are approved in advance by an authorized body of the organization (as defined below) composed entirely of individuals who do not have a conflict of interest with respect to the arrangement or transfer; (2) the authorized body obtained and relied upon appropriate data as to comparability prior to making its determination; and (3) the authorized body adequately documented the basis for its determination concurrently with making that determination.[538] If these requirements are satisfied, the IRS may overcome the presumption of reasonableness if it develops sufficient contrary evidence to rebut the probative value of the comparability data relied upon by the authorized body.[539]

An authorized body is defined as: (1) the governing body of the organization; (2) a committee of the governing body, which may be composed of any individuals permitted under State law to serve on such a committee, to the extent that the committee is permitted by State law

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[537] Joint Committee on Taxation, *General Explanation of the Tax Reform Act of 1969*, December 3, 1970, at 30 ("Arm's-length standards have proved to require disproportionately great enforcement efforts, resulting in sporadic and uncertain effectiveness of the provisions. . . . Also the Congress concluded that compliance with arm's length standards often does not in itself prevent the use of a private foundation to improperly benefit those who control the foundation.").

[538] Treas. Reg. sec. 53.4958-6(a). See also H. Rep. No. 506, 104th Congress, 2d Sess. (1996), 53, 56-7.

[539] Treas. Reg. sec. 53.4958-6(b).

to act on behalf of the governing body; or (3) to the extent permitted by State law, other parties authorized by the governing body of the organization to act on its behalf by following procedures specified by the governing body in approving compensation arrangements or property transfers.[540]

In general, an authorized body has appropriate data as to comparability if, given the knowledge and expertise of its members, it has information sufficient to determine whether the arrangement is reasonable in its entirety or the transfer is at fair market value.[541] In the case of compensation, relevant information includes, but is not limited to, compensation levels paid by similarly situated organizations, both taxable and tax-exempt, for functionally comparable positions; the availability of similar services in the geographic area of the applicable tax-exempt organization; current compensation surveys compiled by independent firms; and actual written offers from similar institutions competing for the services of the disqualified person. In the case of property, relevant information includes, but is not limited to, current independent appraisals of the value of all property to be transferred, and offers received as part of an open and competitive bidding process. For organizations with annual gross receipts (including contributions) of less than $1 million reviewing compensation arrangements, the authorized body is considered to have appropriate data as to comparability if it has data on compensation paid by three comparable organizations in the same or similar communities for similar services. There is no inference with respect to whether circumstances falling outside this safe harbor will meet the requirement with respect to the collection of appropriate data.[542]

In general, for a decision to be documented adequately, the written or electronic records of the authorized body must note: (1) the terms of the transaction that was approved and the date it was approved; (2) the members of the authorized body who were present during debate on the transaction that was approved and those who voted on it; (3) the comparability data obtained and relied upon by the authorized body and how the data was obtained; and (4) any actions taken with respect to consideration of the transaction by anyone who is otherwise a member of the authorized body but who had a conflict of interest with respect to the transaction.[543]

Amount of the excise tax

The excess benefit tax is imposed on the disqualified person and, in certain cases, on the organization's managers, but is not imposed on the exempt organization. This follows the structure for the private foundation self-dealing tax, which imposes a tax on disqualified persons and private foundation managers, but not the private foundation.

An initial tax of 25 percent of the excess benefit amount is imposed on the disqualified person that receives the excess benefit. An additional tax on the disqualified person of 200

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[540] Treas. Reg. sec. 53.4958-6(c)(1)(i).

[541] Treas. Reg. sec. 53.4958-6(c)(2)(i).

[542] Treas. Reg. sec. 53.4958-6(c)(2)(ii).

[543] Treas. Reg. sec. 53.4958-6(c)(3).

percent of the excess benefit applies if the violation is not corrected. A tax of 10 percent of the excess benefit (not to exceed $10,000 with respect to any excess benefit transaction) is imposed on an organization manager who knowingly participated in the excess benefit transaction, if the manager's participation was willful and not due to reasonable cause, and if the initial tax was imposed on the disqualified person.[544] If more than one person is liable for the tax on disqualified persons or on management, all such persons are jointly and severally liable for the tax.[545]

Standard for knowing violations

A manager participates in a transaction knowingly only if the manager: (1) has actual knowledge of sufficient facts so that, based solely upon those facts, such transaction would be an excess benefit transaction; (2) is aware that such a transaction under these circumstances may violate the provisions of Federal tax law governing excess benefit transactions; and (3) negligently fails to make reasonable attempts to ascertain whether the transaction is an excess benefit transaction, or the manager is in fact aware that it is such a transaction.[546] Similar standards apply to foundation managers for purposes of imposition of the excise tax on private foundation managers for knowing participation in an act of self-dealing. The burden of proof in a Tax Court proceeding as to whether an organization manager (or foundation manager) acted knowingly is on the Secretary.[547]

Knowing does not mean having a reason to know.[548] However, evidence tending to show that an organization manager has reason to know of a particular fact or particular rule is relevant in determining whether the manager had actual knowledge of such a fact or rule. Thus, for example, evidence tending to show that a manager has reason to know of sufficient facts so that, based solely upon such facts, a transaction would be an excess benefit transaction is relevant in determining whether the manager has actual knowledge of such facts.[549]

Participation by an organization manager is willful if it is voluntary, conscious, and intentional. No motive to avoid the restrictions of the law or the incurrence of any tax is necessary to make the participation willful. Participation by an organization manager is not

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[544] Sec. 4958(d)(2). Taxes imposed may be abated if certain conditions are met. Secs. 4961 and 4962.

[545] Sec. 4958(d)(1).

[546] Treas. Reg. sec. 53.4958-1(d)(4)(i); Treas. Reg. sec. 53.4941(b)(3). Similar rules apply to private foundations with respect to jeopardizing business investments (sec. 4944) and taxable expenditures (sec. 4945). Treas. Reg. sec. 53.4944-1(b)(2); Treas. Reg. sec. 53.4945-1(a)(2)(iii).

[547] Sec. 7454(b).

[548] Treas. Reg. sec. 53.4958-1(d)(4)(ii).

[549] *Id.*

willful if the manager does not know that the transaction in which the manager is participating is an excess benefit transaction.[550] An organization manager's participation is due to reasonable cause if the manager has exercised responsibility on behalf of the organization with ordinary business care and prudence.[551] Similar standards of willfulness and reasonable cause apply to foundation managers for purposes of imposition of tax on the manager for knowing participation in an act of self-dealing.[552]

Special rules

An organization manager's reliance on professional advice generally means that the manager has not knowingly participated in an excess benefit transaction. Under Treasury regulations, an organization manager's participation in a transaction ordinarily is not considered knowing, even though the transaction subsequently is held to be an excess benefit transaction, to the extent that, after full disclosure of the factual situation to an appropriate professional, the organization manager relies on a reasoned written opinion of that professional with respect to elements of the transaction within the professional's expertise. A written opinion is considered as reasoned even though it reaches a conclusion that is subsequently determined to be incorrect so long as the opinion addresses itself to the facts and the applicable standards. A written opinion is not considered to be reasoned if it does nothing more than recite the facts and express a conclusion. The absence of a written opinion of an appropriate professional with respect to a transaction does not, by itself, give rise to any inference that an organization manager participated in the transaction knowingly.

Appropriate professionals on whose written opinion an organization manager may rely, are: (1) legal counsel, including in-house counsel; (2) certified public accountants or accounting firms with expertise regarding the relevant tax law matters; and (3) independent valuation experts who hold themselves out to the public as appraisers or compensation consultants, perform the relevant valuations on a regular basis, are qualified to make valuations of the type of property or services involved, and include in the written opinion a certification that the three preceding requirements are met.[553] A similar special rule for private foundation managers, provided in the context of self-dealing, permits reliance only on advice of counsel and not on other persons.[554]

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[550] Treas. Reg. sec. 53.4958-1(d)(5). A similar standard applies to foundation managers for purposes of the self-dealing rules (sec. 4941) and taxable expenditures (sec. 4945). Treas. Reg. sec. 53.4941(b)(4); Treas. Reg. sec. 53.4945-1(a)(2)(iv).

[551] Treas. Reg. sec. 53.4958-1(d)(6).

[552] A similar standard applies to foundation managers for purposes of taxable expenditures. Treas. Reg. sec. 53.4945-1(a)(2)(v).

[553] Treas. Reg. sec. 53.4958-1(d)(4)(iii).

[554] Treas. Reg. sec. 53.4941(a)-1(b)(6). A similar special rule for foundation managers provided for purposes of taxable expenditures (sec. 4945) permits reliance only on advice of counsel and not on other persons. Treas. Reg. sec. 53.4945-1(a)(2)(vi). A similar special rule

An organization manager's participation in a transaction ordinarily is not considered knowing even though the transaction subsequently is held to be an excess benefit transaction, if an appropriate authorized body that approved the transaction meets the requirements of the rebuttable presumption of reasonableness with respect to the transaction.[555]

Initial contract exception for excess benefit transactions

Under Treasury Regulations, the tax on excess benefit transactions does not apply to fixed payments made by an organization to a disqualified person pursuant to a binding written contract between the organization and a person who was not a disqualified person immediately before entering into the contract (the "initial contract exception").[556] For purposes of the initial contract exception, a fixed payment is an amount of cash or other property specified in the contract, or determined by a fixed formula specified in the contract, which is to be paid or transferred in exchange for the provision of specified services or property.

For example, if a public charity hires a chief financial officer by entering into a five-year contract with an individual who was not a disqualified person immediately prior to entering into the contract, and the contract provides for a fixed annual salary, payable in monthly installments, the excess benefit tax does not apply to the individual's compensation under the contract.[557] Accordingly, under the regulations, it is unnecessary to evaluate whether any portion of the compensation paid to the individual pursuant to the five-year contract is an excess benefit transaction.

There is no similar exception for the private foundation self-dealing tax.

Reasons for Change

The intermediate sanctions regime was enacted in 1996 to provide a sanction short of revocation of tax-exemption in cases where the assets of a public charity or social welfare organization are used to benefit insiders. Since the enactment of intermediate sanctions, however, there continue to be reports of abuses by insiders and managers of public charities, as well as by private foundations. Compensation packages, loans, sales of property to insiders, joint ventures, conversions, and other transactions, increasingly are raising questions about the extent to which excess benefits are being provided to insiders of exempt organizations.[558] Transactions

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for foundation managers provided for purposes of the excise tax on jeopardizing investments (sec. 4944) permits reliance on advice of legal counsel and qualified investment counsel. Treas. Reg. sec. 53.4944-1(b)(2)(v).

[555] Treas. Reg. sec. 53.4958-1(d)(4)(iv).

[556] Treas. Reg. sec. 53.4958-4(a)(3).

[557] Treas. Reg. sec. 53.4958-4(a)(3)(vii), Example (1).

[558] Press reports frequently highlight questions of the reasonableness of compensation paid to charity executives, and other insider transactions. For example, the Washington Post in May 2003, published a series of articles raising questions about practices by The Nature

with insiders create widespread opportunities for abuse, especially when the determination of whether a transaction passes muster depends upon a subjective determination of fair market value or reasonableness of compensation. Given the practical difficulties of enforcing valuation questions, the continued report of abuses, and the critical importance of ensuring that charitable assets are not used for private purposes, the proposal addresses specific aspects of the intermediate sanctions regime that impede enforcement and extends certain of these reforms to the self-dealing regime applicable to private foundations.

Description of Proposal

Modify the rebuttable presumption of reasonableness

Eliminate rebuttable presumption and establish due diligence procedures that apply to public charities and private foundations

The proposal eliminates the rebuttable presumption of reasonableness contained in the intermediate sanctions regulations. Under the proposal, the procedures that presently provide an organization with a presumption of reasonableness (i.e., advance approval by an authorized body, reliance upon data as to comparability, and adequate and concurrent documentation) generally will establish instead that an organization has performed the minimum standards of due diligence with respect to an arrangement or transfer involving a disqualified person. Satisfaction of these minimum standards will not result in any presumption, of reasonableness or otherwise. In addition, the proposal extends such minimum standards of due diligence to transactions between private foundations and disqualified persons for purposes of the self-dealing rules (sec. 4941).

Under the proposal, section 501(c)(3) organizations (including public charities and private foundations) and section 501(c)(4) organizations are required to disclose whether such minimum standards of due diligence are satisfied with respect to any transactions potentially subject to the intermediate sanctions or self-dealing rules. If such standards are not adhered to, the organization is required to disclose the procedures, if any, that were adopted to ensure that no excess benefit was provided. Use of information not provided in the minimum due diligence standards, or use of alternative procedures, do not establish a presumption of unreasonableness, but do place an additional burden on the organization to explain the procedures used and the data relied upon to approve a transaction.

Conservancy, including executive compensation, loans to employees, and purchases and sales of land from and by trustees or other insiders. For a description of such concerns in the case of conversion transactions, see Part VIII.B. of this report, "Impose Termination Tax on Conversions of Assets of Charities." Part VIII.L. of this report, "Establish Additional Exemption Standards for Credit Counseling Organizations," describes practices in the credit counseling industry whereby organization insiders profit from self-dealing. (The proposal with respect to credit counseling organizations primarily addresses exemption standards, and not the application of intermediate sanctions to insider transactions.)

Entity level tax on public charities, private foundations, and social welfare organizations

Under the proposal, if an initial tax is imposed on a disqualified person under the intermediate sanctions rules[559] or on a self-dealer under the self-dealing rules,[560] the organization is subject to an excise tax equal to, in the case of a public charity or a social welfare organization, 10 percent of the excess benefit and, in the case of a private foundation, 2.5 percent of the amount involved (increased to 10 percent of the amount involved with respect to the payment of compensation). No tax on the organization is imposed if the organization establishes to the satisfaction of the Secretary that the organization operated consistent with the minimum standards of due diligence (described above) with respect to the transaction resulting in the imposition of tax. The tax is not otherwise subject to abatement, i.e., the tax applies even if the excess benefit transaction is corrected.

Eliminate certain special rules for knowing behavior by organization and foundation managers

The proposal eliminates the special rule that provides that an organization manager's or foundation manager's participation ordinarily is not "knowing" for purposes of the intermediate sanctions and self-dealing excise taxes if the manager relied on professional advice. Although the proposal eliminates the special rule, whether an organization or foundation manager relies on professional advice is a relevant consideration in determining whether an organization or foundation manager knowingly participated in an excess benefit or self-dealing transaction.

The proposal also eliminates the special rule that provides that an organization manager ordinarily does not act knowingly for purposes of the excess benefit excise tax if the organization has met the requirements of the rebuttable presumption procedure.

Modify initial contract exception

The proposal modifies the initial contract exception for purposes of the intermediate sanctions rules. Under the proposal, an initial contract between an organization described in section 501(c)(3) or (c)(4) and a person who was not a disqualified person immediately prior to entering into the initial contract is subject to the intermediate sanctions rules if such person would become a disqualified person upon (a) entering into the contract, or (b) under the terms of the initial contract, at any time within two years of the time the contract is entered into. The proposal applies to all payments under the initial contract, whether fixed or otherwise, and irrespective of whether the disqualified person is a disqualified person for the first two years of the initial contract. For example, the initial employment contract between a public charity and an individual who, upon entering into the contract, becomes the chief financial officer of the charity, is subject to the intermediate sanctions rules even if such person was not a disqualified person immediately before the contract was entered into.

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[559] Sec. 4958(a)(1).

[560] Sec. 4941(a)(1).

Effective Date

The proposal is effective for taxable years beginning after the date of enactment.

Discussion

Modify rebuttable presumption of reasonableness

The rebuttable presumption of reasonableness is intended to be an incentive for organizations to adopt procedures that, if followed, will protect against the occurrence of an excess benefit transaction.[561] Thus, for the presumption to be available, transactions must be approved by an independent body, appropriate data must be relied on, and the body's decision must be properly substantiated. Once the standards for the presumption of reasonableness have been met, the burden is on the Secretary to develop "sufficient contrary evidence to rebut the probative value of the comparability data relied upon by the authorized body."[562] In general, under a presumption of reasonableness approach, the tax law places confidence in the integrity of the procedures (and the persons using the procedures) to produce reasonable results.

The issue addressed by the proposal is whether use of such procedures should shift the burden of proof away from the organization manager and the disqualified person and to the

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[561] The rebuttable presumption of reasonableness does not have a statutory basis. The presumption appears to have originated as a proposal by the American Bar Association in hearings before the Ways & Means Oversight Subcommittee on public charity abuses in 1993. See U.S. Department of the Treasury's Proposals to Improve Compliance by Tax-Exempt Organizations: Hearing before the Subcommittee on Oversight of the Committee on Ways and Means House of Representatives, 103rd Cong., Serial 103-72, at 47. At the same hearing, the Treasury Department introduced its intermediate sanctions proposal. *Id.* at 20. The Treasury proposal did not contain a rebuttable presumption of reasonableness. Rather, the Treasury emphasized that certain actions taken by an organization, e.g., approval by an independent board, generally would "weigh in favor of a finding of reasonableness". *Id.* at 21 ("The weight to be given to this factor would depend on the circumstances"). The Treasury noted that:

> Determinations of the reasonableness of compensation would be made in accordance with the procedures that govern the resolution of any factual question involved in the application of a tax rule. Therefore, taxpayers who disagree with an IRS determination of unreasonableness would have recourse to the normal review procedures, including, as necessary, administrative appeals and judicial proceedings.

The law eventually enacted by Congress largely followed the Treasury proposal. However, the legislative history to the provision outlined the rebuttable presumption of reasonableness in terms substantially similar to the American Bar Association proposal. The legislative history then provided the underpinning for the rebuttable presumption of reasonableness, which became part of the Treasury regulations. H. Rep. No. 506, 104th Cong., 2d Sess. (1996), 53, 56-7.

[562] Treas. Reg. sec. 53.4958-6(b).

Secretary. There appear to be no reasons to depart from normal tax rules by providing special treatment for organization managers and disqualified persons. Shifting the burden of proof to the Secretary may undermine the effectiveness of the intermediate sanctions regime by emphasizing process instead of substance, with the result that organization managers and insiders may be able to use the process to reach a desired result with impunity. Thus, the proposal eliminates the presumption of reasonableness.

Nonetheless, the procedures that create a rebuttable presumption of reasonableness are laudable. The proposal continues to encourage use of such procedures, described under the proposal as minimum standards of due diligence, by imposing a tax on the organization equal to 10 percent of the excess benefit provided if the organization fails to use the procedures with respect to an excess benefit transaction upon which tax is imposed on the disqualified person. In addition, organizations that do not use the procedures are required generally to disclose what steps the organization takes to ensure that inurement does not occur. Thus, in general, the proposal is intended to strengthen the hand of the IRS in excess benefit transactions by placing the burden of proof on organization managers and disqualified persons, while still requiring use of the prophylactic procedures.

Some might argue that it is too soon to conclude that the rebuttable presumption of reasonableness should be modified because the Treasury Regulations were finalized only relatively recently (January 2002). Although the final regulations are recent, the rebuttable presumption has been a penumbral part of the rules since the 1996 enactment. More importantly, as a threshold matter, the tax system arguably should not rely primarily on the use of procedures, often implemented by self-interested parties, to enforce a penalty excise tax regime intended to deter misconduct by insiders. The very issue for which the burden is shifted by the presumption is in many, if not most, cases valuation, a subject with inherent subjectivity. Independently prepared appraisals or compensation studies may reach a result that the IRS believes is unreasonable, but proving unreasonableness can be difficult. Thus, the IRS already faces a high hurdle on the issue of valuation, even prior to assuming the burden of proof established by the presumption of reasonableness.

It can be argued that the effect of the presumption is to take the IRS out of the substantive issue entirely because, as a practical matter, examining agents will focus not on whether too much compensation is paid, or whether fair market value is provided in a property transaction, but instead will look to whether appropriate procedures were followed. If the procedures were followed, the agent knows success on the merits is unlikely because the IRS will have to overcome a presumption of reasonableness in favor of the taxpayer. Under such circumstances, agents often will abandon the issue. Thus, for the IRS to have a realistic chance at success in overcoming the present-law presumption of reasonableness, the excess benefit provided must manifestly be unreasonable.

Some might suggest, however, that the main benefit of the rebuttable presumption of reasonableness is that it provides certainty, both to organization managers and insiders, and to the IRS. Without the presumption, some might claim that organizations will have no reassurance that their dealings with insiders will not fall prey to an overzealous IRS agent; and, that organization managers need the security the presumption provides in order to conduct the organization's affairs without the constant threat of an intermediate sanction. Some might also

say that the IRS benefits as well because the IRS can focus less on the resource intensive and sometimes futile issue of valuation and more on the straightforward issue of process.

Abandoning the rebuttable presumption of reasonableness likely will result in the loss of some certainty on the part of organization managers and other insiders. The question is whether providing such certainty overrides the purpose of the intermediate sanctions regime. The premise of the regime was to provide an effective alternative to revocation of exemption, i.e., a threat that would deter private inurement. However, the rebuttable presumption of reasonableness undermines that threat by placing control of the substantive issue – whether a benefit is excessive – in the hands of organization managers and insiders. Such persons may satisfy the technical requirements of the procedure in order to immunize themselves against sanctions, but nevertheless reach the desired substantive result. In short, the certainty provided by the rebuttable presumption of reasonableness generally is a certainty that a sanction will not be imposed.

It is noted that even after the proposed elimination of the rebuttable presumption of reasonableness, the intermediate sanctions regime is more liberal than the regime that applies to self-dealing transactions by private foundations. Private foundations simply are barred from entering into certain transactions with insiders, regardless of whether fair value is paid (with the exception of compensation, with respect to which only excessive compensation is barred). Following the private foundation model, one reform approach for intermediate sanctions would be to replace the intermediate sanctions regime with the stricter private foundation self-dealing rules. Such an approach is simple in that it treats as suspect most insider transactions, and also has the benefit of virtually eliminating the need to value transactions (except in the case of compensation). However, some might argue that to the extent the intermediate sanctions regime is imperfect, adoption of a per se rule against fair market value transactions would severely affect the ability of public charities to enter into many below-market transactions that substantially benefit the charity and directly further its charitable purposes. To address this concern, an alternative would be to ban insider transactions, as under the private foundation self-dealing rules, unless a benefit is provided to the charitable organization at or below fair market value.

Unlike an approach that would apply some or all of the private foundation self-dealing rules to public charities and social welfare organizations, the proposed elimination of the rebuttable presumption of reasonableness does not alter the basic policy of the intermediate sanctions regime, i.e., fair market value transactions still are permitted. The proposal also gives the IRS more authority to enforce the regime and thus provides a stronger deterrent to self-dealing and private inurement than under present law. If the presumption of reasonableness becomes further entrenched in the law, it could undermine the ability of the IRS to enforce the intermediate sanctions rules to such an extent that Congress might be forced to revisit (as it did for private foundations in 1969) whether arm's length standards must be replaced by per se prohibitions.

Impose entity level tax for failure to use minimum due diligence procedures

Under the proposal, an entity level tax is imposed on organizations that do not use the minimum procedures of due diligence (known under present law as the procedures that provide a rebuttable presumption of reasonableness) with respect to a transaction that is an excess benefit

transaction. Such a tax provides a direct incentive for an organization to adopt the prophylactic procedures.

Some might argue that a tax on the organization is unfair to the charitable (or other) beneficiaries, who must bear the brunt of the tax. Taxes should be paid, some might say, only by the perpetrators of the transaction. However, holding the organization harmless for condoning an excess benefit transaction, as under present law, does not provide the organization with any incentive to prevent an excess benefit transaction from occurring. An entity level tax on a matter over which the organization generally has control gives the organization a role in preventing inurement, and provides an intermediate sanction on the organization, instead of just on organization insiders, that is short of revocation of the organization's exempt status. It is reasonable to expect the organization to require procedures that satisfy the minimum due diligence standards, and tax it for failing to do so if its insiders (because of the absence of the procedures) are allowed to benefit improperly from dealing with the organization.

Arguably, an entity level tax should apply to all excess benefit transactions regardless of whether the minimum due diligence procedures are used. Without such a tax, a member of the Board of Directors (or other insider) who does not benefit from an excess benefit transaction but who knows the person who does benefit, might ignore such a transaction because the organization itself is not at risk. Such obliging conduct by some insiders might change if the entity were subject to tax. Although the entity level tax could be applied more broadly, the proposal limits application of the tax to situations where the organization can be held directly responsible, i.e., the failure of the organization to establish the prophylactic procedures. Such a tax generally is consistent with the policy supporting entity level taxes on foundations for not meeting minimum payout requirements, for having excess business holdings, for investments that jeopardize charitable purposes, and for taxable expenditures.[563] All such taxes are imposed on conduct over which the foundation generally has control or responsibility as an entity.

Extend minimum due diligence procedures and entity level tax to private foundations

In addition to eliminating the rebuttable presumption of reasonableness, the proposal extends the mandated use of the minimum standards of due diligence and the entity level tax imposed for failures to use such procedures to self-dealing transactions by private foundations. In general, the intermediate sanctions regime and the private foundation self-dealing regime should be consistent unless there is a clear policy rationale in favor of a distinction. Requiring the use of certain procedures to prevent against self-dealing transactions, if recommended for use by public charities, also should be used by private foundations. The entity level tax, in this case, is an enforcement mechanism for the use of the procedures, and also should apply to private foundations.

Rate of entity-level tax

With respect to the intermediate sanctions regime, the proposed rate of the entity-level tax is 10 percent of the excess benefit provided. The proposed 10 percent rate is equal to twice

[563] Secs. 4942-4945.

the rate applicable under present-law to private foundations for excess business holdings and jeopardizing investments, and is equal to the present law rate on private foundations for taxable expenditures.[564] Thus, the 10 percent rate is comparable to entity-level taxes provided under present law.

With respect to the private foundation self-dealing regime, the proposed rate of the entity level tax generally is 2.5 percent. This rate is substantially less than the 10 percent rate proposed for purposes of intermediate sanctions because the base of the tax for self-dealing purposes generally is the entire amount of the transaction, as compared to just the excess amount paid as is the case for excess benefit transactions. Thus, a lower rate of tax is warranted for private foundations.

A 10 percent rate of tax on private foundations, however, is proposed with respect to the payment of compensation. For compensation arrangements, the tax base is the same under both regimes, i.e., the excess amount paid, and thus the proposed rate of tax on compensation self-dealing and excess benefit transactions -- ten percent -- also is the same.

Revise special rules for knowing behavior by organization managers

Under present law, an organization manager is subject to intermediate sanctions only if the organization manager knowingly participated in an excess benefit transaction. Similarly, a private foundation manager is subject to an excise tax for self-dealing only if the foundation manager's participation in the act is knowing.

The knowing standard is a high threshold in both cases. Knowing conduct, for this purpose, requires actual knowledge of sufficient facts that would constitute an excess benefit or self-dealing transaction, awareness that the transaction may violate Federal law, and negligent failure to make reasonable attempts to determine whether a transaction is an excess benefit transaction or an act of self-dealing (or actual awareness that a transaction is an excess benefit or self-dealing transaction). Knowing conduct must be willful, meaning that it must be voluntary, conscious, and intentional. The burden of proof to show knowing conduct in the Tax Court is placed specifically on the Secretary. In addition, an organization or foundation manager is not subject to tax if the manager acted with reasonable cause, i.e., the manager exercised responsibility on behalf of the organization with ordinary business care and prudence.

The standard for knowing conduct is high because, in general, there is a belief that managers of exempt organizations should be subject to tax only in cases where it is clear that a manager truly is culpable. A standard less than knowing, such as reason to know, or negligence, might deter qualified individuals from serving as managers of charitable or social welfare organizations for fear that a tax would be imposed unfairly. However, to be an effective

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[564] Part VIII.E. of this report, "Increase the Amounts of Excise Taxes Imposed on Public Charities, Social Welfare Organizations, and Private Foundations," proposes doubling the rates of these taxes. If such proposal is adopted, the 10 percent entity-level tax described here would be equal to the tax rate applicable to foundations for excess business holdings and jeopardizing investments, and half the rate with respect to taxable expenditures.

deterrent to errant behavior, there must be at least a realistic possibility that the tax will be imposed and upheld. The regulatory special rules that are layered on top of the already rigorous statutory standards of knowing conduct described above may unnecessarily excuse an organization or foundation manager from imposition of tax in cases where the manager has the requisite knowledge.

With respect to excess benefit transactions, the proposal eliminates the special rules that conduct ordinarily is not knowing if the organization manager relied on the advice of an appropriate professional or that the organization satisfied the procedures required for the rebuttable presumption of reasonableness. In effect, the reliance on professional advice special rule permits a manager to delegate his or her judgment to a professional -- whether it be legal counsel, a certified public accountant, or an independent valuation expert -- who may be under pressure from a culpable organization manager to reach a certain result. Under the proposal, instead of providing a special rule, reliance on professional advice that a transaction is not an excess benefit transaction generally would be a favorable factor showing that the organization manager did not know the transaction provided an excess benefit. Reliance on sound professional advice therefore is still encouraged, but such reliance does not provide the organization manager with a special rule.

Some might argue that the reliance on professional advice special rule is a long-standing regulatory rule, variations of which are provided to private foundation managers for purposes of the excise taxes with respect to self-dealing, jeopardizing business investments, and taxable expenditures.[565] Thus, some might say that in promulgating regulations on excess benefit transactions, the Treasury merely extended similar protections to organization managers and that it would not be fair to give private foundation managers greater protection than public charity and social welfare organization managers. However, the proposal also eliminates the special rule with respect to self-dealing by private foundation managers, and for similar reasons, i.e., the statutory standard for knowing behavior is sufficiently high without a special rule that immunizes culpable conduct.[566]

It is noted that the reliance on professional advice special rule for foundation managers is narrower than that provided for organization managers in that reliance is permitted only on the advice of legal counsel, and not on certified public accountants or independent valuation experts. Thus, the possibilities for abuse of the special rule are less in the private foundation self-dealing context because fewer types of professional judgment may be relied upon, e.g., a compensation consultant's determination of reasonable compensation may not be relied upon by a foundation

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[565] Secs. 4941, 4944, and 4945.

[566] The proposal does not recommend elimination of the reliance on counsel special rule for purposes of the taxes on jeopardizing investments and taxable expenditures. Seeking the advice of investment or legal counsel for purposes of making an investment for the foundation, or seeking the advice of legal counsel to determine whether an expense of the foundation is a taxable expenditure are different types of inquiries than seeking professional advice with respect to self-dealing transactions. It is in the very nature of self-dealing that a manager's duties are highest and where personal responsibility is paramount.

manager for purposes of the special rule. Nevertheless, responsibility for whether private inurement knowingly is facilitated by a foundation (or organization) manager should rest ultimately on the manager's own knowledge and conduct, and not on whether a manager seeks outside advice.

The proposal also eliminates the special rule that is provided an organization manager if the organization acts pursuant to the rebuttable presumption procedure. In general, the original logic behind the special rule -- that a transaction earning the presumption of reasonableness should protect an organization manager from tax -- no longer applies when considered in conjunction with the proposal to eliminate the presumption of reasonableness. Thus, without a presumption of reasonable conduct by the organization, there should not be a presumption of unknowing conduct by an organization manager. Even if the presumption of reasonableness is retained in present law, the special rule arguably still should be eliminated because the standard of knowing is sufficiently rigorous without the special rule, and also because a person's knowledge of bad conduct should not be immunized just because the organization took steps, yet failed, to protect against an excess benefit transaction occurring.

Modify initial contract exception

An initial contract exception was not provided in the statute, the legislative history, or the proposed Treasury regulations. After the issuance of the proposed regulations, the United States Court of Appeals for the Seventh Circuit issued its decision in *United Cancer Council, Inc. v. Commissioner of Internal Revenue Service*.[567] The transactions at issue in that case were conducted prior to the effective date of the intermediate sanctions rules. Nonetheless, in that case the court concluded that prohibited private inurement under section 501(c)(3) cannot result from a contractual relationship negotiated at arm's length with a party having no prior relationship with the exempt organization, regardless of the relative bargaining strength of the parties or resultant control over the exempt organization created by the terms of the contract. Based on this decision and on comments received by the Secretary, the subsequent temporary and final regulations issued by the Secretary created the initial contract exception that removed from scrutiny certain fixed payments made pursuant to an initial contract between a third party and the exempt organization.

Some would argue that the initial contract exception is needed because it is unfair and unnecessary to apply intermediate sanctions to an initial contract between an organization and a person who does not yet have the legal authority to exercise substantial influence over the affairs of the organization, even if that person becomes a disqualified person by virtue of entering into the contract. Some would assert that until the contract is executed, the organization and the third party are conducting negotiations at arm's length and that the organization is not under the control of the third party. However, in cases where the organization is contracting with a person who will have the capacity to exercise control or substantial influence over the organization upon entering into the contract, it is questionable whether an organization generally can conduct negotiations entirely at arm's length and free of the influence of the third party. Although organizations have a financial incentive and legal obligation to protect their own interests in such

[567] 165 F.3d 1173 (7th Cir. 1999), *rev'ing and remanding* 109 T.C. 326 (1997).

cases, they often are under intense pressure (e.g., due to fear of losing the individual to competitors or of creating tension and hostility between the organization and an individual who will be critical to the organization's success) to negotiate contractual terms that may result in an excess benefit being provided to the third party.

Allowing initial contracts to escape the scrutiny of the intermediate sanction provisions permits an organization to provide a substantial excess benefit to a third party without any real threat of a sanction to a party to the transaction or to the organization managers.[568] The initial contract exception encourages long-term contracts by removing all fixed compensation paid under the contract from excise tax exposure for its organization managers (and for the disqualified person), no matter how long the term of the contract. (For example, an organization might enter into a five-year contract rather than a two-year contract to assure that the first five years of compensation paid to a new officer escape scrutiny. If a two-year contract were used, only the first two years would avoid scrutiny). The initial contract exception also encourages structuring the compensation arrangement as fixed payments, rather than as performance-based variable payments that allow for the subsequent discretion of the organization, even if a performance-based structure would best serve the interests of the organization.

[568] The legislative history to section 4958 states that "[i]n practice, revocation of tax-exempt status, with or without the imposition of excise taxes, would occur only when the organization no longer operates as a charitable organization." H. Rept. No. 104-506, 59, n.15. Thus, under present law, an initial contract likely would have to be found to be so unfair to the exempt organization that the organization cannot be regarded as operating in a charitable manner before any sanction would be imposed.

E. Increase the Amount of Excise Taxes Imposed on Public Charities, Social Welfare Organizations, and Private Foundations (secs. 4941, 4942, 4943, 4944, 4945, and 4958)

Present Law

Public charities and social welfare organizations

The Code imposes excise taxes on excess benefit transactions between disqualified persons (as defined in section 4958(f)) and charitable organizations (other than private foundations) or social welfare organizations (as described in section 501(c)(4)).[569] An excess benefit transaction generally is a transaction in which an economic benefit is provided by a charitable or social welfare organization directly or indirectly to or for the use of a disqualified person, if the value of the economic benefit provided exceeds the value of the consideration (including the performance of services) received for providing such benefit.

The excess benefit tax is imposed on the disqualified person and, in certain cases, on the organization manager, but is not imposed on the exempt organization. An initial tax of 25 percent of the excess benefit amount is imposed on the disqualified person that receives the excess benefit. An additional tax on the disqualified person of 200 percent of the excess benefit applies if the violation is not corrected. A tax of 10 percent of the excess benefit (not to exceed $10,000 with respect to any excess benefit transaction) is imposed on an organization manager that knowingly participated in the excess benefit transaction, if the manager's participation was willful and not due to reasonable cause, and if the initial tax was imposed on the disqualified person.[570] If more than one person is liable for the tax on disqualified persons or on management, all such persons are jointly and severally liable for the tax.[571]

Private foundations

Self-dealing by private foundations

Excise taxes are imposed on acts of self-dealing between a disqualified person (as defined in section 4946) and a private foundation.[572] In general, self-dealing transactions are any direct or indirect: (1) sale or exchange, or leasing, of property between a private foundation and a disqualified person, including transfers of property subject to a mortgage or lien that the private foundation assumes or that was put on the property by the disqualified person within 10 years of

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[569] Sec. 4958. The excess benefit transaction tax is commonly referred to as "intermediate sanctions," because it imposes penalties generally considered to be less punitive than revocation of the organization's exempt status.

[570] Sec. 4958(d)(2). Taxes imposed may be abated if certain conditions are met. Secs. 4961 and 4962.

[571] Sec. 4958(d)(1).

[572] Sec. 4941.

the transfer; (2) lending of money or other extension of credit between a private foundation and a disqualified person, except for no-interest loans by a disqualified person, the proceeds of which are used exclusively for charitable purposes; (3) the furnishing of goods, services, or facilities between a private foundation and a disqualified person, unless the goods, services, or facilities are (i) functionally related to the foundation's exempt purposes and are provided to or by the foundation on the same basis as provided by the foundation or disqualified person to the general public, (ii) reasonable and necessary to performing exempt purposes and not excessive, or (iii) provided by disqualified person without charge; (4) the transfer to, or use by or for the benefit of, a disqualified person of the income or assets of the private foundation, unless the use or benefit is de minimis; and (5) certain payments of money or property to a government official. Leases provided by a disqualified person without charge to a private foundation, even if the foundation pays for maintenance, are permitted.

An initial tax of five percent of the amount involved with respect to an act of self-dealing is imposed on any disqualified person (other than a foundation manager acting only as such) who participates in the act of self-dealing. If such a tax is imposed, a 2.5-percent tax of the amount involved is imposed on a foundation manager who participated in the act of self-dealing knowing it was such an act (and such participation was not willful and was due to reasonable cause) up to $10,000 per act. Such initial taxes may not be abated.[573] Such initial taxes are imposed for each year in the taxable period, which begins on the date the act of self-dealing occurs and ends on the earliest of the date of mailing of a notice of deficiency for the tax, the date on which the tax is assessed, or the date on which correction of the act of self-dealing is completed. A government official (as defined in section 4946(c)) is subject to such initial tax only if the official participates in the act of self-dealing knowing it is such an act. If the act of self-dealing is not corrected, a tax of 200 percent of the amount involved is imposed on the disqualified person and a tax of 50 percent of the amount involved (up to $10,000 per act) is imposed on a foundation manager who refused to agree to correcting the act of self-dealing. Such additional taxes are subject to abatement.[574]

Tax on failure to distribute income

Private nonoperating foundations are required to pay out a minimum amount each year as qualifying distributions. In general, a qualifying distribution is an amount paid to accomplish one or more of the organization's exempt purposes, including reasonable and necessary administrative expenses.[575] Failure to pay out the minimum results in an initial excise tax on the foundation of 15 percent of the undistributed amount. An additional tax of 100 percent of the undistributed amount applies if an initial tax is imposed and the required distributions have not been made by the end of the applicable taxable period.[576] A foundation may include as a

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[573] Sec. 4962(b).

[574] Sec. 4961.

[575] Sec. 4942(g)(1)(A).

[576] Sec. 4942(a) and (b). Taxes imposed may be abated if certain conditions are met. Secs. 4961 and 4962.

qualifying distribution the salaries, occupancy expenses, travel costs, and other reasonable and necessary administrative expenses that the foundation incurs in operating a grant program. A qualifying distribution also includes any amount paid to acquire an asset used (or held for use) directly in carrying out one or more of the organization's exempt purposes and certain amounts set-aside for exempt purposes.[577] Private operating foundations are not subject to the payout requirements.

Tax on excess business holdings

Private foundations are subject to tax on excess business holdings.[578] In general, a private foundation is permitted to hold 20 percent of the voting stock in a corporation, reduced by the amount of voting stock held by all disqualified persons (as defined in section 4946). If it is established that no disqualified person has effective control of the corporation, a private foundation and disqualified persons together may own up to 35 percent of the voting stock of a corporation. A private foundation shall not be treated as having excess business holdings in any corporation if it owns (together with certain other related private foundations) not more than two percent of the voting stock and not more than two percent in value of all outstanding shares of all classes of stock in that corporation. Similar rules apply with respect to holdings in a partnership ("profits interest" is substituted for "voting stock" and "capital interest" for "nonvoting stock") and to other unincorporated enterprises (by substituting "beneficial interest" for "voting stock"). Private foundations are not permitted to have holdings in a proprietorship. Foundations generally have a five-year period to dispose of excess business holdings (acquired other than by purchase) without being subject to tax.[579] This five-year period may be extended an additional five years in limited circumstances.[580]

The initial tax is equal to five percent of the value of the excess business holdings held during the foundation's applicable taxable year. An additional tax is imposed if an initial tax is imposed and at the close of the applicable taxable period, the foundation continues to hold excess business holdings. The amount of the additional tax is equal to 200 percent of such holdings.

Tax on jeopardizing investments

Private foundations and foundation managers are subject to tax on investments that jeopardize the foundation's charitable purpose.[581] In general, an initial tax of five percent of the

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[577] Sec. 4942(g)(1)(B) and 4942(g)(2). In general, an organization is permitted to adjust the distributable amount in those cases where distributions during the five preceding years have exceeded the payout requirements. Sec. 4942(i).

[578] Sec. 4943. Taxes imposed may be abated if certain conditions are met. Secs. 4961 and 4962.

[579] Sec. 4943(c)(6).

[580] Sec. 4943(c)(7).

[581] Sec. 4944. Taxes imposed may be abated if certain conditions are met. Secs. 4961 and 4962.

amount of the investment applies to the foundation and to foundation managers who participated in the making of the investment knowing that it jeopardized the carrying out of the foundation's exempt purposes. The initial tax on foundation managers may not exceed $5,000 per investment. If the investment is not removed from jeopardy (e.g., sold or otherwise disposed of), an additional tax of 25 percent of the amount of the investment is imposed on the foundation and five percent of the amount of the investment on a foundation manager who refused to agree to removing the investment from jeopardy. The additional tax on foundation managers may not exceed $10,000 per investment. An investment, the primary purpose of which is to accomplish a charitable purpose and no significant purpose of which is the production of income or the appreciation of property, is not considered a jeopardizing investment.[582]

Tax on taxable expenditures

Certain expenditures of private foundations are subject to tax.[583] In general, taxable expenditures are expenses: (1) for lobbying; (2) to influence the outcome of a public election or carry on a voter registration drive (unless certain requirements are met); (3) as a grant to an individual for travel, study, or similar purposes unless made pursuant to procedures approved by the Secretary; (4) as a grant to an organization that is not a public charity or exempt operating foundation unless the foundation exercises expenditure responsibility[584] with respect to the grant; or (5) for any non-charitable purpose. For each taxable expenditure, a tax is imposed on the foundation of 10 percent of the amount of the expenditure, and an additional tax of 100 percent is imposed on the foundation if the expenditure is not corrected. A tax of 2.5 percent of the expenditure (up to $5,000) also is imposed on a foundation manager who agrees to making a taxable expenditure knowing that it is a taxable expenditure. An additional tax of 50 percent of the amount of the expenditure (up to $10,000) is imposed on a foundation manager who refuses to agree to correction of such expenditure.

Reasons for Change

The Tax Reform Act of 1969 introduced the present-law regime of excise taxes that is applicable to certain actions of private foundations (self-dealing, failure to distribute income, excess business holdings, jeopardizing investments, and taxable expenditures). The amount of such taxes has not been changed since. The excise taxes were established to provide strong deterrents to foundations, and in some cases foundation managers, from engaging in abusive or disapproved transactions. In the years following passage of the 1969 Act, the IRS closely monitored the conduct of private foundations, and in 1990 the Treasury Department concluded

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[582] Sec. 4944(c).

[583] Sec. 4945. Taxes imposed may be abated if certain conditions are met. Secs. 4961 and 4962.

[584] In general, expenditure responsibility requires that a foundation make all reasonable efforts and establish reasonable procedures to ensure that the grant is spent solely for the purpose for which it was made, to obtain reports from the grantee on the expenditure of the grant, and to make reports to the Secretary regarding such expenditures. Sec. 4945(h).

that foundations were largely a compliant sector.[585] In subsequent years, however, audits of foundations and other section 501(c)(3) organizations generally has fallen significantly. For example, the audit rate of private foundation returns for 1985 was several times the audit rate of such returns during 2002 and 2003.[586] With such a decreased enforcement presence, there is an increased likelihood that private foundations are not as compliant as reported by the Treasury Department in 1990 and that the current excise tax rates, which have not increased in 35 years, are not providing a sufficient deterrent.[587] Thus, the proposal generally recommends that the initial taxes, and the dollar amount limitations on foundation manager liability, be doubled.

Description of Proposal

Self-dealing and excess benefit transaction initial taxes and dollar limitations

For acts of self-dealing other than the payment of compensation by a private foundation to a disqualified person, the proposal increases the initial tax on the self-dealer from five percent of the amount involved to 10 percent of the amount involved. For acts of self-dealing regarding the payment of compensation by a private foundation to a disqualified person, the proposal increases the initial tax on the self-dealer from five percent of the amount involved (none of which is subject to abatement) to 25 percent of the amount involved (15 percent of which is subject to abatement). The proposal increases the initial tax on foundation managers from 2.5 percent of the amount involved to five percent of the amount involved and increases the dollar limitation on the amount of the initial and additional taxes on foundation managers per act of self-dealing from $10,000 per act to $20,000 per act. Similarly, the proposal doubles the dollar limitation on organization managers of public charities and social welfare organizations for

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[585] Internal Revenue Service, "*Private Foundation Grant-Making Administrative Expenses Study*" (January 1990).

[586] Based on IRS Statistics of Income, it appears that between 60,000 and 75,000 annual information returns were filed by private foundations for each of the taxable years examined during 2002 and 2003. Less than 150 of such returns were examined by the IRS during each of those years (approximately 0.3 percent). The number of such returns filed for 1985, the year that was the subject of the IRS compliance study, was approximately 31,000. The IRS examined 882 private foundation returns for the study (approximately 2.8 percent of returns filed). *Id.* at Appendix A.

[587] A recent series of reports in the Boston Globe highlight many brazen abuses by private foundation managers. See, e.g., *Boston Globe*, "Some officers of charities steer assets to selves" (October 9, 2003); *Boston Globe*, "Foundation's sale of nonprofit hospital a windfall for administrator" (October 9, 2003); *Boston Globe*, "Charity money funding perks" (November 9, 2003); *Boston Globe*, "Costly furnishings come at charities' expense" (November 9, 2003); *Boston Globe*, "The trustees' perk that keeps on giving" (November 9, 2003); *Boston Globe*, "Foundations veer into business" (December 3, 2003); *Boston Globe*, "Philanthropist's millions enrich family retainers" (December 21, 2003); *Boston Globe*, "Foundation's tax returns left unchecked" (December 29, 2003).

participation in excess benefit transactions from $10,000 per transaction to $20,000 per transaction.

Failure to distribute income, excess business holdings, jeopardizing investments, and taxable expenditures

The proposal doubles the amounts of the initial taxes and the dollar limitations on foundation managers with respect to the private foundation excise taxes on the failure to distribute income, excess business holdings, jeopardizing investments, and taxable expenditures.

Specifically, for the failure to distribute income, the initial tax on the foundation is increased from 15 percent of the undistributed amount to 30 percent of the undistributed amount.

For excess business holdings, the initial tax on excess business holdings is increased from five percent of the value of such holdings to 10 percent of such value.

For jeopardizing investments, the initial tax of five percent of the amount of the investment that is imposed on the foundation and on foundation managers is increased to 10 percent of the amount of the investment. The dollar limitation on the initial tax on foundation managers of $5,000 per investment is increased to $10,000 and the dollar limitation on the additional tax on foundation managers of $10,000 per investment is increased to $20,000.

For taxable expenditures, the initial tax on the foundation is increased from 10 percent of the amount of the expenditure to 20 percent, the initial tax on the foundation manager is increased from 2.5 percent of the amount of the expenditure to five percent, the dollar limitation on the initial tax on foundation managers is increased from $5,000 to $10,000, and the dollar limitation on the additional tax on foundation managers is increased from $10,000 to $20,000.

Effective Date

The proposal is effective for taxable years beginning after the date of enactment.

Discussion

In general, the proposal doubles the amount of excise taxes with respect to certain activities by private foundations and private foundation managers and increases the dollar limitations applicable to excise taxes on public charity, private foundation, and social welfare organization managers. Excise tax regimes that penalize certain conduct generally are effective if there is the right combination of a punitive sanction and the threat that the sanction will be enforced. Because of the general decrease in enforcement activities for charitable organizations, the proposal increases the amount of the sanction in order to impose an additional deterrent to prohibited behavior.

With respect to the payment of compensation by a private foundation to a self-dealer, the proposal increases the initial tax from five percent to 25 percent. The increase to 25 percent is intended to provide partial conformity with the intermediate sanctions regime, which taxes the disqualified person at the rate of 25 percent of the excess benefit provided. Such conformity is warranted with respect to the payment of compensation and not to other acts of self-dealing

because the tax base is the same under both regimes for payment of compensation, i.e., the excess compensation paid.[588] Substantially similar acts (payment of excess compensation) generally should not be subject to different excise tax rates.

The proposal does not completely conform the two excise tax regimes with respect to the payment of compensation because the proposal preserves, in part, the stricter private foundation rule that no abatement is provided for initial taxes on the self-dealer. Thus, the proposal provides that up to 15 percent of the tax is subject to abatement (i.e., the present law initial tax of five percent of the amount involved, none of which is subject to abatement, is doubled, and in addition, a tax of 15 percent tax may be imposed, which is subject to abatement).

The dollar limitations applicable to organization managers and private foundation managers are increased from $10,000 per act to $20,000 per act (or in some cases, from $5,000 per act to $10,000 per act). Higher penalties are warranted to provide an even greater deterrent to knowing participation in an excess benefit transaction, act of self-dealing, or the making of a jeopardizing investment or taxable expenditure.

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[588] The tax base for other acts of self-dealing by private foundations generally is the entire amount of a transaction. The tax base for purposes of intermediate sanctions, by contrast, is always the excess above fair market value.

F. Modify Charitable Deduction for Contributions of Conservation and Facade Easements (sec. 170)

Present Law

In general

Section 170(h) provides special rules that apply to charitable contributions of qualified conservation contributions, which include conservation easements and facade easements. Qualified conservation contributions are not subject to the "partial interest" rule, which generally bars deductions for charitable contributions of partial interests in property. Accordingly, qualified conservation contributions are contributions of partial interests that are eligible for a fair market value deduction.

A qualified conservation contribution is a contribution of a qualified real property interest to a qualified organization exclusively for conservation purposes. A qualified real property interest is defined as: (1) the entire interest of the donor other than a qualified mineral interest; (2) a remainder interest; or (3) a restriction (granted in perpetuity) on the use that may be made of the real property.[589] Qualified organizations include certain governmental units, public charities that meet certain public support tests, and certain supporting organizations. Conservation purposes include: (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 (including farmland and forest land) where such preservation will yield a significant public benefit and is either for the scenic enjoyment of the general public or pursuant to a clearly delineated Federal, State, or local governmental conservation policy; and (4) the preservation of an historically important land area or a certified historic structure.

In general, no deduction is available if the property may be put to a use that is inconsistent with the conservation purpose of the gift.[590] A contribution is not deductible if it accomplishes a permitted conservation purpose while also destroying other significant conservation interests.[591]

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[589] Charitable contributions of interests that constitute the taxpayer's entire interest in the property are not regarded as qualified real property interests within the meaning of section 170(h), but instead are subject to the general rules applicable to charitable contributions of entire interests of the taxpayer (i.e., generally are deductible at fair market value, without regard to satisfaction of the requirements of section 170(h)). Priv. Ltr. Rul. 8626029 (March 25, 1986).

[590] Treas. Reg. sec. 1.170A-14(e)(2).

[591] Treas. Reg. sec. 1.170A-14(e)(2).

Valuation of conservation restrictions

Valuation standards

The value of a conservation restriction granted in perpetuity generally is determined under the "before and after approach." Such approach provides that the fair market value of the restriction is equal to the difference (if any) between the fair market value of the property the restriction encumbers before the restriction is granted and the fair market value of the encumbered property after the restriction is granted.[592] Courts generally apply this standard by looking at the objective uses of the property. At least one court, however, has examined the subjective intentions of the contributing taxpayer to apply this standard.[593]

If the granting of a perpetual restriction has the effect of increasing the value of any other property owned by the donor or a related person, the amount of the charitable deduction for the conservation contribution is to be reduced by the amount of the increase in the value of the other property.[594] In addition, the donor is to reduce the amount of the charitable deduction by the amount of financial or economic benefits that the donor or a related person receives or can reasonably be expected to receive as a result of the contribution.[595] If such benefits are greater than those that will inure to the general public from the transfer, no deduction is allowed.[596] In those instances where the grant of a conservation restriction has no material effect on the value of the property, or serves to enhance, rather than reduce, the value of the property, no deduction is allowed.[597]

Valuation-related penalties

Present law imposes accuracy-related penalties on a taxpayer in cases involving a substantial valuation misstatement or gross valuation misstatement relating to an underpayment of income tax.[598] For this purpose, a substantial valuation misstatement generally means a value

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[592] Treas. Reg. sec. 1.170A-14(h)(3).

[593] *McLennan v. U.S.*, 24 Cl. Ct. 102 (1991) (highest and best use refers to "the most profitable and probable use" of the property; although the property could be subdivided into eight parcels, the taxpayer's "strong aversion to development" meant that a valuation based on an assumption of subdividing the entire property was "untenable" and "directly contradicts [taxpayers'] clear intention to preserve their land from development;" found that the reasonable and probable use of the property was as an undivided country estate, not as a subdivision, and that the easement did not affect the highest and best use of the land).

[594] Treas. Reg. sec. 1.170A-14(h)(3)(i).

[595] *Id.*

[596] *Id.*

[597] Treas. Reg. sec. 1.170A-14(h)(3)(ii).

[598] Secs. 6662(b)(3) and 6662(h).

claimed that is at least twice the amount determined to be the correct value, and a gross valuation misstatement generally means a value claimed that is at least four times the amount determined to be the correct value.[599] Present law does not impose substantial or gross valuation misstatement penalties on an appraiser that conducted an appraisal that was used by a taxpayer to support the value claimed on the taxpayer's return. However, the Secretary may disqualify an appraiser from practicing before the IRS under certain circumstances.[600]

Conservation purposes

Public recreation or education

Under Treasury Regulations, a donation satisfies the conservation purpose of preservation of land areas for recreation or education if there is substantial and regular use of the property by the general public.[601] There is no requirement that the preservation of the land area be made pursuant to a governmental policy or that the area be certified by a governmental unit as worthy of conservation efforts.

Protection of a significant habitat or ecosystem

Treasury Regulations provide that the donation of a qualified real property interest to protect a significant natural habitat in which a fish, wildlife, plant community, or similar ecosystem normally lives will satisfy the conservation purpose requirement.[602] Whether a donation satisfies the conservation purpose requirement generally depends on the type of animal or plant life that exists on the property being protected. If a property is a habitat for any endangered species of plant or animal life, a restriction protecting that habitat likely satisfies the conservation purpose requirement. Administrative rulings provide that if a particular species has been identified as unique to a particular place or is approaching an endangered or other protected status, protection of the habitat will suffice.

Preservation of open space

A conservation purpose includes the preservation of open space (including farmland and forest land) where such preservation will yield a significant public benefit and is (1) for the scenic enjoyment of the general public; or (2) pursuant to a clearly delineated Federal, State, or

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[599] Sec. 6662(e) and 6662(h).

[600] 31 U.S.C. sec. 330(c) (after notice and opportunity for a hearing to any appraiser with respect to whom a penalty for aiding and abetting understatement of tax liability has been assessed, the Secretary may provide that appraisals by such appraiser shall not have any probative effect in any administrative proceeding before the Treasury or the IRS, and bar such appraiser from presenting evidence or testimony in any such proceeding).

[601] Treas. Reg. sec. 1.170A-14(d)(2)(i).

[602] Treas. Reg. sec. 1.170A-14(d)(3)(i).

local government conservation policy.[603] Scenic enjoyment is evaluated by considering all pertinent facts and circumstances germane to the contribution. The factors identified in the regulations include the compatibility of the land use with other land in the vicinity, the degree of contrast and variety provided by the visual scene, the harmonious variety of shapes and textures, and the consistency of the proposed scenic view with a methodical State scenic identification program.

Treasury Regulations provide that the purpose of preserving open space pursuant to a clearly delineated government policy is satisfied by donations that further a specific conservation purpose identified by public representatives.[604] A general declaration of conservation goals by a single official or legislative body is not sufficient, although the government policy need not be a certification program that identifies particular lots or small parcels of individually owned property.[605] For example, a governmental program according preferential tax assessment or preferential zoning for certain property deemed worthy of protection for conservation purposes constitutes a significant commitment by a government, and accordingly satisfies the requisite standard.[606]

Preservation of historic property

Section 170(h) defines conservation purpose to include the preservation of an historically important land area or a certified historic structure.[607] For this purpose, a structure means any structure, whether or not it is depreciable, and, accordingly, easements on private residences may qualify under this provision.[608] If restrictions to preserve a building or land area within a registered historic district permit future development on the site, a deduction will be allowed

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[603] Treas. Reg. sec. 1.170A-14(d)(4)(i).

[604] Treas. Reg. sec. 1.170A-14(d)(4)(iii).

[605] *Id.*

[606] *Id.*

[607] The conservation purpose standard for historically important land is that the area be: (1) an independently significant land area including any related historic resources that meets the National Register Criteria for Evaluation; (2) an area within a registered historic district including any buildings on the land areas that can reasonably be considered as contributing to the significance of the district; and (3) an area (including related historic resources) adjacent to a property listed individually in the National Register of Historic Places (but not within a registered historic district) in a case where the physical or environmental features of the land area contribute to the historic or cultural integrity of the property. Treas. Reg. sec. 1.170A-14(d)(5)(ii).

[608] Treas. Reg. sec. 1.170A-14(d)(5)(iii).

only if the terms of the restrictions require that such development conform with appropriate local, State, or Federal standards for construction or rehabilitation within the district.[609]

The IRS and the courts have held that a facade easement may constitute a qualifying conservation contribution.[610] In general, a facade easement is a restriction the purpose of which is to preserve certain architectural, historic, and cultural features of the facade, or front, of a building. The terms of a facade easement might permit the property owner to make alterations to the facade of the structure if the owner obtains consent from the qualified organization that holds the easement.

Reasons for Change

Charitable deductions of qualified conservation contributions, including conservation and facade easements, present serious policy and compliance issues. Valuation is especially problematic because the measure of the deduction (i.e., generally the difference in fair market value before and after placing the restriction on the property) is highly speculative, considering that, in general, there is no market and thus no comparable sales data for such easements. In many instances, present law does not require that the preservation or protection of conservation be pursuant to a clearly delineated governmental conservation policy, only requiring such a policy in cases of open space preservation if the preservation is not for the scenic enjoyment of the general public. As a result, taxpayers and donee organizations have considerable flexibility to determine the conservation purpose served by an easement or other restriction, enabling taxpayers to claim substantial charitable deductions for conservation easements that arguably do not serve a significant conservation purpose.

Description of Proposal

In general

The proposal eliminates the charitable contribution deduction with respect to facade and conservation easements relating to personal residence properties, substantially reduces the deduction for all other qualified conservation contributions, and imposes new standards on appraisals and appraisers regarding the valuation of such contributions.

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[609] Treas. Reg. sec. 1.170A-14(d)(5)(i).

[610] *Hillborn v. Commissioner*, 85 T.C. 677 (1985) (holding the fair market value of a facade donation generally is determined by applying the "before and after" valuation approach); *Richmond v. U.S.*, 699 F. Supp. 578 (E.D. La. 1988); Priv. Ltr. Rul. 199933029 (May 24, 1999) (ruling that a preservation and conservation easement relating to the facade and certain interior portions of a fraternity house was a qualified conservation contribution).

Facade easements with respect to certified historic structures

Personal residences

The proposal disallows a charitable contribution deduction for a contribution of a facade easement relating to a certified historic structure that recently has been or is being used, or is reasonably expected to be used, by the donor or a family member of the donor as a personal residence (principal or otherwise). The proposal does not modify the present-law definition of certified historic structure.

All other certified historic structures

The proposal limits the charitable contribution deduction that may be allowed with respect to a facade easement relating to a certified historic structure that is not being used (and is not reasonably expected to be used) as a personal residence to the lesser of (1) five percent of the fair market value of the structure (determined without regard to the facade easement); or (2) 33 percent of the value of the facade easement. This rule applies to any certified historic structure not used or reasonably expected to be used as a personal residence by the donor or a family member of the donor, including commercial buildings, rental properties, and properties held for investment. The proposal provides that if a charitable deduction is allowed with respect to a facade easement for a property that is subsequently converted to a residence of the donor or a member of the donor's family, the deduction is subject to recapture by the donor in the year of conversion, at the declining rate of 10 percent per year beginning in the third year after the contribution (e.g., a conversion in the first two years following the contribution results in a 100 percent recapture of the deduction, a conversion in the third year is subject to a 90 percent recapture, and a conversion in the twelfth year results in no recapture), plus interest. Donors are required to report any such conversion to the IRS and to the donee or other organization that owns the easement or restriction.

Other conservation easements and restrictions

In general

Under the proposal, a contribution of a qualified real property interest for: (1) the preservation of land areas for outdoor recreation by, or the education of, the general public; (2) the protection of a relatively natural habitat of fish, wildlife, or plants, or a similar ecosystem; or (3) the preservation of open space (including farmland and forest land) that yields a significant public benefit; is exclusively for conservation purposes only if the preservation or protection is pursuant to a clearly delineated Federal, State, or local governmental conservation policy. For this purpose, the determination of whether preservation or protection is pursuant to a clearly delineated governmental policy is to be made in accordance with present-law standards applicable to open space preservation, meaning that the preservation or protection must further a specific, identified conservation project.[611] The proposal does not modify the present-law conservation purpose standards relating to the preservation of an historically important land area or certified historic structure.

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[611] Treas. Reg. sec. 1.170A-14(d)(4)(iii).

The proposal provides that the amount of the charitable deduction for a qualified real property interest (excluding facade easements, which are described above) is reduced from 100 percent to 33 percent of the fair market value of such contributed interest. The proposal provides for a disallowance of 67 percent of the value of the easement (as claimed by the taxpayer, or where applicable, as determined to be the correct amount pursuant to an IRS examination or by litigation), with no limitation on the deduction based on a percentage of the value of the underlying property.

Personal residence use

A qualified real property interest is not considered as contributed exclusively for a conservation purpose if the donor (or a family member of the donor) has a right to use all or a portion of the real property as a personal residence (principal or otherwise) at any time after the contribution. Thus, under the proposal, no deduction is allowed for a contribution of a conservation easement if the donor or a family member may use all or a portion of the underlying real property as a residence at any time after the contribution. If a donor (or family member of the donor) uses such property as a residence after a contribution deduction has been taken, such use is treated as a conversion to residential use that is subject to the recapture rules described above for facade easement conversions.

Appraiser and appraisal requirements

Substantiation and valuation

Taxpayers are required, as under present law, to substantiate any reduction in value of the underlying property resulting from the easement, and to substantiate that any such reduction supports the amount claimed as a charitable deduction. Any required appraisal is subject to the proposed appraisal and appraisal standards that are described below.

The proposal modifies the definition of a qualified appraiser for purposes of appraisals of qualified conservation contributions with a claimed value above $5,000. Under the proposal, a qualified appraiser is an individual who affirms: (1) that the fair market value of the subject property has been determined in accordance with generally accepted appraisal standards; (2) with respect to the specific property and transaction type, that he or she: (a) has successfully completed educational coursework, including courses for continuing education credits, in generally accepted appraisal practices, principles, concepts, methodologies, and ethics from a recognized provider of such courses; or has earned an appraisal designation from a recognized organization that teaches, tests, and provides continuing education to its members in valuation; and (b) regularly performs appraisals for which he or she receives compensation and has a minimum of two years experience in doing so; and (3) has not been subject to disbarment from practice before the IRS by the Secretary pursuant to 31 U.S.C. section 330(c).[612]

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[612] 31 U.S.C. sec. 330(c) (after notice and opportunity for a hearing to any appraiser with respect to whom a penalty for aiding and abetting understatement of tax liability has been assessed, the Secretary may provide that appraisals by such appraiser shall not have any

Effective Date

The proposal is effective for contributions made in taxable years beginning after the date of enactment.

Discussion

In general

The charitable deduction available for qualified conservation contributions depends largely upon an accurate measure of the value of the contribution, and the promotion of a conservation purpose that provides a substantial benefit to the public. Inaccurate valuations result in improper deduction amounts. Absence of a meaningful conservation purpose means that a tax benefit has been provided that exceeds any public benefit to be derived from the conservation contribution. Valuation difficulties and conservation purpose issues are especially problematic in the case of a contribution of a partial interest in property, such as easements, because the donor both relinquishes and retains rights and value relating to the underlying property.

Whenever possible, tax incentives should be targeted to those persons who are most likely to modify their behavior in substantial part because of the provision of the tax benefit. Otherwise, providing such benefits constitutes a windfall rather than an incentive. The present charitable deduction regime for qualified conservation contributions provides a windfall to those taxpayers who grant an easement or other restriction to a qualified organization if the activity or use restricted by the easement or restriction likely would never occur. For example, a person who purchases a residence in a historic district that has homes that were designed and constructed in a particular period and with a particular architectural style generally does not acquire the home with the intention of altering the exterior of the building in a manner that would be inconsistent with the neighboring structures. Similarly, a person who acquires real property located by a nature preserve often is attracted to the area because of the preserve, and in such cases would not alter or use the acquired property for a purpose that would impede or contravene such preservation efforts.

The ability of a donor of a qualified conservation contribution to use the retained property after the contribution of the partial interest often makes it difficult to determine whether a significant public benefit or conservation purpose is served by the contribution. For example, if a donor is able to continue to use real property as a residence after the contribution is made, the donor may benefit economically and in other ways from making the contribution, and the extent of the public benefit and conservation purpose may be diminished by such use. Such personal use cases involve competing public and private interests, as well as subjectivity regarding valuation of the contributed partial interest, that are not efficiently addressed in a context where proper valuations are expensive and the IRS lacks the expertise or resources to assess conservation purposes.

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probative effect in any administrative proceeding before the Treasury or the IRS, and bar such appraiser from presenting evidence or testimony in any such proceeding).

Some might argue that there is no need to limit the deduction for qualified conservation contributions because the issues are mostly valuation-based and should be addressed by increased enforcement and by imposing additional standards on appraisers and appraisals. Although present law should operate to deny a deduction to those donors whose property value is enhanced as a result of the restriction, or to reduce the deduction if the donor claims a deduction in excess of the actual reduction in value (e.g., if local ordinances or other restrictions are already in place to limit the owner's use or alteration of the property), it is difficult for the IRS to identify and challenge such cases. The present-law regime creates significant administrative obstacles for the IRS with respect to easements, including the cost of conducting appraisals that are required to properly measure the value of the restriction under the "before and after approach," and the ongoing need to monitor the easements for compliance given that they are to be enforced in perpetuity. It also is difficult to determine the extent to which the conservation or preservation benefit (which often is tenuous and speculative) exceeds the economic and other benefits the donor derives from the contribution. The task becomes especially difficult where, as appears to be the case with respect to facade easements, many appraisers are using "rules of thumb" rather than objective appraisals to value the contributions. This practice makes it virtually certain that many appraised values are incorrect, and would necessitate a review by the IRS of many such contributions to assure the correct value is used in most cases.

Facade easements and conservation easements where property is used as a residence

Contributions of façade easements generally can be expected to reduce the value of the property owner's interest in the underlying structure in those areas where no local ordinances or other restrictions are already in place to prohibit the use or alteration of the property. However, there potentially is no limit to the varieties of local land ordinances, zoning requirements, and other types of legal restrictions on an owner's use or alteration of a structure throughout the United States. Thus, an appraiser and the IRS must examine the particular local restrictions already in place with respect to the underlying property in order to accurately measure the value of the contributed facade easement. This makes it difficult and costly to determine the extent to which a particular facade easement affects the value of the underlying property. In addition, weighing competing public and private benefits when the underlying property is the donor's residence is inherently more difficult than when the underlying property is to be used for investment or commercial purposes. Accordingly, the proposal disallows a charitable deduction for any qualified conservation contribution of a facade easement if the structure may be used by the donor or the donor's family as a personal residence. Thus, the proposal eliminates the need to assess valuation, conservation benefits, and private benefits with respect to a large group of transactions that often provide questionable or limited public benefits.

For the same reasons applicable to façade easements, the proposal eliminates the deduction for all conservation easements relating to property to be used by the donor or donor's family as a personal residence.

Other facade easements

With respect to facade easements relating to a certified historic structure to be used other than as a personal residence of the donor or donor's family, the proposal limits the deduction to the lesser of five percent of the fair market value of the property or 33 percent of the value of the

easement. In general, property held for business or investment purposes is not subject to the same concerns of competing public and private benefits applicable to property used as a personal residence. However, significant valuation concerns justify a cap on the deduction amount for contributions of such other properties. The proposed cap of 33 percent of the value of the easement goes directly to valuation abuses pertaining to easements. The additional cap of five percent of the value of the unencumbered property is imposed because, in general, the nature of a property restriction on the front of a structure should be a fairly low percentage of the value of the entire property.

Other conservation easements

Present law attempts to incorporate a public benefit or conservation purpose standard into each of the different types of qualifying conservation contributions. However, the standards vary for the different types of contributions, and in many cases a deduction may be available even if no substantial public benefit or conservation purpose is demonstrated. The present-law standards for recreation by or education of the general public, for protection of an environmental system, and for open space easements that are not made pursuant to a clearly delineated governmental policy, arguably are so broad that the IRS effectively has no basis to challenge contributions claimed to have been made for such purposes. A significant public benefit and conservation purpose may be best demonstrated when a contribution promotes preservation or protection that is pursuant to a clearly delineated governmental conservation policy. Accordingly, the proposal extends this standard, presently applicable only to certain open space preservation cases, to all other qualified conservation contributions (excluding historically important land areas and certified historic structures, which have independent but similar provisions). Although some might argue that extension of this requirement to such contributions will deter contributions for such purposes, the status quo in essence permits the donor and the donee, the two parties with the greatest incentive to reach such a conclusion, to determine that a conservation purpose is served. Under these circumstances, there is no practical limit to the types or quantities of land areas that may be treated by taxpayers as contributed for public education or recreation, for the protection of environmental systems, or for scenic enjoyment of the general public, and no assurance that such contributed properties promote conservation and provide a public benefit commensurate with the tax expenditure.

Imposing a more meaningful conservation purpose requirement for most qualified conservation contributions should isolate the primary tax problem in many cases to one of valuation. To address the valuation concern, the proposal limits the deduction for conservation easements (other than facade easements and personal residence properties) to 33 percent of the value of the easement. The proposal does not eliminate the deduction in these cases, because doing so would be a significant change in policy that arguably should be made only if there is a strong case that such contributions pose the same valuation and private benefit concerns that formed the basis of the proposal to eliminate the deduction with respect to personal residence properties.

Unlike the proposal for facade easements pertaining to commercial and investment properties, the proposal does not impose an additional deduction limitation based on a percentage of the value of the underlying property. Such a limitation would not adequately take into account the wide range of restrictions an owner may place on the underlying property, and could

discourage those contributions which provide the most significant conservation benefits. Some might argue that the proposed disallowance percentage is arbitrary, or that other disallowance percentages should be used. Similar disallowance provisions are used for other purposes relating to difficult "mixed-use" properties or expenditures, such as the 50-percent test for business use of listed property (sec. 280F(b)), and the 50-percent disallowance of meal and entertainment expenses (sec. 274(n)). Others might argue that the proposal does not eliminate the need for appraisals, but only reduces the effect of erroneous valuations at the expense of reduced deductions for those who comply with the tax laws.

There are possible alternative ways to address the valuation and conservation purpose concerns pertaining to qualified conservation contributions. For example, a cap could be imposed on the amount of the deduction that may be claimed, a floor below which no deduction is available (and above which only the excess may be deducted) could be imposed, or a combination of a cap and floor could be imposed. The cap alternative often would reduce the amount of the deduction, but in time could become treated by taxpayers as a "safe harbor" within which deductions would not be challenged. Although the latter concern could be addressed by using a low specified dollar amount cap, a cap that is too low would effectively eliminate the incentive to make contributions that provide significant conservation benefits. Imposing a floor also would disallow many deductions, but might discourage relatively small contributions and increase the incentive to overvalue properties. The combination of a cap and a floor would disallow small contribution deductions and potentially a significant portion of large contributions.

Appraisal requirements and penalties for erroneous valuations

Under the proposal, a proper determination of the fair market value of a contribution of a conservation or facade easement remains critical in many cases. The proposal attempts to address valuation difficulties by establishing qualified appraiser requirements with respect to contributions exceeding $5,000. Appraiser standards should eliminate some valuation problems that arise under present law, but could make the appraisal process more expensive.

The proposal does not explicitly provide that penalties be imposed on appraisers who overvalue qualified conservation contributions, because of concerns regarding the potential unfairness to an appraiser of imposing penalties based on an overvaluation the amount of which will be determined in a proceeding in which the appraiser is not a party, and for which there is no assurance that the interests of the taxpayer and the appraiser will be aligned. Imposition of appraiser penalties in material overvaluation cases might be appropriate if these concerns can be addressed.

G. Limit Charitable Deduction for Contributions of Clothing and Household Items (sec. 170)

Present Law

Deductibility of charitable contributions

In general

In computing taxable income, a taxpayer who itemizes deductions generally is allowed to deduct the amount of cash and the fair market value of property contributed to an organization described in section 501(c)(3) or to a Federal, State, or local governmental entity.[613] The amount of the deduction allowable for a taxable year with respect to a charitable contribution of property may be reduced or limited depending on the type of property contributed, the type of charitable organization to which the property is contributed, and the income of the taxpayer.[614] In general, more generous charitable contribution deduction rules apply to gifts made to public charities than to gifts made to private foundations. Within certain limitations, donors also are entitled to deduct their contributions to section 501(c)(3) organizations for Federal estate and gift tax purposes.

Contributions of property

The amount of the deduction for charitable contributions of capital gain property generally equals the fair market value of the contributed property on the date of the contribution. Capital gain property means any capital asset or property used in the taxpayer's trade or business the sale of which at its fair market value, at the time of contribution, would have resulted in gain that would have been long-term capital gain. Contributions of capital gain property are subject to different percentage limitations than other contributions of property.

For certain contributions of property, the deductible amount is reduced from the fair market value of the contributed property by the amount of any gain, generally resulting in a deduction equal to the taxpayer's basis. This rule applies to contributions of: (1) ordinary income property, e.g., property that, at the time of contribution, would not have resulted in long-term capital gain if the property was sold by the taxpayer on the contribution date;[615] (2) tangible personal property that is used by the donee in a manner unrelated to the donee's exempt (or

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[613] The deduction also is allowed for purposes of calculating alternative minimum taxable income.

[614] Secs. 170(b) and 170(e).

[615] For certain contributions of inventory and other property, C corporations may claim an enhanced deduction equal to the lesser of (1) basis plus one-half of the item's appreciated value (i.e., basis plus one half of fair market value in excess of basis) or (2) two times basis. Secs. 170(e)(3), 170(e)(4), and 170(e)(6).

governmental) purpose; and (3) property to or for the use of a private foundation (other than a foundation defined in section 170(b)(1)(E)).

Charitable contributions of clothing and household items are subject to the tangible personal property rule (number (2) above) if the property is not used to further the donee's exempt purpose. In general, however, the value of clothing and household items is less than the taxpayer's basis in such property, with the result that taxpayers generally deduct the fair market value of such contributions, regardless of whether the property is used for exempt or unrelated purposes by the donee.

In general, if the total charitable deduction claimed for non-cash property exceeds $500, the taxpayer must file Form 8283 (Noncash Charitable Contributions) with the IRS. In general, taxpayers are required to obtain a qualified appraisal for donated property with a value of $5,000 or more, and to attach an appraisal summary to the tax return.

Vehicles and Intellectual Property – American Jobs Creation Act

The American Jobs Creation Act ("AJCA") established new rules for charitable contributions of qualified vehicles[616] and qualified intellectual property.[617] A deduction for a contribution of a qualified vehicle with a claimed value in excess of $500 generally may not exceed the gross proceeds received by the donee upon the sale of the vehicle. If the donee does not sell the vehicle or performs a significant intervening use or material improvement of the vehicle prior to sale, the deduction generally is the fair market value of the vehicle at the time of the contribution. The deduction for a charitable contribution of qualified intellectual property generally is the donor's basis in the property (or fair market value, if less). The donor is eligible for additional charitable deductions in certain future years based on the net income received by or accrued to the donee that is properly allocable to the contributed intellectual property.

Reasons for Change

Clothing and household items are tangible personal property that typically are loss property, with the result that a fair market value deduction (rather than a deduction equal to basis, if greater) is available for contributions of such items. Often of low value, clothing and household items typically do not meet the threshold for which an appraisal is required ($5,000), meaning that for most of such items, the value is arrived at solely by a determination of the taxpayer. In general, there is no objective method for determining the value of used clothing and household items, with the result that overvaluations are likely to occur. In many cases overvaluations may not be deliberate, but may be based on taxpayer misunderstanding, or may arise for example, because an item, while not having a high fair market value, has sentimental value to the taxpayer. In some cases, an item may be of very low value and would have been disposed of by the taxpayer if not for the possibility of a deduction. Present law also encourages deliberate overvaluations by aggressive and even moderately aggressive taxpayers, because there

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[616] Sec. 170(f)(12).

[617] Secs. 170(e)(1)(B)(iii) and 170(m).

is a remote likelihood of challenge by the IRS except in egregious or random cases. Some taxpayers may overvalue items on the assumption that other taxpayers do, that those taxpayers will not be caught by the IRS, and that it is therefore "fair" to overvalue.

Description of Proposal

Under the proposal, the income tax deduction for charitable contributions of clothing and household items made to organizations eligible to receive deductible contributions (i.e., organizations described in section 170(c)) is limited to $500 per taxable year (regardless of filing status) for the aggregate of all such contributions made by the taxpayer. No carryover of such contributions over $500 is allowed. As under present law, the deduction for a particular item may not exceed fair market value and the taxpayer must retain records to substantiate the deduction. The proposal does not apply to contributions by corporations (other than closely held or personal service corporations). The proposal applies to new and used items. Household items include furniture, furnishings, electronics, appliances, linens, and other similar items. Food is not considered a household item. Paintings, antiques, and other objects of art, jewelry and gems, and collections are excluded from the proposal. A collection must be something given for use or sale as a collection and generally must have value independent of its component parts.

Effective Date

The proposal is effective for contributions made in taxable years beginning after the date of enactment.

Discussion

The proposal limits the aggregate amount that a taxpayer may deduct for charitable contributions of clothing and household items to $500 per year (regardless of filing status), with no provision for a carryover of amounts in excess of $500. The proposed aggregate taxpayer cap attempts to limit the extent of the overvaluation problem, yet still provides a reasonable deduction amount for those who make such contributions. Five hundred dollars is the amount above which information reporting is triggered under present law, thus a $500 limit minimizes the filing burdens of taxpayers and donee organizations. However, the number could be adjusted higher or lower.[618]

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[618] Contributions of clothing and household items present a similar problem to that recently addressed by Congress in the AJCA with respect to contributions of vehicles. As with vehicles under prior law, donors may deduct the fair market value of clothing and household items irrespective of the use by the donee because the value of such items typically is less than the donor's basis. However, the approach Congress took with vehicles, generally limiting the deduction to the sales price of the vehicle, is not appropriate for clothing and household items. Such items often may not be sold by the donee organization, in which case a rule limiting the deduction to sales proceeds would not address most contributions. To the extent donee organizations sell contributed clothing and household items, reporting the sales price to the donor for purposes of determining the deductible amount would be impracticable.

Some might argue that the deduction for clothing and household items should be eliminated entirely, in part on grounds that such property is difficult to value and such contribution deductions are difficult for the IRS to enforce, but also for the reason that taxpayers that contribute such property do not need a tax incentive to make the contribution. Under this argument, taxpayers will continue to donate old clothes and other items because they no longer have a use for the items and want them to be used by a person in need. On the other hand, some might argue that the tax incentive in many cases encourages people to take the extra step of delivering their used personal items to a suitable donee organization rather than merely throwing them away, or giving them to a friend or relative, and thus that a deduction for such items should be retained, if limited.

An aggregate limitation on the deduction retains the deduction and so continues to provide an incentive to make the donation. The limitation also limits the effect of excessive overvaluation abuses and, at the margin, is not likely to deter someone from increasing the number of items given in a year. However, the proposal could in some cases postpone contributions in an amount in excess of $500 to another year, and in cases where the value of a single item significantly exceeds $500, donors may decide not to make the contribution.

Some might argue that an exception should be provided for contributions made for purposes of disaster relief. Often, at the onset of a disaster, an outpouring of support and sympathy prompts people to contribute time, money, and property such as clothing and other household items to disaster relief organizations (including governmental entities). Although many donee organizations often prefer to receive cash rather than used property in such cases, some might argue that the $500 limitation might result in fewer contributions of clothing and household items to the detriment of victims of a disaster. However, others argue that donations made as a response to a disaster are often made entirely without consideration of any tax incentive. Perhaps more than in any other context, people give in such situations from a pure motive of care and sympathy for fellow human beings in immediate need of assistance, and do not need the tax laws to encourage such gifts. Under this view, the aggregate limitation on clothing and household items should not materially affect giving in disaster relief situations, and thus an exception to the limitation for disaster relief purposes is not necessary.

Under the proposal, household items do not include antiques, jewelry, or collections. Antiques, jewelry, and collections generally are of a different kind of property than used clothing, electronics, or other household goods, and have an intrinsic value.[619] It is not intended that under the proposal a person could describe an assemblage of, for example, a child's stuffed animals as a "collection." Rather, a collection is something given for use or sale as a collection and generally must have value independent of its component parts. Although there is a risk that an exception for antiques, jewelry, or collections will encourage taxpayers to attempt to circumvent the limitation by, for example, labeling plastic jewelry as jewelry not subject to the limit, or an old dining room table as an "antique," any such claim would be subject to reporting on the Form 8283 and generally would require that a taxpayer potentially misreport twice: once

[619] The rules for contributions of such items are, however, affected by the proposal in Part VIII.H. of this report, "Reform Rules for Charitable Contributions of NonCash Property."

in classifying the property, and again in determining a value. In any event, the Treasury likely would have to develop guidance on the definition of such items, especially collections.

H. Reform Rules for Charitable Contributions of Property (sec. 170)

Present Law

Deductibility of charitable contributions

In general

In computing taxable income, a taxpayer who itemizes deductions generally is allowed to deduct the amount of cash and the fair market value of property contributed to an organization described in section 501(c)(3) or to a Federal, State, or local governmental entity.[620] The amount of the deduction allowable for a taxable year with respect to a charitable contribution of property may be reduced or limited depending on the type of property contributed, the type of charitable organization to which the property is contributed, and the income of the taxpayer.[621] In general, more generous charitable contribution deduction rules apply to gifts made to public charities than to gifts made to private foundations. Within certain limitations, donors also are entitled to deduct their contributions to section 501(c)(3) organizations for Federal estate and gift tax purposes. By contrast, contributions to nongovernmental, non-charitable tax-exempt organizations generally are not deductible by the donor,[622] though such organizations are eligible for the exemption from Federal income tax with respect to such donations.

In general, if a donor receives a benefit or quid pro quo in return for a contribution, any charitable contribution deduction is reduced by the amount of the benefit received. For contributions of $250 or more, no charitable contribution deduction is allowed unless the donee organization provides a contemporaneous written acknowledgement of the contribution that describes and provides a good faith estimate of the value of any goods or services provided by the donee organization in exchange for the contribution.[623]

Contributions of property

The amount of the deduction for charitable contributions of capital gain property generally equals the fair market value of the contributed property on the date of the contribution.

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[620] The deduction also is allowed for purposes of calculating alternative minimum taxable income.

[621] Secs. 170(b) and 170(e).

[622] Exceptions to the general rule of non-deductibility include certain gifts made to a veterans' organization or to a domestic fraternal society. In addition, contributions to certain nonprofit cemetery companies are deductible for Federal income tax purposes, but generally are not deductible for Federal estate and gift tax purposes. Secs. 170(c)(3), 170(c)(4), 170(c)(5), 2055(a)(3), 2055(a)(4), 2106(a)(2)(A)(iii), 2522(a)(3), and 2522(a)(4).

[623] Sec. 170(f)(8).

Capital gain property means any capital asset, or property used in the taxpayer's trade or business, the sale of which at its fair market value, at the time of contribution, would have resulted in gain that would have been long-term capital gain. Contributions of capital gain property are subject to different percentage limitations than other contributions of property.

For certain contributions of property, the deductible amount is reduced from the fair market value of the contributed property by the amount of any gain, generally resulting in a deduction equal to the taxpayer's basis. This rule applies to contributions of: (1) ordinary income property, e.g., property that, at the time of contribution, would not have resulted in long-term capital gain if the property was sold by the taxpayer on the contribution date;[624] (2) tangible personal property that is used by the donee in a manner unrelated to the donee's exempt (or governmental) purpose; and (3) property to or for the use of a private foundation (other than a foundation defined in section 170(b)(1)(E)).

In general, a charitable contribution deduction is allowed only for contributions of the donor's entire interest in the contributed property, and not for contributions of a partial interest.[625] If a taxpayer sells property to a charitable organization for less than the property's fair market value, the amount of any charitable contribution deduction is determined in accordance with the bargain sale rules.[626] If a taxpayer pays more than fair market value for property acquired from a charitable organization, the excess above fair market value may be deductible assuming that the donor intended to make a gift of such excess.

In general, if the total charitable deduction claimed for non-cash property exceeds $500, the taxpayer must file IRS Form 8283 (Noncash Charitable Contributions) with the IRS. C corporations (other than personal service corporations and closely-held corporations) are required to file Form 8283 only if the deduction claimed exceeds $5,000. Information required on the Form 8283 includes, among other things, a description of the property, the appraised fair market value (if an appraisal is required), the donor's basis in the property, how the donor acquired the property, a declaration by the appraiser regarding the appraiser's general

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[624] For certain contributions of inventory, C corporations may claim an enhanced deduction equal to the lesser of (1) basis plus one-half of the item's appreciated value (i.e., basis plus one half of fair market value in excess of basis) or (2) two times basis. Sec. 170(e)(3). To be eligible for the enhanced deduction, the contributed property generally must be inventory of the taxpayer, contributed to a charitable organization described in section 501(c)(3) (except for private nonoperating foundations), and the donee must: (1) use the property consistent with the donee's exempt purpose and solely for the care of the ill, the needy, or infants; (2) not transfer the property in exchange for money, other property, or services; and (3) provide the taxpayer a written statement that the donee's use of the property will be consistent with such requirements. A similar enhanced deduction is available for contributions of scientific property and equipment (sec. 170(e)(4)) and for contributions of computer technology used for educational purposes made in taxable years beginning before January 1, 2006 (sec. 170(e)(6)).

[625] Sec. 170(f)(3).

[626] Sec. 1011(b) and Treas. Reg. sec. 1.1011-2.

qualifications, an acknowledgement by the donee that it is eligible to receive deductible contributions, and an indication by the donee whether the property is intended for an unrelated use. If a donee organization sells, exchanges, or otherwise disposes of contributed property with a claimed value over $5,000 (other than publicly traded securities) within two years of the property's receipt, the donee is required to file a return (Form 8282), and furnish a copy of the return to the donor, showing the name, address, and taxpayer identification number of the donor, a description of the property, the date of the contribution, the amount received on the disposition, and the date of the disposition.[627]

Taxpayers are required to obtain a qualified appraisal for donated property with a value of $5,000 or more, and to attach an appraisal summary to the tax return.[628] In the case of contributions of art valued at $20,000 or more, taxpayers are required to attach the appraisal to the tax return. Under Treasury regulations, a qualified appraisal means an appraisal document that, among other things: (1) relates to an appraisal that is made not earlier than 60 days prior to the date of contribution of the appraised property and not later than the due date (including extensions) of the return on which a deduction is first claimed under section 170;[629] (2) is prepared, signed, and dated by a qualified appraiser; (3) includes (a) a description of the property appraised; (b) the fair market value of such property on the date of contribution and the specific basis for the valuation; (c) a statement that such appraisal was prepared for income tax purposes; (d) the qualifications of the qualified appraiser; and (e) the signature and taxpayer identification number of such appraiser; and (4) does not involve an appraisal fee that violates certain prescribed rules.[630]

Vehicles and Intellectual Property – American Jobs Creation Act

The American Jobs Creation Act ("AJCA") established new rules for charitable contributions of qualified vehicles[631] and qualified intellectual property.[632] A deduction for a contribution of a qualified vehicle with a claimed value in excess of $500 generally may not

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[627] Sec. 6050L(a)(1).

[628] Pub. L. No. 98-369, sec. 155(a)(1) through (6) (1984) (providing that not later than December 31, 1984, the Secretary shall prescribe regulations requiring an individual, a closely held corporation, or a personal service corporation claiming a charitable deduction for property (other than publicly traded securities) to obtain a qualified appraisal of the property contributed and attach an appraisal summary to the taxpayer's return if the claimed value of such property (plus the claimed value of all similar items of property donated to one or more donees) exceeds $5,000).

[629] In the case of a deduction first claimed or reported on an amended return, the deadline is the date on which the amended return is filed.

[630] Treas. Reg. sec. 1.170A-13(c)(3).

[631] Sec. 170(f)(12).

[632] Sec. 170(e)(1)(B)(iii) and 170(m).

exceed the gross proceeds received by the donee upon the sale of the vehicle. If the donee does not sell the vehicle or performs a significant intervening use or material improvement of the vehicle prior to sale, the deduction generally is the fair market value of the vehicle at the time of the contribution. The deduction for a charitable contribution of qualified intellectual property generally is the donor's basis in the property (or fair market value, if less). The donor is eligible for additional charitable deductions in certain future years based on the net income received by or accrued to the donee that is properly allocable to the contributed intellectual property.

Reasons for Change

The determination of fair market value creates a significant opportunity for error or abuse by taxpayers making charitable contributions of property. To the extent that taxpayers claim inflated valuations that are not corrected by the IRS, the Treasury loses revenue that should be collected under present law because charitable contribution deductions are greater than are warranted. Whether due to mistake, incompetence, misunderstanding of the law or facts, or efforts to evade taxes, valuation misstatements are common.

In addition, valuation is a difficult and resource intensive issue for the IRS to identify, audit, and litigate. The IRS must determine which values are suspect, prepare its own appraisal of the questioned property, and persuade a court that the IRS's value, and not the taxpayer's, is correct. Such hurdles often mean, as a practical matter, that attacking valuation misstatements in the charitable contribution context is not a high priority for the IRS because the probable revenue collected does not compare favorably with the resource cost (at least when compared to other tax compliance areas).

Another contributing factor to problems in this area is that unlike in an arm's length negotiation to arrive at a price between unrelated parties, for a charitable contribution the interests of a donor and a donee organization are not adverse. A donee organization has no incentive to question a donor's inflated value because there is no countervailing tax consequence to the donee if a donor inflates the value of contributed property, i.e., the donee generally does not pay tax on the receipt of the contribution or a subsequent disposition of the contributed property. Some donees may even directly or indirectly support an inflated value in order to secure a desired gift. Such circumstances cause the valuation of property in the charitable contribution context to be a particularly difficult determination.

Apart from the issues of valuation and enforcement, the fair market value deduction for property contributions raises separate policy questions. The fair market value deduction for property generally places gifts of cash and gifts of property on an equal footing. A primary goal of the charitable deduction, however, should be to encourage gifts that are most useful to a charitable organization, and should not be to encourage gifts that entail significant diversion of resources from the charitable mission or that require a charity to incur substantial transaction costs. Cash, publicly traded securities, and arguably property that can be used directly in substantial furtherance of exempt purposes meet this standard. Other gifts of property generally do not and so need not be as favored.

Description of Proposal

Option 1

Under Option 1, the deduction for charitable contributions of property (including capital gain property) is the donor's basis in the property or, if less, the fair market value of the property. Thus, the proposal generally extends the "basis not to exceed fair market value" rule presently applicable to contributions of certain tangible personal property to all in-kind property. The proposal does not apply to charitable contributions of publicly traded securities, which continue to be eligible for a fair market value deduction.[633]

The proposal does not apply to qualified intellectual property (as defined in section 170(m)(9)), a qualified vehicle (as defined in section 170(f)(12)(E)), or a qualified conservation contribution (as defined in section 170(h)(1)).[634] The proposal also does not apply to charitable contributions that meet the requirements of sections 170(e)(3), (e)(4), or (e)(6), i.e., contributions eligible for an enhanced deduction.

The information return requirement imposed on a donee organization upon a disposition of contributed property (Form 8282, sec. 6050L) is eliminated under Option 1.

Option 2

In general

Option 2 follows the general rule of Option 1 (i.e., basis not to exceed fair market value), with an exception for contributions of property to be used to substantially further exempt purposes ("exempt use" property). Like Option 1, Option 2 retains a fair market value deduction

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[633] Publicly traded securities are defined as securities for which (as of the date of the contribution) market quotations are readily available on an established securities market. See sec. 6050L(a)(2)(B).

[634] Congress recently enacted special rules for contributions of qualified vehicles and intellectual property, which are tailored to the circumstances pertaining to such property contributions. Thus, such contributions are excepted from Option 1 and Option 2. See Part VIII.F. of this report, "Modify Charitable Deduction for Contributions of Conservation and Facade Easements," for a proposal to change the charitable deduction rules for qualified conservation contributions. If the present-law special rules for qualified conservation contributions are not separately addressed, Option 1 could be modified to apply to such contributions. The merits of applying Option 1 to qualified conservation contributions are not discussed in this report. See Part VIII.G. of this report, "Limit Charitable Deduction for Contributions of Clothing and Household Items," for a proposal on the treatment of contributions of clothing and household items.

for publicly traded securities, and does not apply to contributions of qualified intellectual property, qualified vehicles, or contributions eligible for an enhanced deduction.[635]

Unlike Option 1, for charitable contributions of exempt use capital gain property, Option 2 retains the present-law fair market value deduction. In addition, for exempt use property with a claimed value of more than $500 that the donee identifies as exempt use property on the Form 8283, the proposal generally provides for a reduced tax benefit to the donor if such property is disposed of by the organization within three years of the contribution.

The information return requirement imposed on a donee organization upon a disposition of contributed property (Form 8282, sec. 6050L) is eliminated for property that is identified by the donee organization on the Form 8283 as not intended for use in substantial furtherance of an exempt purpose ("nonexempt use" property), but is retained and expanded for exempt use property.

The revenue effect of Option 2 is not estimated in the revenue table include in this Report due to insufficient data at this time for such an estimate.

Reduction of tax benefit upon subsequent disposition of exempt use property

Under Option 2, with respect to exempt use property for which a deduction of more than $500 is claimed, and which is identified as exempt use property by the donee organization on the Form 8283, present law rules generally apply[636] except that, if the donee organization disposes of such property within three years of the contribution date, the property is deemed to be nonexempt use property with the result that the deductible amount with respect to such property is adjusted, as follows.[637] If the disposition occurs in the same taxable year of the donor as the contribution date, the donor's deduction generally is basis (or if less, the fair market value), and no subsequent adjustment is required.[638] If the disposition occurs in a subsequent year, the donor must include as ordinary income for its taxable year in which the disposition occurs an amount

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[635] Because they are not excepted from Option 2, qualified conservation contributions generally would receive the same deduction as under current law (fair market value) because such contributions generally are exempt use property. See Part VIII.F. of this report, "Modify Charitable Deduction for Contributions of Conservation and Facade Easements," for a proposal to change the charitable deduction rules for qualified conservation contributions.

[636] Under present law, the donor's deduction generally is the fair market value of the property. There are exceptions for contributions to private nonoperating foundations and for contributions of tangible personal property not intended to further exempt purposes. The deduction for such contributions generally is the donor's basis or, if less, fair market value. Option 2 does not change the rules for contributions to nonoperating foundations.

[637] Present-law rules continue to apply to any contribution of exempt use property for which a deduction of $500 or less is claimed.

[638] The disposition proceeds are regarded as relevant to a determination of fair market value.

equal to the excess (if any) of (i) the amount of the deduction previously claimed by the donor as a charitable contribution with respect to such property, over (ii) the donor's basis in such property at the time of the contribution. The donee's use of proceeds from the disposition of property in a manner that furthers exempt purposes is not an exempt use.

Upon a disposition of exempt use property subject to the recapture tax, a donor is not required to adjust the deductible amount from the amount claimed if the donee organization certifies to the Secretary, by written statement signed under penalties of perjury by an officer of the organization, that the property disposed of was used for a significant intervening exempt use. The certification must explain the use of the property and how such use substantially furthered the purpose or function that constitutes the organization's basis for exemption. The organization must furnish a copy of the certification to the donor (as part of the present-law requirement to furnish the Form 8282 to the donor).

Reporting for exempt use property

In addition to the present-law requirement that the donee organization identify on the Form 8283 whether property for which an amount of more than $500 is claimed is exempt use property, Option 2 requires that the donee explain the intended use of such property. A penalty of $1,000 applies to any person that agrees to identify property as exempt use property while having a reason to know that the property is not intended for such use.[639] A penalty of $10,000 applies to a person that identifies property as exempt use property knowing that it is not intended for such use.

The proposal modifies the present-law information return requirements that apply upon the sale of contributed property by a charitable organization (Form 8282, sec. 6050L). For property identified by the donee organization on the Form 8283 as exempt use property, the return requirement is extended to dispositions made within three years after receipt (from two years) and to property for which an amount of more than $500 is claimed (as compared to the present-law amount of more than $5,000). The donee organization also must provide, in addition to the information already required to be provided on the return, a description of the donee's use of the property, a statement of whether the property was used to substantially further exempt purposes, a certification of such use (described above), and if such certification is provided, a statement of whether a copy of the certification was provided to the donor of the property.

Effective Date

The proposal is effective for contributions made in taxable years beginning after the date of enactment.

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[639] Other present-law penalties also may apply, such as the penalty for aiding and abetting the understatement of tax liability under section 6701.

Discussion

In general

Options 1 and 2 eliminate the value-based deduction for certain charitable contributions of property because of both valuation issues and independent policy concerns. Retaining the fair market value deduction while attempting to improve the method for determining value is not adequate because a system based on appraisals and other estimates of value will continue to be open to abuse and costly to administer properly. Reducing the fair market value deduction, for example, by providing that the deduction is a certain percentage of fair market value, would address valuation abuses in part by reducing the amount of the deduction, but would retain the need for fair market value determinations and their enforcement. Elimination of the value-based deduction is preferable to either approach because it eliminates the need for estimates of value, is easy to enforce, and by disfavoring property contributions generally, promotes contributions that a charitable organization needs most: cash, publicly traded securities (which present no valuation problem and are easily converted to cash), and arguably, property that substantially furthers exempt purposes. Providing for a basis deduction instead of a fair market value deduction already is the general rule for tangible personal property not intended for exempt purposes and for contributions to private nonoperating foundations. Thus, the proposal extends this general rule to other property contributions. Some contributions affected by the basis rule of the proposal include contributions of the following types of appreciated property: closely held stock; partnership interests; other securities that are not publicly traded; land; and, under Option 1 but not Option 2, property for use to further exempt purposes. To the extent any of such listed property is for exempt purposes, the fair market value deduction is preserved under Option 2.

Option 1: Deduction for property contributions is the lesser of basis or fair market value

Option 1 provides that for contributions of property that is not excepted by Option 1, the deduction is basis, or if less, fair market value. This is the rule under present law for charitable contributions to nonoperating private foundations and for charitable contributions of nonexempt use tangible personal property. Thus, Option 1 generally extends the nonexempt use tangible personal property rule to all property not excepted by the proposal.[640]

In general, the proposal is a simple and effective solution to overvaluation of property. The rule is easy to apply, requiring that the taxpayer substantiate its basis in the property. By providing a basis deduction for appreciated property instead of a fair market value deduction (or a deduction based on a percentage of fair market value) the proposal eliminates the need to rely on appraisals or other means of determining value for all such property. The proposal also reduces the filing burden on donee organizations by eliminating the present-law information return requirement with respect to property disposed of by the donee within two years of contribution. Under Option 1, the return requirement is no longer necessary because the IRS

[640] Much of the discussion regarding Option 1 also is applicable to Option 2, as the two Options are largely identical except with respect to the treatment of exempt use property.

does not need to track the disposition amount of property for which a basis deduction is claimed.[641]

Option 1 preserves the fair market value deduction for loss property. Taxpayers would still have an incentive to overvalue any loss property they contribute, although a taxpayer might be better off (as under present law) selling the property, recognizing the loss (if available for tax purposes), and donating the sales proceeds. Nevertheless, short of introducing significant complexity by basing the deduction for loss property on the disposition amount and taxing the donee organization on the gain upon disposition (similar to an approach discussed below), or eliminating the deduction for hard-to-value property entirely, there is no simple comprehensive solution to this problem. In some cases, overvaluation of loss property may best be addressed through adoption of special rules for certain types of loss property, e.g., the new rules enacted by the AJCA for vehicles, which use the selling price as a proxy for value. Another example is to adopt a special rule, such as the aggregate cap proposed in this Report for contributions of clothing and household items, which are another type of commonly contributed loss property.[642]

The proposal is likely to reduce the amount of contributions of hard-to-value property. In general, donors would be better off selling the property instead of contributing it, paying tax at long term capital gain rates, and contributing (and deducting) all or a portion of the after-tax proceeds to charity. In such a case, the charity might receive less from a donor, but such a shortfall is at least partially offset because the charity would not have any transaction costs associated with disposing of the property. A larger question, however, is whether any loss in fundraising outweighs the loss to the Treasury from excess deductions based on overvalued property, the cost to enforce correct valuations, and the damage to the tax system from generally tolerating taxpayers that claim deductions to which they are not entitled.

There also is a question of whether the tax system should encourage charitable contributions of property. Gifts most useful to charity are cash, gifts readily convertible to cash (like publicly traded securities), and gifts of property a charity can use to substantially further charitable programs.[643] Other property contributions generally divert a charity's resources from its charitable mission and toward soliciting and disposing of such contributions. Accordingly,

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[641] Option 1 eliminates the return requirement with respect to all property, including loss property. Ideally, returns should continue to be required for dispositions of contributed loss property because donors claim a fair market value deduction for such property and the IRS could benefit from comparing the disposition amount to the amount claimed as a deduction. However, requiring an information return for dispositions of loss property but not for appreciated property could be confusing for donees, and the potential for abusive valuations is limited in such cases because in no event is the taxpayer allowed to claim a deduction in excess of the taxpayer's basis in the property.

[642] See Part VIII.G. of this report, "Limit Charitable Deduction for Contributions of Clothing and Household Items."

[643] Option 2 preserves the fair market value deduction for exempt use property.

reasons independent of valuation difficulties may support discouraging hard-to-value property contributions.

Option 2: Fair market value deduction for exempt use property, with recapture tax on certain dispositions by donee

Option 2 follows Option 1 except that the fair market value deduction generally is preserved for contributions of exempt use property (in addition to publicly traded securities). This is similar to the present law rule providing for a fair market value deduction for contributions of tangible personal property for an exempt use, or a basis deduction if for another use. Thus, the proposal generally retains the tangible personal property rule and extends it to contributions of other property susceptible for use in exempt purposes, such as land, interests in land, and buildings, which under Option 1 receive a basis deduction.

As noted above, contributions generally most useful to charities are cash, property easily convertible to cash, and property that can be used to substantially further charitable programs. Providing an incentive for exempt use property may be viewed as efficient because the charity will not have to expend resources separately to acquire the good. In addition, some types of property, such as artwork, are unique, and some would argue, accessible to charity only because of the fair market value deduction. However, preserving the incentive to make charitable contributions of exempt use property retains the valuation difficulty and introduces the complexity of a recapture tax to prevent misclassification, as compared to Option 1.[644] The complexity is minimized, however, because a determination of exempt or nonexempt use already is required under present law on the Form 8283, though because of the recapture tax the consequences of such a determination would be greater under Option 2. Some would argue that providing an incentive for exempt use property is unfair to donors who contribute nonexempt use property of equal value but who receive a basis deduction, and that the incentive is not necessary to ensure that unique property be contributed to charity because charities that truly want such property will acquire it by other means.

Under Option 2, a recapture tax applies if exempt use property is disposed of by the donee organization within three years of the contribution date. The recapture tax does not apply, however, if the donee organization certifies to the Secretary under penalties of perjury a significant intervening exempt use of the contributed property. The recapture tax is intended to provide the donor with a net deduction equal to the deduction the donor would have received if the property had been correctly identified as nonexempt use property at the time of contribution, that is, the donor's basis. Option 2 treats a sale or other disposition of exempt use property as evidence that the property was not used substantially to further exempt purposes, and therefore

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[644] Independent of Option 2, the recapture tax could be applied to enforce the present-law rule for contributions of tangible personal property. Under present law, the fair market value deduction may be claimed for such contributions. However, if the donee does not so use the property, there is no automatic recapture of the donor's deduction. Recapture may occur under present law if the IRS audits the taxpayer and the taxpayer cannot show, for example, that at the time of the contribution, it is reasonable to anticipate that the property will not be put to an unrelated use by the donee. Treas. Reg. sec. 1.170A-4(b)(3)(ii).

that an adjustment to the donor's deduction is warranted (assuming the donee does not certify as to a significant intervening exempt use).[645]

Option 2 also provides for a penalty of $1,000 on any person who identifies property as exempt use property with reason to know that such property is not intended for an exempt use and a penalty of $10,000 on any person who identifies property as exempt use property with actual knowledge that such property is not intended for an exempt use. The penalties are designed to ensure that donee organizations and their managers assume responsibility for how contributed property is identified and to deter intentional misclassification of property deemed to enable the donor to take the generally more favorable deduction provided for exempt use property.

The recapture tax will result in some additional reporting by the donee organization. The donee will have to report dispositions for property with a claimed value of more than $500 over a three-year period as compared to present law which requires reporting dispositions of property with a claimed value of more than $5,000 over a two-year period. This increase in reporting should be offset by the elimination of such reporting for property identified as nonexempt use property. To minimize the overall reporting and compliance burden, the recapture tax does not apply to exempt use property with a claimed value of $500 or less.[646] For such property, a fair market value deduction generally is available and rules similar to the present-law rule for contributions of tangible personal property apply, i.e., donors will have to determine whether the property is exempt use property.

As an illustration of the recapture tax, assume at the time of contribution that the value of the property is $100 and the donor's basis is $60. The donee organization identifies the property as exempt use property, but sells the property two years later and does not provide a certification of a significant intervening exempt use. In such a case, the donor takes a $100 ordinary income deduction in the year of contribution but has ordinary income recapture in the year of sale of $40 (the difference between the fair market value at the time of contribution and the donor's basis) with a resulting net deduction of $60, or the donor's basis. If the sale occurred in the year that is the same taxable year of the donor as the contribution date, the donor would take a $60 deduction (basis) for that year. As another example, assume that at the time of contribution the value of the property is $100, the donor's basis is $140, and the donee sells the property two years later for $120 without an exempt use certification. The donor takes a deduction of $100 in the year of contribution and has no additional income with respect to the contribution in the year of sale (because the $100 initial deduction does not exceed the donor's basis of $140).

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[645] If the donee organization certifies as to the property's exempt use and thus the recapture tax does not apply, the disposition amount could still inform the Treasury as to whether an appraised amount for the property, and thus the donor's fair market value-based deduction, was reasonable.

[646] For property with a claimed value of $500 or less, information reporting, such as whether property is exempt use property, generally is not required. It would be possible to require that a donee make a determination of use of the property on the substantiation required under present law for contributions of property with a value of $250 or more (sec. 170(f)(8)).

Other possible approaches to property contributions

Strengthen present-law appraiser and appraisal rules

Present law attempts to address valuation concerns by requiring appraisals of contributed property for which a deduction of more than $5,000 is claimed.[647] Appraisals must be conducted by a qualified appraiser, who is defined as a person who holds himself or herself out to the public as an appraiser or performs appraisals on a regular basis, is qualified to make appraisals of the type of property being valued (as determined by the appraiser's background, experience, education, and membership, if any, in professional appraisal associations), is independent, and understands that an intentionally false or fraudulent overstatement of the value of the appraised property may subject the appraiser to civil penalties.[648] Although professional organizations exist that educate, train, and certify appraisers, and the appraisal community has developed some uniform standards applicable to appraising many types of property, the tax law does not require that a qualified appraiser meet any objective professional qualifications or adhere to any specific appraisal standards.

Accordingly, one approach to address overvaluation would be to tighten the definition of a qualified appraiser explicitly to require certain professional qualifications of appraisers, that appraisals conform to generally accepted uniform appraisal guidelines, and provide that an appraiser subject to disbarment from practice before the IRS may not qualify. The IRS could be charged with enforcing specific appraisal standards for different types of property and with publishing a list of necessary qualifications of qualified appraisers. In addition, the penalty structure could be strengthened so that appraisers, in addition to donors, are penalized for valuation misstatements, with increasing penalties for multiple violations.[649] Taxpayers could be required to pay a fee for a review appraisal by the IRS prior to a gift of highly valued property.

Strengthening the appraisal regime generally is sensible, and reforms such as those suggested above should be considered; however, as an answer to the issues raised by valuation, tightening appraisal standards and penalties for appraisers does not address the main problem. The very practical difficulty of the IRS finding and enforcing valuation misstatements would remain, as would the incentive to overstate valuations. Under present law there are plausible methods of valuing even the most difficult to value property, but not every appraiser will follow such methods, legitimate disputes will arise about which method is appropriate, and there will be multiple acceptable ways of application and interpretation of a given method to the particular property being valued. In addition, as estimates of value, appraisals inherently involve the judgment of a person who is hired and compensated by the taxpayer and who, no matter how

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[647] The AJCA recently amended the law generally to require that C corporations obtain an appraisal in such cases.

[648] Treas. Reg. sec. 1.170A-13(c)(5)(i).

[649] Under present law, appraisers generally are subject to penalties only for aiding and abetting the understatement of tax liability (sec. 6701), but not for providing an appraisal that is determined to be a valuation misstatement under section 6662.

independent or capable of ignoring the reality that the appraiser's economic interests are aligned with the taxpayer's interests, understands the difficulties presented by the tax system to the successful challenge of an appraisal.

Provide that the donor's deduction for nonexempt use property generally is equal to the disposition amount and tax donee on the gain upon disposition

Another approach would be to provide that for property contributions a donor would take an initial deduction of the donor's basis (or if less, fair market value), and the donor would be eligible for an additional charitable contribution deduction in the year the contributed property is disposed of by the donee. The additional deduction would equal the excess (if any) of the disposition amount over the amount of the initial deduction.[650] This approach would not apply to publicly traded securities[651] or to property that is intended for use to substantially further the donee organization's exempt purpose.[652]

Such an approach would preserve the fair market value-based deduction by using as determinative of fair market value the disposition amount. The donor might not receive the entire amount of the deduction initially as under present law, but assuming the property is disposed of by the donee shortly after receipt, the timing of the donor's full deduction would not differ significantly, if at all, from present law. Use of the disposition amount as determinative of fair market value would eliminate the need for appraisals and their inherent uncertainty. To the extent that donors receive less as a deduction under this proposal (after taking into account any additional deduction) than under present law, the difference (the amount by which the disposition amount is less than the appraised amount used by the taxpayer) arguably would be equal to the amount by which the appraisal overvalued the property.

One significant issue under this approach would be that of post-contribution appreciation or depreciation in the property. Because the additional deduction would be based on the disposition amount, the donor would receive the benefit of an increase in value of the

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[650] If the property is disposed of on a date within the same taxable year of the donor as the contribution date, the deduction would equal the disposition amount and no additional deduction would be available. If the property was disposed of for less than the taxpayer's basis, the deduction would be adjusted downward.

[651] The approach could carve out qualified intellectual property, or qualified vehicles, which have newly enacted special rules.

[652] Exempt use property by definition is unlikely to be sold or otherwise disposed of by the organization. Thus, if such an approach applied to exempt use property, additional deductions generally would not be available for contributions of such property with the untenable result that property used for exempt purposes would be disfavored as compared to property not so used. A separate proposal therefore would be required to address overvaluations of exempt use property (perhaps similar to that discussed in Option 2).

property.[653] Thus, if property worth $100 on the date of contribution (with a donor's basis of $50) increased in value to $500 on the date of its sale five years later, the donor would reap the benefit with an additional deduction in the year of sale of $450, which is $350 more than the donor would receive under present law (not taking into account the time value of money). Some would view this as a windfall to the donor, because the amount of the deduction significantly differs from the value of the property when contributed. One solution would be to impose a time limit to the additional deduction, e.g., no additional deduction would be available for dispositions more than three years after receipt. However, even a three-year time period could create significant windfalls to the donor and to the fisc. A shorter period, e.g., six months, arguably would not give the donee organization enough time to dispose of the property and, in certain cases, could force sales of property in nonoptimal market conditions.

To more fully counter the issue of post-contribution appreciation, this approach could, in addition to a time limit on additional deductions, provide for a tax on gain at the time of disposition at the highest unrelated business taxable income tax rate, payable by the donee.[654] The donor would still reap the benefit of post-contribution appreciation in the form of an additional charitable deduction (but not beyond the time limit), but the Treasury generally would not be worse off because the gain in the property would be fully taxed.[655] Such a tax could be justified as a tax on the donee organization's unrelated activity of accepting, preparing for sale, and selling property for which the organization had no exempt use.[656] Alternatively, an excise tax on the gross disposition proceeds could be used, which would reduce administrative complexity associated with tracking gain on the property.

An anti-abuse rule would be required to cover the possibility of a double deduction in the case of a part-gift part sale. For example, assume that a donor gives property to charity (e.g., a compact disc) that is worth $15 and the donor has a basis of $15. The charity sells the compact disc for $100 as part of a membership fundraising drive. Without an anti-abuse rule, the

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[653] The donor also would receive the detriment of any post-contribution decrease in value.

[654] The donee would use the donor's basis in the property as reported by the donor on the Form 8283. Such an approach might prohibit a donee from claiming any loss with respect to the property.

[655] Although the tax could apply only to post-contribution appreciation and not the entire appreciation in the property, imposing tax only on post-contribution appreciation would still require a determination of fair market value at the time of contribution and thus would not eliminate the need for appraisals.

[656] Taxing donee organizations on the gain realized from the disposition of nonexempt use property could have the salutary effect of encouraging donees that regularly accept nonexempt use property for disposition to better negotiate fundraising contracts with third parties, and discouraging donee organizations from engaging in fundraising practices that provide substantial benefits to non-exempt third parties because such practices, considering the tax effects to the donee, might not be worth it.

disposition amount could be viewed as $100 providing the donor of the disc with a $100 deduction, while the buyer of the disc takes a deduction of $85 (because the purchase of property valued at $15 for $100 could be viewed as a charitable contribution of $85). An anti-abuse rule might provide that a donee organization, in disposing of contributed property, either (1) inform the donor that no portion of the disposition amount is deductible as a charitable contribution; or (2) inform the donor that the disposition amount with respect to the property is $X and the remainder paid by the buyer of the property may be deductible by the buyer as a charitable contribution. In general, donees would have an incentive to establish a disposition amount for this purpose at or close to the fair market value of the property. If the donee sets the amount too low, the original donor would be displeased. If the donee sets the amount too high, there might be fewer buyers (due to reduced contribution deductions for buyers) and the donee would have more gain on which to pay the proposed unrelated business income tax. Donees that did not want to put a value on property would have the option of informing prospective purchasers that no part of the purchase is deductible as a contribution. To avoid the complexities presented by low value gifts generally, the proposal also could exempt property with a claimed value of $500 or less.

In sum, under this approach, if the donee organization disposes of nonexempt use property within a certain time period, the donor's deduction (as adjusted) generally would equal the disposition amount. If the donee organization disposes of nonexempt use property after expiration of the time period, no additional charitable deduction would be available to the donor (the donor's deduction would equal the lesser of basis or fair market value, determined at the contribution date). For all dispositions of nonexempt use property, the donee might pay unrelated business income tax on the gain. Additional reporting requirements would be required.

This approach would introduce significant complexity for contributions of property. The approach preserves the fair market value deduction by using the disposition amount as the proxy for value and as determinative of the donor's deduction. As a result, however, the deduction for many charitable contributions of nonexempt use property would take years to determine, and donees would be required to track dispositions of property for the duration of the time period, which is a significantly greater burden than under present law.

Eliminate, in whole or in part, the charitable contribution deduction for property

The simplest alternative would be to eliminate, in whole or in part, the charitable contribution deduction for in-kind property. The main argument in support of such an approach is that the Code should provide incentives only for contributions of cash because cash is of most use to charity, presents no valuation questions, and generally has no transaction costs associated with it. To the extent publicly traded securities or exempt use property should be encouraged, a fair market value deduction could be retained for such property. This approach would discourage much systematic and institutionalized fundraising. Donors with property to contribute would be encouraged to dispose of the property and give all or a portion of the disposition amount to charity. Such a proposal has the benefit of being simple. Some might argue, however, that donors of property should at least recover their basis in appreciated property and to deny a basis deduction is unfair.

I. Require Public Disclosure of Form 990-T and Related Certification Requirements (secs. 6104 and 6685)

Present Law

In general, an organization described in section 501(c) or (d) is required to make available for public inspection a copy of its annual information return (Form 990) and exemption application materials.[657] A penalty may be imposed on any person who does not make an organization's annual returns or exemption application materials available for public inspection. The penalty amount is $20 for each day during which a failure occurs. If more than one person fails to comply, each person is jointly and severally liable for the full amount of the penalty. The maximum penalty that may be imposed on all persons for any one annual return is $10,000. There is no maximum penalty amount for failing to make exemption application materials available for public inspection. Any person who willfully fails to comply with the public inspection requirements is subject to an additional penalty of $5,000.[658]

These requirements do not apply to an organization's annual return for unrelated business income tax (Form 990-T).[659]

Reasons for Change

Although exempt organizations are required to file their unrelated business income tax returns with the IRS, the public does not have access to information pertaining to an organization's unrelated business activities that is included in the IRS returns. Public disclosure of nonproprietary trade or business information would provide the public an opportunity to review the extent and type of unrelated business activities an organization conducts, enabling the public to assess all of the activities being conducted by organizations it supports through tax-deductible charitable contributions or through the tax exemption. In addition, more complete and accurate reporting of unrelated business activities conducted by large organizations would be improved by requiring independent auditors or counsel to make certain certifications regarding their review of such organizations' unrelated and other activities.

Description of Proposal

Require public availability of Form 990-T

The proposal extends the present-law public inspection and disclosure requirements and penalties applicable to the Form 990 to an organization's Form 990-T. The proposal provides that certain information may be withheld by the organization from public disclosure and

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[657] Sec. 6104(d).

[658] Sec. 6685.

[659] Treas. Reg. sec. 301.6104(d)-1(b)(4)(ii).

inspection if public availability would adversely affect the organization, similar to the information that may be withheld under present law with respect to applications for tax exemption and the Form 990 (e.g., information relating to a trade secret, patent, process, style of work, or apparatus, of the organization, if the Secretary determines that public disclosure of such information would adversely affect the organization). The proposal applies to all organizations required to file a Form 990-T with respect to its unrelated business income.[660]

Require a UBIT certification for certain large organizations

Organizations that normally have annual total gross revenues (including contributions and grants, program service revenue, investment income, and revenues from an unrelated trade or business or other sources) or gross assets of at least $10 million must include with its Form 990 and Form 990-T filings (if any) a certification by an independent auditor or by independent counsel that the organization's filings accurately reflect the unrelated business income tax liability of the organization for the taxable year.

The certification must attest that the independent auditor or counsel with respect to the taxable year that is the subject of the return:

(1) has reviewed the trades and businesses of the organization, the organization's sources of investment income, and the organization's sources of program service revenues, and determined that the reporting and descriptions of such items as contained in the Form 990 and, where applicable, Form 990-T, are complete and accurate;

(2) has determined that the organization's expense allocations between exempt, unrelated business income activities, and other activities used to determine the organization's unrelated business income tax comply with the requirements set forth in Treasury Regulations section 1.512(a)-1;

(3) has or has not reviewed or provided a tax opinion regarding the organization's treatment of income or an activity under the unrelated business income tax rules;[661]

(4) has or does not have knowledge that the organization: (a) participated in a transaction that is a listed transaction (as defined in section 6707A), or a

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[660] A similar proposal was recommended by the Joint Committee staff in its earlier study of disclosure relating to tax-exempt organizations. See *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*, Prepared by the Staff of the Joint Committee on Taxation, 93 (JCS-1-00), January 28, 2000.

[661] If the certifying party has provided or reviewed such an opinion, it also must include a description of the material facts regarding the income or activity that was the subject of such opinion.

confidential transaction or a transaction with contractual protection (as defined in Treasury Regulations issued under section 6011); or (b) received a fee or other amounts from another party to such a transaction in exchange for participating in such transaction during the taxable year; and

(5) has or does not have knowledge that the organization participated in a transaction that is a reportable transaction within the meaning of section 6707A with respect to the organization, that has not been disclosed by the organization to the IRS.

Failure to satisfy the certification requirement results in a penalty, imposed on the organization, of one half of one percent (0.5 percent) of the organization's total gross revenues for the taxable year, excluding revenues from contributions and grants.

Effective Date

The proposal applies to returns filed after the date of enactment.

Discussion

Public availability of Form 990-T

Present law requires public disclosure of certain information pertaining to an exempt organization's annual information return and exemption application materials. Public access to such information promotes transparency and accountability with respect to an organization's exempt activities, but generally does not provide any meaningful information about the organization's unrelated activities. The purpose of the proposal is to require comparable public disclosure for all of an exempt organization's activities, not just those treated by the organization as an exempt activity. Public review of certain information pertaining to an organization's commercial activities reasonably could be expected to provide an additional safeguard that the organization's unrelated activities comply with applicable tax laws and that the profits derived from such activities remain dedicated to its exempt purposes. To protect against public disclosure of certain proprietary information that could harm the organization, the proposal provides an exception to public disclosure of such information.

Some might argue that an exempt organization should not be required to disclose to the public any tax information that it would not be required to disclose if it were a for-profit business or other taxpayer. Subjecting an exempt organization to public disclosure of information pertaining to its unrelated trades or businesses arguably puts the organization in a less favorable position than a taxable party that conducts the same or a comparable activity. Under present law, however, exempt organizations already are required to disclose certain information with respect to its annual information returns and application for exemption, because Congress determined that transparency and public access were important safeguards related to the tax benefits provided to such organizations. The proposal is consistent with the notion that an exempt organization should be subject to a heightened standard of care with respect to its reporting and tax obligations because of its special treatment under the tax laws. The fact that an organization may pay tax on income from an activity does not lessen the public's need to have available to it certain information regarding the organization's activities. Some might argue that the justification for public access to information is even greater with respect to commercial activities

of the organization, because such activities might be more likely to raise issues with respect to private inurement, private benefit, excess benefit transactions, and other matters that may affect the organization's exempt status. Further, the tax laws should not permit an organization to avoid making available to the public certain information regarding its activities by choosing to treat the activity as an unrelated trade or business, instead of as an exempt activity, regardless of whether the activity generates income subject to the tax.[662]

UBIT certification for certain large organizations

Exempt organizations often do not provide any meaningful disclosure regarding unrelated trade or business income or unrelated activities in the financial reports they make available to the public. This appears to result from the absence of any special financial reporting rules requiring the disclosure of a nonprofit organization's unrelated business income tax or unrelated activities in such reports. The extent to which an exempt organization conducts activities that do or potentially could subject the organization to Federal income tax affects the organization's financial strength and viability, and thus its ability to carry out its exempt mission. In addition, some members of the public might benefit from improved information regarding an organization's nonexempt activities when making decisions whether to provide financial and other support to such organization.

The proposal attempts to promote more complete and accurate reporting of unrelated business activities and income by requiring that large organizations (defined as those with annual gross revenues or assets of at least $10 million) obtain certain reviews and certifications from independent auditors or counsel with respect to its activities. In addition, the proposal requires the certifying auditor or counsel to attest to whether it has knowledge regarding whether the organization has participated in or derived income from listed or reportable transactions. To encourage compliance with the certification requirement, the proposal imposes a penalty for failure to satisfy the certification requirements. The amount of the penalty varies with the amount of the organization's revenues (excluding grants and contributions that are clearly related to the organization's exempt purposes), and should be substantial enough to encourage compliance without being unduly harsh. For example, under the proposal, an organization that has $10 million of annual revenues (regardless of sources) and that fails to satisfy the certification requirements is liable for a penalty of up to $50,000, depending on the amount of its revenues other than from contributions and grants. The organization would not be subject to the penalty if all of its revenues were from contributions and grants.

Based on information relating to reporting year 2000, approximately six percent of public charities had total assets of at least ten million dollars, and approximately five percent of all public charities had total revenues of at least that amount.[663] Limiting the certification

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[662] Under present law, for example, an organization might conduct an activity that generates a loss or a small amount of income, and avoid public disclosure regarding such activity by choosing to treat it as an unrelated business activity (with little or no tax cost) rather than as an exempt activity.

[663] IRS Publication 1136, *Statistics of Income Bulletin*, Fall 2003, Volume 23, Number 2, at 123.

requirement to organizations with revenues or assets of at least ten million dollars excludes the vast majority of charities from the certification requirement, but imposes the requirement on those organizations with the bulk of the total assets and revenues of all public charities.[664] Although the measure of the penalty that is imposed for failing to satisfy the certification requirement is based on revenues (not assets), the certification requirement also applies to large asset-based organizations with relatively small revenues, in order to expand the scope of review by outside counsel or auditors. The proposal could be modified to base the penalty on a percentage of revenues or assets, if that is considered appropriate to increase the level of compliance.

The proposal requires the organization to provide the certification with both its Form 990 and Form 990-T filings, in order to increase the availability of the information to the public, and to subject the organization to the certification requirement even if a Form 990-T is not filed with respect to its unrelated trade or business activities.

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[664] The 13,967 public charities with total assets of at least ten million dollars had 88 percent of the total assets and total fund balances of all such charities, and 80 percent of the total revenues of all such organizations. The 10,296 public charities with revenues of at least ten million dollars had 79 percent of total assets, 78 percent of total fund balances, and 81 percent of total revenues, of all such organizations. The proposal also would apply to approximately nine thousand private foundations with total assets of at least $10 million. IRS Publication 1136, *Statistics of Income Bulletin*, Fall 2003, Volume 23, Number 2, at 140.

J. Expand the Base of the Tax on Private Foundation Net Investment Income (sec. 4940)

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,[665] also are subject to an excise tax under section 4940(b) based on net investment income and unrelated business income. The two-percent rate of tax is reduced to one-percent if certain requirements are met in a taxable year.[666] 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.

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.

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.[667] 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 supervision and the tax should not be understood as withdrawal of the income tax exemption.[668] 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.[669] In 1978, the rate was lowered to two percent in part because Congress determined that the tax was raising more than twice the revenue

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[665] See sec. 4947(a)(1).

[666] Sec. 4940(e).

[667] H. Rep. No. 413 (Part 1) at 19 (1969).

[668] S. Rep. No. 552 at 27 (1969).

[669] H.R. Conf. Rep. No. 782 at 278 (1969).

needed to finance the IRS's oversight of exempt organizations.[670] Also in 1978, Congress added "payments with respect to securities loans" to the definition of gross investment income.

Amounts collected pursuant to the tax based on investment income are not earmarked for use in administering the tax law for tax-exempt organizations.

Net Investment Income

Internal Revenue Code

In general, 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.[671]

Gross investment income is the gross amount of income from interest, dividends, rents, payments with respect to securities loans, and royalties. Gross investment income does not include any income that is included in computing a foundation's unrelated business taxable income.[672]

Capital gain net income takes into account only gains and losses from the sale or other disposition of property used for the production of interest, dividends, rents, and royalties, and property used for the production of income included in computing the unrelated business income tax (except to the extent the gain or loss is taken into account for purposes of such tax). Losses from sales or other dispositions of property are allowed only to the extent of gains from such sales or other dispositions, and no capital loss carryovers are allowed.[673]

Treasury Regulations and case law

The Treasury regulations elaborate on the Code definition of net investment income. The regulations cite items of investment income listed in the Code, and in addition clarify that net investment income includes interest, dividends, rents, and royalties derived from all sources, including from assets devoted to charitable activities. For example, interest received on a student loan is includible in the gross investment income of a foundation making the loan.[674]

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[670] S. Rep. No. 1263, 95th Cong., 2d Sess. 218 (1978).

[671] Sec. 4940(c)(1). 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). Sec. 4940(c)(5).

[672] Sec. 4940(c)(2).

[673] Sec. 4940(c)(4).

[674] Treas. Reg. sec. 53.4940-1(d)(1).

The regulations further provide that gross investment income includes certain items of investment income that are described in the unrelated business income tax regulations.[675] Such additional items include payments with respect to securities loans (an item added to the Code in 1978), annuities, income from notional principal contracts, and other substantially similar income from ordinary and routine investments to the extent determined by the Commissioner.[676] These latter three categories of income are not enumerated as net investment income in the Code.

The Treasury regulations also elaborate on the Code definition of capital gain net income. The regulations provide that the only capital gains and losses that are taken into account are (1) gains and losses from the sale or other disposition of property held by a private foundation for investment purposes (other than program related investments), and (2) property used for the production of income included in computing the unrelated business income tax (except to the extent the gain or loss is taken into account for purposes of such tax).

This definition of capital gain net income builds on the definition provided in the Code by providing an exception for gain and loss from program related investments and by stating, in addition, that "gains and losses from the sale or other disposition of property used for the exempt purposes of the private foundation are excluded."677 As an example, the regulations provide that gain or loss on the sale of buildings used for the foundation's exempt activities are not taken into account for purposes of the section 4940 tax. If a foundation uses exempt income for exempt purposes and (other than incidentally) for investment purposes, then the portion of the gain or loss received upon sale or other disposition that is allocable to the investment use is taken into account for purposes of the tax.

The regulations further provide that "property shall be treated as held for investment purposes even though such property is disposed of by the foundation immediately upon its receipt, if it is property of a type which generally produces interest, dividends, rents, royalties, or capital gains through appreciation (for example, rental real estate, stock, bonds, mineral interest, mortgages, and securities)."[678]

This regulation has been challenged in the courts. The regulation says that property is treated as held for investment purposes if it is of a type that "generally produces" certain types of income. By contrast, the Code provides that the property be "used" to produce such income. In *Zemurray Foundation v. United States*, the taxpayer foundation challenged the Treasury's attempt to tax under section 4940 capital gain on the sale of timber property. The taxpayer asserted that the property was not actually used to produce investment income, and that the Treasury Regulation was invalid because the regulation would subject to tax property that is of a type that could generally be used to produce investment income. On this issue, the court upheld the Treasury regulation, reasoning that the regulation's use of the phrase "generally used,"

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[675] *Id.*

[676] Treas. Reg. sec. 1.512-1(a)(1).

[677] Treas. Reg. sec. 53.4940-1(f)(1).

[678] *Id.*

though permitting taxation "so long as the property sold is *usable* to produce the applicable types of income, regardless of whether the property is actually used to produce income or not" was not unreasonable or plainly inconsistent with the statute.[679] However, on remand to the district court, the district court concluded that the timber property at issue, though a type of property generally used to produce investment income, was not susceptible for such use.[680] Thus, the district court concluded that the Treasury could not tax the gain under this portion of the regulation.

The question then turned to the taxpayer's second challenge to the regulation. At issue was the meaning of the regulatory phrase "capital gains through appreciation." The regulation provides that if property is of a type that generally produces capital gains through appreciation, then the gain is subject to tax. The Treasury argued that the timber property at issue, although held by the court not to be property (in this case) susceptible for use to produce interest, dividends, rents, or royalties, still was held by the taxpayer to produce capital gain through appreciation and therefore the gain should be subject to tax under the regulation.

On this issue, the court held for the taxpayer, reasoning that the language of the Code clearly is limited to certain gains and losses, e.g., the court cited the Code language providing that "there shall be taken into account *only* gains and losses from the sale or other disposition of property used for the production of interest, dividends, rents, and royalties . . . ."[681] The court noted that "capital gains through appreciation" is not enumerated in the statute. The court used as an example a jade figurine held by a foundation. Jade figurines do not generally produce interest, dividends, rents, or royalties, but gain on the sale of such a figurine would be taxable under the "capital gains through appreciation" standard, yet such standard does not appear in the statute. After *Zemurray*, the Treasury generally conceded this issue.[682]

With respect to capital losses, the Code provides that carryovers are not permitted, whereas the regulations state that neither carryovers nor carrybacks are permitted.[683]

Application of *Zemurray* to the Code and the regulations

Applying the *Zemurray* case to the Code and regulations results in a general principle for purposes of present law: private foundations are subject to tax under section 4940 only on the items of income and only on gains and losses specifically enumerated therein. Under this principle, private foundations generally are not subject to the section 4940 tax on other substantially similar types of income from ordinary and routine investments, notwithstanding

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[679] *Zemurray Foundation v. United States*, 687 F.2d 97, 100 (5th Cir. 1982).

[680] *Zemurray Foundation v. United States*, 53 A.F.T.R. 2d (RIA) 842 (E. D. La. 1983).

[681] *Zemurray Foundation v. United States*, 755 F.2d 404 (5th Cir. 1985), 413 (citing Code sec. 4940(c)(4)(A).

[682] General Counsel Memorandum 39538 (July 23, 1986).

[683] Treas. Reg. sec. 53.4940-1(f)(3).

Treasury regulations to the contrary. In addition, the regulations provide that gain or loss from the sale or other disposition of assets used for exempt purposes, with specific reference to program-related investments, is excluded. The Code provides for no such blanket exclusion; thus, under the language of the Code and the reasoning of *Zemurray*, if a foundation provided office space at below market rent to a charitable organization for use in the organization's exempt purposes, gain on the sale of the building by the foundation should be subject to the section 4940 tax despite the Treasury regulations.[684]

In addition, under the logic of *Zemurray*, capital loss carrybacks arguably are permitted, notwithstanding Treasury regulations to the contrary, because the Code mentions only a bar on use of carryovers and says nothing about carrybacks.

Reasons for Change

The *Zemurray* case casts doubt on the application of the tax on net investment income of private foundations beyond the facts of that case. As a result, it is not clear under present law whether income from certain investments is subject to tax. The proposal clarifies the scope of the section 4940 tax.

Description of Proposal

The proposal amends the definition of gross investment income to include certain items of income not presently enumerated in the Code but identified in Treasury regulations, namely, income from notional principal contracts, annuities, and other substantially similar income from ordinary and routine investments. In addition, the capital gains and losses subject to the tax are modified to include capital gains from appreciation, including capital gains and losses from the sale or other disposition of assets used to further an exempt purpose.

The proposal provides that there are no carrybacks of losses from sales or other dispositions of property.

Effective Date

The proposal is effective for taxable years beginning after the date of enactment.

Discussion

The proposal takes into account the reasoning of the *Zemurray* case that the section 4940 tax applies only to the items of income and to capital gains and losses that are specifically provided in the Code. Thus, the proposal broadens the Code definition of gross investment income to include other items of investment income that are listed in the Treasury regulations. By doing so, the proposal protects the tax base by providing certainty for taxpayers and administrators that income from annuities, notional principal contracts, and other substantially similar income from ordinary and routine investments are subject to the tax.

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[684] See also the example in Treas. Reg. sec. 53.4940-1(f)(1).

The proposal overrides the Treasury regulations to the extent that the regulations provide that capital gain from the sale or other disposition of assets used to further exempt purposes is not subject to the tax. Some might argue that subjecting such gain to tax is inconsistent with the reason for the tax, which is to tax purely investment type income, and not program-related income. But, the present-law definition of gross investment income subjects to tax any investment type income, even if the income is from a related activity. The Treasury regulations explicitly confirm this interpretation, and provide that the interest on a student loan, although program-related income, is includible in gross investment income. Given that program-related gross investment income is subject to the tax, consistency argues for subjecting to the tax the gain or loss on the sale or disposition of property that generates program-related income.

In addition, the proposal expands the definition of capital gain net income to include all capital gains and losses through appreciation. Arguably, capital gains through appreciation are similar to capital gains on property held for the production of investment income such as dividends in that the property generally is used or held for investment purposes. Extending the tax to include all capital gain through appreciation produces neutrality in the treatment of investment assets, and is consistent with the Treasury's original interpretation of the statute.

The proposal provides that capital loss carrybacks should not be permitted, consistent with existing Treasury regulations.

The tax on the net investment income of private foundations originally was intended as a fee to fund administration of exempt organizations generally. However, there is no evidence that revenues from the tax affects in any way the amount that is appropriated to the IRS for administration of programs related to exempt organizations. Thus, the original reason for the tax is not present, and arguably, the tax could be eliminated.[685] However, ensuring that the tax is applied evenly among private foundations and does not impose undue administrative burdens on taxpayers and the IRS is an important consideration when a tax is imposed. Assuming that the tax on net investment income continues in force, the proposal is intended to rationalize application of the tax.

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[685] The staff of the Joint Committee on Taxation recommended elimination of the tax in 2001 on the ground that elimination would simplify the tax law and could be justified because the original reason for the tax no longer existed. See 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, Volume II at 459.

K. Limit Tax-Exempt Status of Fraternal Beneficiary Societies that Provide Commercial-Type Insurance (sec. 501(c)(8))

Present Law

Fraternal beneficiary societies

A fraternal beneficiary society, order, or association is entitled to tax-exempt status if it operates under the lodge system or for the exclusive benefit of the members of a fraternity itself operating under the lodge system, and provides for the payment of life, sick, accident, or other benefits to the members of such society, order, or association or their dependents (sec. 501(c)(8)).[686] Operating under the lodge system generally means carrying on activities under a form of organization that comprises local branches, chartered by a parent organization and largely self-governing, called lodges, chapters, or the like.[687] Separately organized insurance branches of fraternal societies need not operate under the lodge system, but must provide permissible benefits exclusively to members of a lodge system.[688] The IRS reported 79,390 fraternal beneficiary societies in its master file for its fiscal year 2003.[689]

Fraternal beneficiary societies were first exempted from Federal income taxation under the Tariff Act of 1909, which provided that fraternal beneficiary societies, orders, or associations operating under the lodge system, and providing for the payment of life, sick, accident and other benefits to the members, were exempt.[690] The Revenue Act of 1913 extended the exemption to organizations operating for the exclusive benefit of the members of a fraternity itself operating under the lodge system.[691] The early societies provided members on an informal basis relief during sickness and unemployment and at death, with fraternal life insurance (i.e., the providing

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[686] According to trade association literature, "most fraternal benefit societies were founded more than a century ago to provide a sense of community to new Americans. These societies supported religious, educational and patriotic activities, with fraternal life insurance often providing the only means of support for a family following the death of the primary wage earner." National Fraternal Congress of America, *1998 Activity Report of the Fraternal Benefit System*.

[687] Treas. Reg. sec. 1.501(c)(8)-1.

[688] Rev. Rul. 73-192, 1973-1 C.B. 224.

[689] IRS Data Book, FY 2003, Publication 55b. Fraternal societies operating under the lodge system but that do not, in addition to their fraternal activities, provide for the payment of life, sick, accident and other benefits, may be entitled to exemption under section 501(c)(10). The IRS reported 22,576 such organizations in its master file for fiscal year 2003. *Id.*

[690] Section 38 of the Tariff Act of August 5, 1909, 36 Stat. 113 (1909).

[691] Pub. L. No. 63-6, sec. II(G)(a), 38 Stat. 172 (1913).

of death benefits on a more formal basis) appearing in the mid-nineteenth century.[692] The provision of sickness and accident insurance developed later. The IRS takes the position that life, sick, accident, and other benefits encompasses those benefits that provide insurance against the risk of loss of earning power.[693]

In general, the term "fraternal" applies to an organization whose members have adopted the same, or a very similar calling, avocation, or profession, and who for that reason have banded together to aid and assist one another and to promote a common cause.[694] A fraternal beneficiary society does not serve a fraternal purpose unless its members engage in fraternal activities. Rituals, ceremonies, social activities, and the performance of civic, benevolent, or charitable functions may serve to establish a fraternal purpose. As between fraternal purposes and the provision of benefits, fraternal purposes need not predominate.[695] It is sufficient if both the fraternal and benefit features are present, although an organization whose fraternal features are so insubstantial as to make it indistinguishable from an ordinary insurance company does not qualify for exemption under section 501(c)(8).[696]

Fraternal beneficiary societies described in section 501(c)(8) generally provide three types of services or benefits: insurance, fraternal, and charitable. Fraternal activities, by definition, benefit only members. Charitable activities of fraternal organizations may provide significant benefits to members and to non-members.[697] A fraternal beneficiary society may engage in non-fraternal activities or provide non-fraternal benefits, but such activities and benefits may be taxable as unrelated business income activities, or result in the organization's loss of exempt status unless the organization remains primarily engaged in fraternal activities and its benefits are primarily fraternal benefits.[698]

There were approximately 98 tax-exempt fraternal beneficiary societies in 1999 with assets of approximately $1 million or more, with one such society having assets of

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[692] Priv. Ltr. Rul. 9523027 (citing D. Gregg, *Life and Health Insurance Handbook*, 276 (3rd ed. 1973)).

[693] General Counsel Memorandum 38312 (March 12, 1980). "Other benefits" includes a legal defense fund for charges of misconduct arising from employment (Rev. Rul. 84-48, 1984-1 C.B. 133), an orphanage for surviving children of deceased members (Rev. Rul. 84-49, 1984-1 C.B. 134), and annuities (General Counsel Memorandum 39575 (November 18, 1986)).

[694] *National Union v. Marlow*, 74 F. 775, 778-79 (8th Cir. 1896).

[695] Rev. Rul. 73-165, 1973-1 C.B. 224.

[696] General Counsel Memorandum 34607 (September 13, 1971).

[697] *Report to the Congress on Fraternal Benefit Societies*, Department of the Treasury, Jan. 1993, 12.

[698] General Counsel Memorandum 38312 (March 20, 1980).

approximately $21 billion.[699] The six largest organizations at that time held $57.8 billion, or 87 percent, of the $66.0 billion total assets of the 98 societies,[700] with the largest organization having life insurance contracts in force with a face amount of $88 billion, and premium income of approximately $600 million from life insurance, $826 million from annuities, and $158 million from accident and health insurance.[701]

More recently, 86 of the largest fraternal beneficiary societies reported life insurance in force of $306.5 billion, life insurance issued during 2003 of $23.8 billion, and premiums and consideration from life, annuities, and accident and health during 2003 of $7.6 billion.[702] Following the merger of several of the largest fraternal beneficiary societies, the largest tax-exempt fraternal beneficiary society had assets of $62.5 billion in 2004.[703]

Although the membership eligibility requirements for these organizations vary, the common bond or cause that has served as the traditional fraternal purpose (i.e., the same, or a very similar calling, avocation, or profession, causing persons to band together to aid and assist one another and to promote a common cause) has eroded and become tenuous. The largest such organization, Thrivent Financial for Lutherans, requires that a member "demonstrate a Lutheran connection," either by being a Lutheran or by being a non-Lutheran who satisfies certain affiliation requirements with respect to a Lutheran organization (including Thrivent). Thrivent's membership application lists 12 different statuses that entitle a person to membership in the organization.[704] Another such organization permits a person to become a member if the person is

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[699] *1999 Statistics of Fraternal Benefit Societies: Five-Year Summary*, National Fraternal Congress of America (July 2000), at 3-4.

[700] *1999 Statistics of Fraternal Benefit Societies: Five-Year Summary*, National Fraternal Congress of America (July 2000), at 3-4. These same six organizations reported assets totaling approximately $80 billion in their publicly available annual reports for 2003, an increase of approximately 38 percent from 1999.

[701] *Id.* at 6.

[702] *2003 Statistics of Fraternal Benefit Societies*, National Fraternal Congress of America (July 2004), at 11-12.

[703] *Fraternal Face-Off*, Best's Review, April 2004, 85; Investors Put Their Faith In Funds Tied To Religion, *Wall Street Journal* (December 19, 2002).

[704] Thrivent Financial for Lutherans, Family Membership Application, *available at* www.thrivent.com/joinus/options.html. Membership is open to a current or former member of a Lutheran congregation who professes to be a Lutheran, an associate member of a Lutheran congregation listed on the congregation's membership roster, individuals who have varying family or employment relationships with Thrivent or Lutheran organizations, certain students or graduates of Lutheran educational organizations, residents of a Lutheran nursing home or care center, certain co-owners of Lutheran-owned businesses, a beneficiary of a Thrivent annuity or life insurance contract who uses the proceeds to purchase a Thrivent annuity or insurance contract or to fund a settlement option, and an individual who gifts a Thrivent annuity or

of the requisite Norwegian or Nordic status by "descent, marriage, or interest/affiliation."[705] Many such organizations, it appears, establish membership based upon the purchase of the insurance product, and extend fraternal benefits to those persons who become members by virtue of purchasing the insurance contract.[706]

Insurance activities of certain tax-exempt organizations[707]

An organization described in section 501(c)(3) or (4) (generally including charities and social welfare organizations) is exempt from tax only if no substantial part of its activities consists of providing commercial-type insurance (sec. 501(m)). Commercial-type insurance does not include (1) insurance provided at substantially below cost to a class of charitable recipients, (2) incidental health insurance provided by a health maintenance organization (HMO), (3) certain property or casualty insurance or retirement or welfare benefits provided by a church or convention or association of churches, or (4) charitable gift annuities. Legislative history refers to case law in defining "no substantial part."[708] This rule was enacted because

> Congress was concerned that exempt charitable and social welfare organizations that engage in insurance activities are engaged in an activity whose nature and scope is inherently commercial rather than charitable; hence, tax-exempt status is

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insurance contract to a Lutheran organization that is the owner or irrevocable beneficiary. Each person submitting an application for membership with Thrivent is required to certify that he or she supports the mission of Thrivent, which is as "a faith-based membership organization called to improve the quality of life of our members, their families and their communities by providing unparalleled solutions that focus on financial security, wellness and caring for others."

[705] Sons of Norway, Membership Application, *available at* www.sofn.com/joinus/Signup.html.

[706] E.g., Woodmen of the World/Omaha Woodmen Life Insurance Society, Membership Opportunities, *available at* www.woodmen.com/about/fratmem.cfm ("[b]y purchasing a Woodmen insurance or annuity certificate, you become a Woodmen member and are eligible to receive Woodmen's many member benefits, and enjoy the social and community activities of your local lodge").

[707] Present law also provides tax-exempt status or reduced tax for some types of insurance business that falls below certain dollar thresholds. The rule of section 501(c)(15) permits certain small property and casualty insurers to be tax-exempt if their premiums do not exceed $600,000 and other requirements are satisfied. Other rules generally permit certain taxable property and casualty insurers to elect to be taxed only on taxable investment income if their premiums do not exceed $1.2 million (sec. 831(b)).

[708] *General Explanation of the Tax Reform Act of 1986*, Joint Committee on Taxation, JCS-10-87 (May 4, 1987), 585, citing *Haswell v. U.S.*, 500 F.2d 1133 (Ct. Cl. 1974), *Seasongood v. Commissioner*, 227 F.2d 907 (6th Cir. 1955). The case law provides that under five percent of time and effort is no substantial part of an organization's activities, and 16 percent of an organization's expenditures is beyond the meaning of no substantial part.

inappropriate. Congress believed that the tax-exempt status of organizations engaged in insurance activities provided an unfair competitive advantage to these organizations. Congress further believed that the provision of insurance at a price sufficient to cover the costs of insurance generally constitutes an activity that is commercial. In addition, the availability of tax-exempt status under prior law allowed some large insurance entities to compete directly with commercial insurance companies.[709]

The commercial-type insurance provision was enacted in 1986 as part of the legislation that subjected Blue Cross and Blue Shield organizations to taxation as if they were stock insurance companies (sec. 833).

At the time that this rule was enacted, Congress also directed the Treasury Department to conduct a study of organizations described in section 501(c)(8) that received gross annual insurance premiums in excess of $25 million for 1984.[710] The Treasury study, published in 1993, found that "the insurance activities of fraternal benefit societies are income-producing activities that are similar in nature and scope to that provided by taxable commercial insurers. While there are some distinctions, the insurance policies of fraternal benefit societies appear to serve the same markets as those served by commercial insurers."[711] With respect to the rationale for tax exemption of fraternal beneficiary societies, the Treasury report stated, "[f]raternal benefit societies provide three types of services: insurance, charitable and fraternal. The insurance activities of the fraternal benefit societies are similar to activities of commercial insurers and, therefore, do not appear to have significant benefits that have been used in other contexts to justify tax exemption. The significant external benefits from charitable services, the redistributive nature of some fraternal services, and the use of the conduit organization form for providing fraternal services may, however, justify continuation of tax exemption for these [non-insurance] activities of fraternal benefit societies."[712]

Reasons for Change

Fraternal beneficiary societies that provide insurance are engaged in an activity whose nature and scope is inherently commercial rather than fraternal in nature. The tax-exempt status of fraternal beneficiary societies providing commercial-type insurance gives them an unfair competitive advantage. Tax-exempt status for such activities is inappropriate.

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[709] *Id.* at 584.

[710] Pub. L. No. 99-514, sec. 1012(c)(2).

[711] *Report to the Congress on Fraternal Benefit Societies*, Department of the Treasury, Jan. 1993, 2.

[712] *Id.* at 12.

Description of Proposal

Under the proposal, a fraternal beneficiary society, order, or association is exempt from tax as an organization described in section 501(c)(8) only if no substantial part of its activities consists of providing commercial-type insurance. For this purpose, no substantial part has the same meaning as under the present-law rule, and commercial-type insurance generally is any insurance of a type provided by insurance companies (including annuities). An organization that is treated as not exempt from tax under the proposal is subject to tax as if it were an insurance company, including with respect to its fraternal and other activities. In the case of an organization that is exempt from tax under the proposal, the activity of providing commercial-type insurance is treated as an unrelated trade or business, but is taxed under the rules relating to insurance companies with respect to such activity, rather than under the unrelated business income tax rules generally applicable to exempt organizations.

Effective Date

The proposal is effective for taxable years beginning after the date of enactment.

Discussion

Congress has recognized that providing commercial-type insurance is a commercial business activity, and that providing tax-exempt status for organizations that engage in insurance activities provides an unfair competitive advantage to these organizations. Therefore, tax-exempt status is not appropriate for an organization unless no substantial part of its activities consists of providing commercial-type insurance. This is especially the case when the rationale for providing the exemption for an organization (i.e., that the organization provides benefits exclusively to members that share a common, fraternal bond) has been eroded, and fraternal features are incidental to the insurance activity such that the organization is indistinguishable from a taxable insurance company.

Some might argue that Congress intended to provide tax-exempt status to the insurance activities of fraternal beneficiary societies, as evidenced by the statutory language referring to the payment of life, sick, accident, or other benefits to the members by such organizations, while commercial insurers were subject to income tax under a separate statutory regime also established by Congress. Under this view, changing the treatment of the insurance activities of fraternal beneficiary societies would violate the intent of Congress in making them tax-exempt, and is not appropriate.

On the other hand, it can be said that the commercial-type insurance marketed by tax-exempt fraternal beneficiary societies has grown substantially since the time such organizations were originally provided tax exemption in the early part of the last century. The nature of the commercial insurance business has changed, and the Federal income tax treatment of other organizations providing commercial insurance has evolved to reflect such changes.[713] These

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[713] As recently as 1983, commercial insurance companies were not subject to Federal income tax on a substantial part of their income, but the tax rules were reformed in 1984. As noted above, Congress eliminated the tax exemption for Blue Cross and Blue Shield

major changes may justify a reexamination of the original rationale for exempting fraternal beneficiary societies' insurance activities.

The original fraternal purpose of the organization has been lost if it can effectively provide insurance to any person. This is the result when membership in the organization carries with it little benefit from or obligation to the fraternal organization or other members, other than that which is derived from the insured member being required to pay the insurance premiums pertaining to the insurance product. It might be argued that in many cases, the connection between fraternal beneficiary societies and the insurance benefits they provide has changed from a fraternal society making insurance protection available for its fraternal members, to persons becoming members of a fraternal organization because they purchase insurance products from the organization. Put another way, the common bond or cause that once justified making insurance benefits available to members on an exempt basis has been replaced by a common bond resulting from the fact that many individuals otherwise lacking a common bond have chosen to purchase an insurance product from the same organization. Congress implicitly acknowledged these changes when, in 1986, it requested the Treasury study "so that Congress may consider the recommendations and take such action regarding the tax treatment of fraternal beneficiary societies engaged in insurance activities as is appropriate."[714]

It could be argued that the fraternal and charitable activities of a fraternal beneficiary organization are funded or financially made possible by receipts from the organization's insurance activity, and therefore are inextricably linked to the insurance activity so that continued tax-exempt status for these organizations would be appropriate. If any taxation were appropriate, imposition of unrelated business income tax on the insurance business activity income arguably is all that is required to address the point that such activities are commercial in nature.

The proposal does provide that the activity of providing commercial-type insurance is treated as an unrelated trade or business taxed under the insurance company tax rules, if the insurance activity does not constitute a substantial part of the organization's activities. In those cases where the insurance activity is a substantial part of the organization's overall activities, however, merely imposing an unrelated business income tax on the insurance activity does not adequately address the fundamental nature of the organization as a commercial insurance company. Further, if the non-insurance activities of the organization may be conducted separately, those activities may continue to benefit from tax-exempt status under section 501(c)(10) and the proposal.

No size limit or maximum revenue or asset cap is imposed on the insurance activities of fraternal beneficiary societies under present law. The largest organization reported assets of

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organizations in 1986, on the basis that such organizations were providing commercial-type insurance in competition with other insurance companies from which they could not be distinguished.

[714] *General Explanation of the Tax Reform Act of 1986*, Joint Committee on Taxation, JCS-10-87 (May 4, 1987), at 586.

$62.5 billion in 2004, with the largest of these organizations increasing in asset size by 38 percent from 1999 to 2003. The exemption with respect to commercial insurance activities of other large insurers was revoked in 1986, and fraternally organized insurers are the only significant remaining group of tax-exempt insurers with no significant limitation on the size of its insurance activities.

Several tax rules permit tax exemption or reduced taxation for some types of insurers considered small.[715] It may be argued that Congress has evinced an intent not to impose full income taxation on small insurers, and that taxing the insurance activities of some smaller fraternal beneficiary societies would violate that intent. However, the proposal does not contain any special rule or continuation of exempt status for small fraternal insurers. Historically, exempt status has been provided only for small property and casualty insurers under section 501(c)(15), not for life insurers.[716] The rationale for providing exempt status to small property and casualty insurers -- that they represented a pooling of risks on a small scale, frequently for farmers in a small region or in a county with respect to farming risks like hailstorms -- does not apply to life insurance products or insurers. Indeed, insurance generally requires both risk shifting and risk distribution, which generally require a large pool of mortality or morbidity risks in the case of life insurance products; the larger the pool, the more efficiently the risks can be assessed and priced. Some might argue that providing a small insurer exception under such circumstances could promote underwriting inefficiencies in the life insurance industry.

Under the proposal, no inference is intended regarding the meaning of commercial-type insurance for purposes of section 501(m), as it applies to section 501(c)(3) or (c)(4) organizations.

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[715] The exemption rule of section 501(c)(15) for property and casualty insurers with gross receipts below $600,000, and the reduced tax base for property and casualty insurers with net (or direct) written premiums below $1.2 million are described in the present law section, above.

[716] The section 501(c)(15) rule was modified in 2004 (sec. 206, Pub. L. No. 108-218). An early version of the section 501(c)(15) exemption provided that exempt organizations included "[f]armers' or other mutual hail, cyclone or fire insurance companies, mutual ditch or irrigation companies, mutual or cooperative telephone companies, or like organizations of a purely local character, the income of which consists solely of assessments, dues, and fees collected from members for the sole purpose of meeting expenses." Pub. L. No. 65-254, sec. 231 (10) (1919). Later, dollar limits were imposed on premiums received; section 101(11) of the 1939 Code provided that exempt organizations included "[m]utual insurance companies or associations other than life or marine (including interinsurers and reciprocal underwriters) if the gross amount received during the taxable year from interest, dividends, rents, and premiums (including deposits and assessments) does not exceed $75,000."

L. Establish Additional Exemption Standards for Credit Counseling Organizations (secs. 501(c)(3) and 501(c)(4))

Present Law

Under present law, a credit counseling organization may be exempt as a charitable or educational organization described in section 501(c)(3), or as a social welfare organization described in section 501(c)(4). The IRS has issued two revenue rulings holding that certain credit counseling organizations are exempt as charitable or educational organizations or as social welfare organizations.

In Revenue Ruling 65-299,[717] an organization whose purpose was to assist families and individuals with financial problems, and help reduce the incidence of personal bankruptcy, was determined to be a social welfare organization described in section 501(c)(4). The organization counseled people in financial difficulties, advised applicants on payment of debts, and negotiated with creditors and set up debt repayment plans. The organization did not restrict its services to the poor, made no charge for counseling services, and made a nominal charge for certain services to cover postage and supplies. For financial support, the organization relied on voluntary contributions from local businesses, lending agencies, and labor unions.

In Revenue Ruling 69-441,[718] the IRS ruled an organization was a charitable or educational organization exempt under section 501(c)(3) by virtue of aiding low-income people who had financial problems and providing education to the public. The organization in that ruling had two functions: (1) educating the public on personal money management, such as budgeting, buying practices, and the sound use of consumer credit through the use of films, speakers, and publications; and (2) providing individual counseling to low-income individuals and families without charge. As part of its counseling activities, the organization established debt management plans for clients who required such services, at no charge to the clients.[719] The organization was supported by contributions primarily from creditors, and its board of directors was comprised of representatives from religious organizations, civic groups, labor unions, business groups, and educational institutions.

In 1976, the IRS denied exempt status to an organization, Consumer Credit Counseling Service of Alabama, whose activities were distinguishable from those in Revenue Ruling 69-441 in that (1) it did not restrict its services to the poor, and (2) it charged a nominal fee for its debt

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[717] Rev. Rul. 65-299, 1965-2 C.B. 165.

[718] Rev. Rul. 69-441, 1969-2 C.B. 115.

[719] Debt management plans are debt payment arrangements, including debt consolidation arrangements, entered into by a debtor and one or more of the debtor's creditors, generally structured to reduce the amount of a debtor's regular ongoing payment by modifying the interest rate, minimum payment, maturity or other terms of the debt. Such plans frequently are promoted as a means for a debtor to restructure debt without filing for bankruptcy.

management plans.[720] The organization provided free information to the general public through the use of speakers, films, and publications on the subjects of budgeting, buying practices, and the use of consumer credit. It also provided counseling to debt-distressed individuals, not necessarily poor or low-income, and provided debt management plans at the cost of $10 per month, which was waived in cases of financial hardship. Its debt management activities were a relatively small part of its overall activities. The district court determined the organization qualified as charitable and educational within section 501(c)(3), finding the debt management plans to be an integral part of the agency's counseling function, and that its debt management activities were incidental to its principal functions, as only approximately 12 percent of the counselors' time was applied to such programs and the charge for the service was nominal. The court also considered the facts that the agency was publicly supported, and that it had a board dominated by members of the general public, as factors indicating a charitable operation.[721]

A recent estimate shows the number of credit counseling organizations increased from approximately 200 in 1990 to over 1,000 in 2002.[722] During the period from 1994 to late 2003, 1,215 credit counseling organizations applied to the IRS for tax exempt status under section 501(c)(3), including 810 during 2000 to 2003.[723] The IRS has recognized more than 850 credit counseling organizations as tax exempt under section 501(c)(3).[724] Few credit counseling organizations have sought section 501(c)(4) status, and the IRS reports it has not seen any significant increase in the number or activity of such organizations operating as social welfare

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[720] *Consumer Credit Counseling Service of Alabama, Inc. v. U.S.*, 44 A.F.T.R. 2d (RIA) 5122 (D.D.C. 1978). The case involved 24 agencies throughout the United States.

[721] See also, *Credit Counseling Centers of Oklahoma, Inc., v. U.S.*, 45 A.F.T.R. 2d (RIA) 1401 (D.D.C. 1979) (holding the same on virtually identical facts).

[722] Opening Statement of The Honorable Max Sandlin, Hearing on Non-Profit Credit Counseling Organizations, House Ways and Means Committee, Subcommittee on Oversight (November 20, 2003).

[723] United States Senate Permanent Subcommittee on Investigations, Committee on Governmental Affairs, *Profiteering in a Non-Profit Industry: Abusive Practices in Credit Counseling*, Report Prepared by the Majority & Minority Staffs of the Permanent Subcommittee on Investigations and Released in Conjunction with the Permanent Subcommittee Investigations' Hearing on March 24, 2004, p. 3 (citing letter dated December 18, 2003, to the Subcommittee from IRS Commissioner Everson).

[724] Testimony of Commissioner Mark Everson before the House Ways and Means Committee, Subcommittee on Oversight (November 20, 2003).

organizations.[725] As of late 2003, there were 872 active tax-exempt credit counseling agencies operating in the United States.[726]

A credit counseling organization described in section 501(c)(3) is exempt from certain Federal and State consumer protection laws that provide exemptions for organizations described therein.[727] Some believe that these exclusions from Federal and State regulation may be a primary motivation for the recent increase in the number of organizations seeking and obtaining exempt status under section 501(c)(3).[728] Such regulatory exemptions generally are not available for social welfare organizations described in section 501(c)(4).

Congress recently conducted hearings investigating the activities of credit counseling organizations under various consumer protection laws,[729] such as the Federal Trade Commission Act.[730] In addition, the IRS has commenced a broad examination and compliance program with

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[725] Testimony of Commissioner Mark Everson before the House Ways and Means Committee, Subcommittee on Oversight (November 20, 2003).

[726] United States Senate Permanent Subcommittee on Investigations, Committee on Governmental Affairs, *Profiteering in a Non-Profit Industry: Abusive Practices in Credit Counseling*, Report Prepared by the Majority & Minority Staffs of the Permanent Subcommittee on Investigations and Released in Conjunction with the Permanent Subcommittee Investigations' Hearing on March 24, 2004, at 3 (citing letter dated December 18, 2003 to the Subcommittee from IRS Commissioner Everson).

[727] E.g., The Credit Repair Organizations Act, 15 U.S.C. section 1679 *et seq.*, effective April 1, 1997 (imposing restrictions on credit repair organizations that are enforced by the Federal Trade Commission, including forbidding the making of untrue or misleading statements and forbidding advance payments; section 501(c)(3) organizations are explicitly exempt from such regulation). Testimony of Commissioner Mark Everson before the House Ways and Means Committee, Subcommittee on Oversight (November 20, 2003) (California's consumer protections laws that impose strict standards on credit service organizations and the credit repair industry do not apply to nonprofit organizations that have received a final determination from the IRS that they are exempt from tax under section 501(c)(3) and are not private foundations).

[728] Testimony of Commissioner Mark Everson before the House Ways and Means Committee, Subcommittee on Oversight (November 20, 2003).

[729] United States Senate Permanent Subcommittee on Investigations, Committee on Governmental Affairs, *Profiteering in a Non-Profit Industry: Abusive Practices in Credit Counseling*, Report Prepared by the Majority & Minority Staffs of the Permanent Subcommittee on Investigations and Released in Conjunction with the Permanent Subcommittee Investigations' Hearing on March 24, 2004.

[730] 15 U.S.C. sec. 45(a) (prohibiting unfair and deceptive acts or practices in or affecting commerce; although the Federal Trade Commission generally lacks jurisdiction to enforce consumer protection laws against bona fide nonprofit organizations, it may assert jurisdiction over a nonprofit, including a credit counseling organization, if it demonstrates the organization is

respect to the credit counseling industry, pursuant to which the IRS has initiated audits of 50 credit counseling organizations, including nine of the 15 largest in terms of gross receipts.[731]

Reasons for Change

An entire industry of credit counseling, credit repair, and debt management and debt consolidation has emerged over the past 30 years, with much of this activity conducted by nonprofit organizations that initially received favorable exempt status determinations from the IRS. During this period, judicial decisions relaxed exemption standards for credit counseling organizations claiming exempt status, ultimately resulting in many organizations conducting substantial activities that are not directly related to the charitable and educational purposes that initially formed the rationale for providing exemption from Federal income tax.[732] Activities such as debt management plan and credit repair services test, and in many instances cross, the boundaries of what should be permissible activity for a charitable, educational, or social welfare organization. Although the IRS recently has dedicated substantial resources to address these organizations, and believes that it can make strong legal challenges to the exempt status of many of such organizations under present law,[733] legislation to establish exemption standards tailored to the peculiar aspects of the industry would provide greater certainty that further erosion of exemption standards does not occur, and strengthen enforcement of Federal and State consumer protection laws by limiting exemption from those laws to those organizations that satisfy stricter tax-exemption standards.

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organized to carry on business for profit, is a mere instrumentality of a for-profit entity, or operates through a common enterprise with one or more for-profit entities).

[731] United States Senate Permanent Subcommittee on Investigations, Committee on Governmental Affairs, *Profiteering in a Non-Profit Industry: Abusive Practices in Credit Counseling*, Report Prepared by the Majority & Minority Staffs of the Permanent Subcommittee on Investigations and Released in Conjunction with the Permanent Subcommittee Investigations' Hearing on March 24, 2004, at 31.

[732] See, e.g., Testimony of Commissioner Mark Everson before the House Ways and Means Committee, Subcommittee on Oversight (November 20, 2003) ("In recent years, the Service has seen an increase in applications for tax exempt status from organizations intending to provide credit counseling services. Among the more recent applicants, we are finding credit counseling organizations that vary from the model approved in the earlier rulings and court cases. We are seeing organizations whose principal activity is selling and administering debt management plans. ... The individual budget assistance and public education programs that formed the original basis for exemption under section 501(c)(3) have changed").

[733] The IRS released a legal memorandum (ILM 200431023) (July 13, 2004), in which it concluded that many credit counseling organizations do not qualify for exemption under section 501(c)(3) because of operation for a substantial nonexempt purpose, substantial private benefit, and private inurement.

Description of Proposal

Additional requirements applicable to all credit counseling organizations

Under the proposal, a nonprofit credit counseling agency or other nonprofit organization that provides credit counseling, debt management, and similar services, is eligible for exemption from income tax only as a charitable or educational organization under section 501(c)(3), or as a social welfare organization under section 501(c)(4). The proposal provides additional requirements that must be satisfied by a credit counseling organization in order to be an organization described in section 501(c)(3) or (c)(4). The proposed requirements supplement, rather than replace, the present-law requirements generally applicable to all organizations described in section 501(c)(3) or (c)(4).

Under the proposal, a nonprofit credit counseling agency is eligible for exempt status as an organization described in section 501(c)(3) or (c)(4) only if it is organized and operated in accordance with the following requirements:

(1) it at all times conducts as its primary activities (a) providing educational information to the general public on budgeting, personal finance, financial literacy, saving and spending practices, and the sound use of consumer credit; (b) assisting individuals and families with financial problems by providing them counseling tailored to their specific needs and circumstances; or (c) any combination of such activities;

(2) it makes no loans to debtors, does not negotiate to make loans on behalf of debtors, and provides no credit repair services (i.e., services for the purpose of improving any consumer's credit record, credit history, or credit rating);

(3) it may not refuse to provide counseling services to a consumer due to inability to pay or to qualify for debt management plan enrollment, or because of a consumer's unwillingness to enroll in a debt management plan;

(4) it limits any debt management plan services to individuals or families for whom a debt management plan reasonably is determined to be the most appropriate means to relieve financial distress;

(5) it establishes and implements a fee policy to require that any fees charged to a consumer for its services are reasonable, and prohibits charging any fee based in whole or in part on a percentage of the consumer's debt, the consumer's payments to be made pursuant to a debt management plan, or on projected or actual savings to the consumer resulting from enrolling in a debt management plan;

(6) it at all times has a board of directors or other governing body (a) that is controlled by persons who represent the broad interests of the public, such as public officials acting in their capacities as such, persons having special knowledge or expertise in credit or financial education, and community leaders; and (b) not more than 20 percent of the voting power of which is vested in persons who are employed by the agency or who will benefit financially, directly

or indirectly, from the agency's activities (other than through the receipt of reasonable directors' fees or the repayment of consumer debt to creditors other than the credit counseling agency or its affiliates);

(7) it receives no compensation for providing referrals to others for services to be provided to consumers, and pays no compensation to others for obtaining referrals of consumers; and

(8) it is not related to a person that is in the business of lending money or that provides debt management, credit repair, payment processing, and similar services. For this purpose, a person is treated as related to another person if (1) such person bears a relationship to such other person described in section 267(b) (determined without regard to paragraph (9) thereof), or section 707(b)(1), determined by substituting "25 percent" for "50 percent" each place it appears therein, and (2) if such other person is a nonprofit organization, if such person controls directly or indirectly more than 25 percent of the governing body of such organization.

Additional requirements for charitable or educational organizations

Under the proposal, a credit counseling agency is exempt as a charitable or educational organization under section 501(c)(3) only if, in addition to satisfying the above requirements, it is organized and operated such that (1) it charges no fees (other than nominal fees) for services provided to low-income individuals and families and for credit counseling or educational services, and waives any fees if payment of such fees would work a financial hardship; (2) it does not solicit voluntary contributions from its clients during the initial counseling process or while the client is receiving services from the agency; (3) the provision of debt management plan services to a consumer is in connection with providing counseling and education services to such consumer; (4) the aggregate of the agency's debt management plan services (measured by time, resources, effort expended by the agency, and any other factors prescribed by the Secretary) during the four-year period that includes the agency's current taxable year and the immediately preceding three taxable years does not exceed 10 percent of the agency's total activities during such four-year period; and (5) it satisfies all other requirements of section 501(c)(3).

Additional requirements for social welfare organizations

Under the proposal, a nonprofit credit counseling agency is eligible for exempt status as an organization described in section 501(c)(4) only if, in addition to satisfying the above requirements applicable to such organizations, it is organized and operated such that: (1) it charges no fees (other than nominal fees) for its credit counseling and educational services, and waives any fees if payment of such fees would work a financial hardship; and (2) satisfies the other requirements of section 501(c)(4).

A comparison of the proposal's requirements for the two types of organizations, and to present law, is contained in the following table.

Table 3.–Comparison of Proposed and Present Law

Description of Activity or Requirement	Present Law Standards	Proposed (c)(3) Standards	Proposed (c)(4) Standards
Counseling and education activities	Legally required, but such activities have diminished in practice as the industry has changed	Education and counseling must be primary activity	Education and counseling must be primary activity
Extent of debt management plan (DMP) activities permitted	No clear standards	DMP services for a consumer must be in connection with counseling and education provided to such consumer, and limited to those for whom a DMP is the most appropriate means to relieve distress; agency's aggregate DMP activities cannot exceed 10% of total activities for rolling four-year period (based on time, resources, effort)	DMP services for a consumer must be limited to those for whom a DMP is the most appropriate means to relieve distress; DMP activities cannot be primary activity
Credit repair activities permitted to be performed	Probably limited to insubstantial activities, but no clear standards	Prohibited	Prohibited
Lending and loan negotiation activities that are permitted	No clear standards	Prohibited	Prohibited
Services and fees for poor or low-income persons	No clear standards	Exemption is not dependent upon providing services to low-income persons; may not refuse to provide counseling services to a consumer unwilling to	Exemption is not dependent upon providing services to low-income persons; may not refuse to provide counseling services to a consumer unwilling to

Description of Activity or Requirement	Present Law Standards	Proposed (c)(3) Standards	Proposed (c)(4) Standards
		pay, must charge no or nominal fees for education and counseling services for low-income persons, and must waive any fees for any service that would work a hardship	pay, and must waive any fees for any service that would work a hardship; may charge more than nominal fees to low-income persons
Overall fee policy	No clear standards	Required to have a fee policy that any fee that may be charged must be reasonable in relation to the services provided; certain fee arrangements are prohibited	Required to have a fee policy that any fee that may be charged must be reasonable in relation to the services provided; certain fee arrangements are prohibited
Fees that may be charged for counseling and education	No clear standards	No more than nominal fees may be charged for such services	No more than nominal fees may be charged for such services
Fees that may be charged for debt management services	No clear standards	No more than nominal fees may be charged for such services if provided to low income persons	Fees must be reasonable in relation to the services provided
Fees that may be charged for credit repair services	No clear standards, but such fees probably constitute unrelated business income	None permitted; such activities are prohibited	None permitted; such activities are prohibited
Compensation for referrals	No clear standards	Cannot pay or receive compensation for referrals of consumers	Cannot pay or receive compensation for referrals of consumers
Board composition requirements	No special rules	Board must be controlled by persons who represent the broad public interest, and no more than 20% of its members may be persons who directly or indirectly receive financial benefits from the	Board must be controlled by persons who represent the broad public interest, and no more than 20% of its members may be persons who directly or indirectly receive financial benefits from the

Description of Activity or Requirement	Present Law Standards	Proposed (c)(3) Standards	Proposed (c)(4) Standards
		organization's activities	organization's activities
Related party rules (lending of money, payment processing, debt management, other services)	No special rules	Organization cannot be related to a lender of money, or to a provider of payment processing, debt management, or similar services	Organization cannot be related to a lender of money, or to a provider of payment processing, debt management, or similar services

Effective Date

The proposal is effective for taxable years beginning after the date of enactment, regardless of when the organization was formed or received a determination letter that it was an exempt organization.

Discussion

The primary rationale of the proposal is that judicial interpretations of the application of generally applicable exempt organization law to credit counseling organizations have eroded the meaning of charitable and educational in this industry, which ultimately led to the commercialization of an industry that is largely operated in nonprofit form. An overly expansive definition of "charitable or educational" with respect to credit counseling organizations means that some organizations have improperly avoided paying Federal income tax on their income and activities. In addition, and perhaps equally important, such organizations have escaped Federal and State consumer protection regulation under the erroneous assumption that Federal tax-exempt status has provided sufficient regulatory oversight to identify and address misconduct and mismanagement, thereby eliminating the need for non-tax regulation of such organizations.

The Congressional hearings and IRS compliance and enforcement efforts have reported numerous areas of abuse in the industry, many of which implicate Federal tax exemption policy.[734] Many credit counseling organizations now conduct as their primary activity, and derive most of their revenues from, debt management planning and other activities that are at best only tangentially related to the counseling and educational missions they purport to serve. Relationships with for-profit entities, many of which were established by organizers and

[734] E.g., Testimony of Commissioner Mark Everson before the House Ways and Means Committee, Subcommittee on Oversight (November 20, 2003) ("Often the board of directors is not representative of the community and may be related by family or business ties to the for-profit entities that service and market the debt management plans." ... "The organizations are supported by fees from customers and from credit card companies, and the fees are much higher than those in the rulings or court cases." ... Finally, it does not appear that significant counseling or education is being provided").

managers of the credit counseling organization, reportedly have siphoned off commercial profits of the exempt organization to the for-profit entity, and then been used to pay significant salaries and dividends to the for-profit's employees and owners. Many organizations have been charging consumers substantial fees for services, in some cases based on potential savings a consumer might derive from being placed on a debt management plan, with some initial advance fees equaling the entire first month's payment under the plan. Boards of directors often do not represent the communities the organizations are supposed to serve.

The proposal's additional organizational and operational requirements are designed to address these reported areas of abuse and concern. The proposal subjects both types of exempt organizations (charitable or educational and social welfare) to many of the same requirements, but makes certain distinctions with respect to the fees that may be charged by each to low-income persons, and the extent to which an organization may conduct debt management plan activities. More stringent requirements for charitable or educational organizations apply because such status generally has heightened standards when compared with social welfare organizations described in section 501(c)(4).

The material aspects of the proposal are consistent with the legal and factual conclusions reached by the IRS in its legal memorandum released in July 2004.[735] In that memorandum, the IRS concluded that many credit counseling organizations do not qualify for exemption under section 501(c)(3) because of operation for a substantial nonexempt purpose, substantial private benefit, and private inurement. The memorandum stated that the marketing of debt management plans is "by far the most substantial activity" of many organizations the IRS has reviewed. The proposal addresses debt management plans by imposing strict fee limits on the amount consumers may be charged for such services,[736] and limiting the amount of such activities that may be conducted on an ongoing basis (i.e., no more than 10 percent of total activities if a charitable or educational organization, no more than 50 percent if a social welfare organization). The 10-percent limit applicable to charitable and educational organizations comports with the traditional levels of such activity before the dramatic growth in the industry.

Two areas discussed in the IRS memorandum are not explicitly addressed in the proposal. First, the memorandum concluded that if debt management plan activity of an organization is insubstantial, income from such activities should be examined on a case by case basis to determine whether such income should be taxed as unrelated business income. The proposal does not modify the treatment of debt management plan income as unrelated business income, and relies on present law to determine whether an organization's income from such activities should be taxed. Thus, under the proposal, an organization that conducts its debt management

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[735] Credit Counseling Agencies, ILM 200431023 (July 13, 2004).

[736] For all such organizations, the proposal prohibits charging any fee based in whole or in part on a percentage of the consumer's debt, the consumer's payments to be made pursuant to a debt management plan, or on projected or actual savings to the consumer resulting from enrolling in a debt management plan. For an organization described in section 501(c)(3), no more than nominal fees may be charged for such services if provided to low-income persons. In all cases, debt management service fees must be waived if they would work a financial hardship.

activities in accordance with the proposed requirements could be subject to the unrelated business income tax on none, some or all of its income (if any) derived from such activities, depending upon its facts and circumstances. Second, the IRS noted that service arrangements between a credit counseling organization and unrelated organizations could raise private benefit issues. The proposal addresses related party service arrangements by prohibiting them, but does not explicitly limit or prohibit such arrangements with unrelated service providers. Although service arrangements with unrelated providers may raise private benefit issues, the proposal relies upon the generally applicable private benefit doctrine to address such arrangements.[737] Similar unrelated business income tax and private benefit concerns exist throughout the exempt organization sector, and arguably any reforms in these two areas should be applied more broadly across the exempt sector. The proposal attempts to address those areas that have contributed to the erosion of exemption standards in the credit counseling industry.

Some might argue that the proposal unfairly targets a particular industry, and that the exempt status rules for credit counseling organizations should be the same as for other types of exempt organizations. However, the Code contains various special exemption standards for a particular type of industry or organization. For example, the Code provides special exemption standards for cooperative hospital service organizations (sec. 501(e)), cooperative service organizations of operating educational organizations (sec. 501(f)), certain amateur sports organizations (sec. 501(j)), certain child care organizations (sec. 501(k)), and charitable risk pools (sec. 501(n)), in order to be treated as a charitable organization described in section 501(c)(3). Further, some might argue that imposing supplemental exemption standards on the credit counseling industry is appropriate where, as is the case here: (1) the nontax regulation of an entire industry is dependent upon whether the organization is exempt as a charitable or exempt organization; (2) systematic abuses have been reported by Congress and the IRS with respect to much of the industry; and (3) prior attempts by the IRS to prevent erosion of traditional exempt standards were rejected by the courts.

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[737] If it is determined that additional requirements should be put in place for service arrangements with unrelated providers, perhaps principles similar to those employed in the management contract rules used to determine private use of tax-exempt bond financed facilities could be employed. Rev. Proc. 97-13, 1997-1 C.B. 632, as modified by Rev. Proc. 2001-39, 2001-2 C.B. 38 (addressing types of fee arrangements and other contractual terms that may be used in such management services arrangements without violating the private use requirement).

IX. TAX-EXEMPT BOND PROVISIONS

A. Impose Loan and Redemption Requirements on Pooled Financing Bonds (sec. 149)

Present Law

In general

Section 103 generally provides that gross income does not include interest received on State or local bonds.[738] State and local bonds are classified generally as either governmental bonds or private activity bonds. Governmental bonds are bonds the proceeds of which are primarily used to finance governmental facilities or the debt is repaid with governmental funds. Private activity bonds are bonds in which the State or local government serves as a conduit providing financing to nongovernmental persons (e.g., private businesses or individuals).[739] To qualify for the tax exemption, the Code imposes requirements that apply to all State and local bonds. Arbitrage restrictions, for example, limit the ability of issuers to profit from investment of tax-exempt bond proceeds. In addition, the exclusion from income for State and local bonds does not apply to private activity bonds, unless the bonds are issued for certain permitted purposes. The Code also imposes requirements that only apply to specific types of bond issues. For instance, pooled financing bonds (defined below) are not tax-exempt unless the issuer meets certain requirements regarding the expected use of proceeds.

Pooled financing bond restrictions

At times, State or local bonds are issued to provide financing for the benefit of a third party (a "conduit borrower"). Pooled financing bonds are issues in which the proceeds are used to make or finance loans to two or more conduit borrowers, unless the conduit loans are to be used to finance a single project.[740] The Code imposes several requirements on pooled financing bonds if more than $5 million of proceeds are expected to be used to make loans to conduit borrowers. For purposes of these rules, a pooled financing bond does not include certain private activity bonds.[741]

A pooled financing bond is not tax-exempt unless the issuer reasonably expects that at least 95 percent of the net proceeds will be lent to ultimate borrowers by the end of the third year after the date of issue. The term "net proceeds" is defined to mean the proceeds of the issue less the following amounts: (1) proceeds used to finance issuance costs; (2) proceeds necessary to

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[738] Sec. 103.

[739] Sec. 141.

[740] Treas. Reg. sec. 1.150-1(b).

[741] Sec. 149(f)(4)(B).

pay interest on the bonds during a three-year period; and (3) amounts in reasonably required reserves.[742]

An increase in interest rates or anticipated changes in Federal income tax laws may not be used as a basis for the issuer's reasonable expectations regarding the lending of proceeds to borrowers. Moreover, the legislative history to the pooled financing provision states the "investment of bond proceeds in guaranteed investment contracts which do not permit significant draw downs to originate loans during the three-year period will be prima facie evidence that the reasonable expectations test is not satisfied."[743] An issuer's past experience regarding loan origination is a criterion upon which the reasonableness of the issuer's expectations can be based. As an additional requirement for tax exemption, all legal and underwriting costs associated with the issuance of pooled financing bonds may not be contingent and must be substantially paid within 180 days of the date of issuance.

Arbitrage restrictions on tax-exempt bonds

To prevent the issuance of more Federally subsidized tax-exempt bonds than necessary; the tax exemption for State and local bonds does not apply to any arbitrage bond.[744] An arbitrage bond is defined as any bond that is part of an issue if any proceeds of the issue are reasonably expected to be used (or intentionally are used) to acquire higher yielding investments or to replace funds that are used to acquire higher yielding investments. 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 ("arbitrage rebate").

The Code contains several exceptions to the arbitrage rebate requirement, including an exception for bonds issued by small governments (the "small issuer exception"). For this purpose, 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.[745]

Pooled financing bonds are subject to the arbitrage restrictions that apply to all tax-exempt bonds, including arbitrage rebate. Under certain circumstances, however, small governments may issue pooled financing bonds without those bonds counting towards the determination of whether the issuer qualifies for the small issuer exception to arbitrage rebate. In the case of a pooled financing bond where the ultimate borrowers are governmental units with general taxing powers not subordinate to the issuer of the pooled bond, the pooled bond does not

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[742] Sec. 149(f)(2)(C).

[743] H.R. Rep. No.100-1104, at 123 (1988).

[744] Secs. 103(a) and 103(b)(2).

[745] The $5 million limit is increased to $15 million if at least $10 million of the bonds are used to finance public schools.

count against the issuer's $5 million limitation, provided the issuer is not a borrower from the pooled bond.[746] However, the issuer of the pooled financing bond remains subject to the arbitrage rebate requirement for unloaned proceeds.[747]

Reasons for Change

A number of pooled financing bonds have been issued recently under which few or no loans were made to conduit borrowers from bond proceeds.[748] A common feature of these transactions is the use of non-binding demand surveys that fail to adequately identify potential borrowers or evaluate current financing needs. Many of these transactions involve large issuances by small local governments that receive a fee to act as the issuer of the pooled financing. Because these local governments do not borrow proceeds from the pool, present law permits them to issue pooled financing bonds without those bonds counting towards the determination of whether they qualify for the small issuer exception to arbitrage rebate. These transactions result in greater issuance of tax-exempt bonds than necessary to finance current governmental activities, diminishing the utility and value of the tax subsidy.

Description of Proposal

In general

The proposal imposes new requirements on pooled financing bonds as a condition of tax-exemption. First, the proposal imposes a written loan commitment requirement to restrict the issuance of pooled bonds where potential borrowers have not been identified ("blind pools"). Second, in addition to the current three-year expectations requirement, the issuer must reasonably expect that at least 50 percent of the net proceeds of the pooled bond will be lent to borrowers one year after the date of issue. Third, the proposal requires the redemption of outstanding bonds with proceeds that are not loaned to borrowers within the expected loan origination periods. Finally, the proposal eliminates the rule allowing an issuer of pooled financing bonds to disregard the pooled bonds for purposes of determining whether the issuer qualifies for the small issuer exception to rebate.

Borrower identification

Under the proposal, interest on a pooled financing bond is tax exempt only if the issuer obtains written commitments with ultimate borrowers for loans equal to at least 50 percent of the net proceeds of the pooled bond prior to issuance. For purposes of the proposal, a loan commitment exists only if: (a) the issuer is committed to lend bond proceeds to the borrower identified in the commitment, and (b) the borrower has applied for, and agreed to execute, a loan in an amount certain to finance a specifically identified project and, as part of that application,

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[746] Sec. 148(f)(4)(D)(ii)(II).

[747] Treas. Reg. sec. 1.148-8(d)(1).

[748] See Susanna Duff Barnett, "Tax Enforcement: Florida Health Agency Settles Over Pooled Bond Issues," *The Bond Buyer*, (October 26, 2004), at 5.

has paid a nonrefundable commitment fee in an amount that is commensurate with fees customarily paid for similar loan commitments.

Loan origination expectations

The proposal imposes new reasonable expectations requirements for loan originations. The issuer must expect that at least 50 percent of the net proceeds of the pooled bond will be lent to ultimate borrowers one year after the date of issue. This is in addition to the present-law requirement that at least 95 percent of the net proceeds will be lent to ultimate borrowers by the end of the third year after the date of issue.

Redemption requirement

Under the proposal, if bond proceeds are not loaned to borrowers within prescribed periods, outstanding bonds equal to the amount of proceeds that were not loaned within the required period must be redeemed in the following six months. This effectively imposes an actual loan origination requirement in addition to the reasonable expectations tests. The bond redemption requirement applies with respect to excess proceeds that are unoriginated as of expiration of the one-year and three-year loan origination periods. For example, if an amount equal to 45 percent of the net proceeds of an issue are used to make loans to ultimate borrowers as of one year after the bonds are issued, an amount equal to five percent of the net proceeds of the issue is no longer available for lending and must be used to redeem bonds within the following six-month period. Similarly, if only 85 percent of the net proceeds of the issue are used to make qualifying loans (or to redeem bonds) as of three years after the bonds are issued, 10 percent of the remaining net proceeds is no longer available for lending and must be used to redeem bonds within the following six months.

Small issuer exception

The proposal eliminates the rule disregarding pooled financing bonds from the issuer's $5,000,000 annual limitation for purposes of the small issuer exception to arbitrage rebate.

Effective Date

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

Discussion

The Code excludes interest on State and local government bonds from tax to enable these governments to finance their activities at a lower cost than that provided in the taxable debt market. The underlying premise of this exemption is that tax-subsidized borrowing will be limited to amounts for which actual and immediate financing requirements are demonstrated, either for direct governmental activities or for those statutorily enumerated private activities for which tax-exemption is permitted. Issuing more bonds and issuing bonds earlier than what is otherwise necessary to accomplish the governmental purpose of the borrowing have the effect of overburdening the tax-exempt bond market and diminishing the value of the subsidy.

Pooled financing bonds raise special concerns because such bonds generally are not issued to meet the financing requirements of the issuer, but of the borrowers from the pool who may or may not be identified at the time of issuance. Thus, if a prospective issuer of a pooled financing bond fails to adequately evaluate the level of demand and likelihood of participation for potential borrowers from the pool, such a financing may result in greater and/or earlier issuance of tax-exempt bonds than necessary to meet current financing needs.

Congress previously addressed concerns relating to pooled financing bonds when it added section 149(f) to the Code as part of the Technical and Miscellaneous Act of 1988.[749] Section 149(f) was a response to the increased issuance of tax-exempt bonds in cases in which no immediate financing requirements were demonstrated. Congress found that, in many cases, pooled financing bonds were issued not to meet current financing needs of identified borrowers, but rather to "lock-in" low interest rates. This issuance of tax-exempt bonds without an expectation of using proceeds for a current governmental purpose was viewed as an inappropriate use of the subsidy. Congress stated that tax-exempt bonds should be issued only when the proceeds are needed to finance a legitimate purpose and, even then, only for relatively current financing needs.[750] Section 149(f) reflects that intent by prohibiting the issuance of tax-exempt pooled financing bonds without reasonable expectations that 95 percent of net proceeds will be used to make loans to conduit borrowers within three years.

Although not included in the final provision, the original House bill that led to the enactment of section 149(f) would have required identification of borrowers from pooled financings as a condition of tax-exemption.[751] This was intended to address findings that pool-bond arrangements were frequently issued based on demand surveys, rather than written loan commitments. Demand surveys are conducted in advance of issuance of pooled financing bonds to indicate a potential demand for loans, but typically do not bind potential borrowers or lenders. The House Committee on Ways and Means noted that the failure to identify and bind borrowers through written loan commitments contributed to the overissuance of pooled financing bonds.[752] The borrower identification requirement was not included in section 149(f), but the Conference Report states that the Treasury Department is to monitor blind pools to assure conformity with pooled financing restrictions.[753]

The present-law restrictions on pooled financing bonds have not eliminated concerns associated with this financing method. As publicly reported, examinations conducted by both IRS and State regulators have revealed a number of instances where pooled financing bonds were issued but few or no loans were made from bond proceeds. For example, a Florida General Auditor report released in 2003 studied eight tax-exempt pooled bond issuances and found that in

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[749] Pub. L. No. 100-647 (1988).

[750] H.R. Rep. No. 100-795, at 447 (1988).

[751] H.R. 4333 (1988).

[752] H.R. Rep. No. 100-795, at 446 (1988).

[753] H.R. Rep. No. 100-1104, at 123 (1988).

seven of the eight deals approximately 91 percent of the bond proceeds had not been loaned.[754] The IRS also has been examining pooled financings since the mid-1990s. During that time, it has examined numerous pooled financing transactions where only small percentages of bond proceeds were loaned to borrowers. The IRS has stated that it would continue to devote significant resources to address concerns with pooled financings, focusing its efforts on those transactions where few loans were made and where participants received large fees.[755]

A common characteristic of those transactions in which few loans were made is the use of non-binding demand surveys to justify issue size. In many cases, it was found that issuers relied on demand surveys that made only a minimal effort to evaluate the likelihood of participation of potential borrowers or to identify projects requiring financing. Demand surveys conducted in this manner are likely to overestimate financing needs, resulting in excessive issuance of pooled financing bonds. Identifying borrowers by obtaining binding loan commitments prior to issuance will eliminate many of the sizing problems caused by faulty demand surveys. While increased enforcement efforts or the adoption of objective standards for conducting demand surveys may improve issuers' expectations, issuing bonds primarily on the basis of non-binding surveys is less likely to accurately measure current financing needs than written loan commitments that are accompanied by a nonrefundable commitment fee.

Imposing pre-issuance administrative requirements, such as written loan commitments, may increase the costs of issuance and, therefore, reduce the economic benefits of issuing bonds on a pooled basis. However, a loan commitment requirement does not impose new costs, but simply shifts the timing of those costs from post-issuance to pre-issuance. Furthermore, the continued issuance of pooled financing bonds in which issuers are unable to demonstrate an immediate financing need warrants restrictions on blind pools. On the other hand, there may be circumstances when it is impractical for issuers to obtain loan commitments from all potential borrowers prior to issuance. For example, many pooled financings are issued through State bond pools that issue bonds more frequently than small local governments. The largest programs may issue bonds ten or more times each year. In these cases, requiring written loan commitments from all borrowers prior to issuance may prove burdensome. Therefore, to provide issuers continued flexibility when sizing bond issues while simultaneously addressing the concerns raised by blind pools, the proposal requires loan commitments equal to at least 50 percent of the net proceeds of the issue.

The proposal also imposes new expectations requirements for loan originations. In addition to the present-law 95 percent requirement, the issuer must expect that at least 50 percent of the net proceeds of the pooled bond will be lent to ultimate borrowers one year after the date

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[754] See State of Florida Auditor General, *Local Government Bond Pools*, Report No. 03-187, (May 22, 2003). The report also noted that the participants to these transactions received significant fees, despite the fact that few of the proceeds were used for public purposes. The Florida report did not, however, address potential tax issues raised by either the failure to make loans or the amount of fees received by participants.

[755] See Susanna Duff Barnett, "Tax Enforcement: Florida Health Agency Settles Over Pooled Bond Issues," *The Bond Buyer*, (October 26, 2004), at 5.

of issue. Because pooled bonds provide financing for multiple projects, all on different timetables, a one-year origination requirement will restrict borrowers' access to pooled financings, create a need for smaller, more frequent issuances, and may reduce the savings that borrowers realize through pooled financings. However, this requirement will limit the period that bond proceeds remain unspent and will provide additional assurance that pooled financing bonds are only issued for relatively current financing needs. Moreover, curbing excessive issuances will lessen the overall burden on the tax-exempt market, which will ultimately decrease local governments' borrowing costs.

Although written loan commitments and additional reasonable expectations requirements will curtail excessive issuances, these requirements will not eliminate all concerns with pooled financing bonds. For example, there will be many reasons why a prospective borrower might ultimately decide not to, or be unable to, borrow from a pool despite submitting a "binding" loan commitment. Assuming substitute borrowers are not found in such a case, there will be greater issuance of tax-exempt bonds than necessary, even though the issuer's expectations were reasonable at the time of issuance. Furthermore, identifying borrowers without imposing a time limit for originating loans does not address concerns with respect to bonds that are issued earlier than necessary. Thus, the proposal requires the redemption of outstanding bonds with proceeds that are not loaned to borrowers within the one-year or three-year loan origination periods.

The redemption requirements might be criticized on the grounds that they do not provide the flexibility needed when pooled bonds are issued to finance the projects of multiple borrowers. In general, mandatory redemption requirements may cause a need for more frequent issuances of pooled bonds, which will either increase borrowers' costs or simply deny some small governments access to pooled funds. Redemption requirements, however, will provide additional assurance that pooled financing bonds are only issued for current financing needs and will remain outstanding for the minimum period necessary to meet those needs. In addition, the proposal addresses the issue of flexibility by requiring the redemption of only those proceeds that are required to be loaned within the specified origination periods. Therefore, if 45 percent of the net proceeds of an issue are used to make loans to ultimate borrowers as of one year after the bonds are issued, only five percent of the net proceeds of the issue must be used to redeem bonds within the following six-month period and the remaining proceeds may continue to be used to originate loans within the three-year origination period.

Finally, the proposal requires issuers to count pooled financing bonds towards the $5 million small issuer limitation for rebate purposes. Many of the larger pooled financing bonds where few or no loans were made were issued by small local governments that received a fee to act as the pool issuer. In addition to the receipt of compensation, a local government is willing to issue pooled bonds because doing so generally does not impact whether the issuer qualifies for the small issuer exception to arbitrage rebate. Eliminating the rule allowing an issuer to disregard pooled financing bonds for purposes of qualifying for the small issuer exception will remove some of the incentive to issuing pooled bonds at the local level where there is generally less oversight of such financings.[756] In the short term, the proposal may reduce small

[756] See State of Florida Auditor General, *Local Government Bond Pools*, Report No. 03-187, at 31.

governments' access to pooled funds; particularly in States that do not issue pooled bonds, as certain local governments will no longer issue pool bonds. However, pooled financing bonds will still be available to small governments, both as issuers and borrowers. The proposal does not prevent local governments from issuing pooled bonds; rather it limits the ability of a local government to act merely as an accommodation party when issuing pooled bonds and forces issuers to consider their own financing needs before engaging in these transactions.

B. Amend Information Reporting Requirements to Include Interest on Tax-Exempt Bonds (sec. 6049)

Present Law

Tax-exempt bonds

Generally, gross income does not include interest on State or local bonds.[757] State and local bonds are classified generally as either governmental bonds or private activity bonds. Governmental bonds are bonds the proceeds of which are primarily used to finance governmental facilities or the debt is repaid with governmental funds. Private activity bonds are bonds in which the State or local government serves as a conduit providing financing to nongovernmental persons (e.g., private businesses or individuals). The exclusion from income for State and local bonds does not apply to private activity bonds, unless the bonds are issued for certain purposes ("qualified private activity bonds") permitted by the Code.[758]

Tax-exempt interest reporting by taxpayers

The Code provides that every person required to file a return must report the amount of tax-exempt interest received or accrued during any taxable year.[759] There are a number of reasons why the amount of tax-exempt interest received is relevant to determining tax liability despite the general exclusion from income. For example, the interest income from qualified private activity bonds (other than qualified 501(c)(3) bonds) issued after August 7, 1986, is a preference item for purposes of calculating the alternative minimum tax ("AMT").[760] Tax-exempt interest also is relevant for determining eligibility for the earned income credit (the "EIC")[761] and the amount of Social Security benefits includable in gross income.[762] Moreover, determining includable Social Security benefits is necessary for calculating either adjusted or modified adjusted gross income under several Code sections.[763] Thus, the amount of tax-exempt interest paid to taxpayers is germane to these provisions as well.

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[757] Sec. 103.

[758] Secs. 103(b)(1) and 141.

[759] Sec. 6012(d).

[760] Sec. 57(a)(5). Special rules apply to exclude refundings of bonds issued before August 8, 1986, and certain bonds issued before September 1, 1986.

[761] Sec. 32(i).

[762] Sec. 86.

[763] See secs. 135, 219, and 221.

Information reporting by payors

The Code generally requires every person who makes payments of interest aggregating $10 or more or receives payments of interest as a nominee and who makes payments aggregating $10 or more to file an information return setting forth the amount of interest payments for the calendar year and the name, address, and TIN[764] of the person to whom interest is paid.[765] Treasury regulations prescribe the form and manner for filing interest payment information returns. Penalties are imposed for failures to file interest payment information returns or payee statements.[766] Treasury Regulations also impose recordkeeping requirements on any person required to file information returns.[767] The Code excludes interest paid on tax-exempt bonds from the interest payment reporting requirements.[768]

Tax-exempt bond enforcement

The IRS begins examinations of tax-exempt bonds at the issuer level, rather than through the examination of individual bondholders. This is done largely as a matter of administrative convenience because the issuer of tax-exempt bonds is more likely to have information with respect to the transaction. However, if the IRS makes a determination that interest on a bond sold as tax-exempt is taxable, bondholders, not issuers, are the parties whose tax liability is affected.

Reasons for Change

Although generally exempt from tax, the amount of interest received on tax-exempt bonds is pertinent to a number of tax determinations, including AMT liability, taxable Social Security benefits, and eligibility for the EIC. For this reason, under present law, taxpayers are required to report the amount of tax-exempt interest received during the taxable year. Issuers of tax-exempt bonds, however, are not required to file information returns identifying the recipients of interest payments. The lack of a reporting requirement for interest payments on qualified private activity bonds may lead to incorrect reporting and erroneous calculations of tax liability by individual taxpayers.

Moreover, the lack of a reporting requirement increases the administrative burdens confronted by the IRS in the examination of tax-exempt bonds. Individual bondholders, rather than issuers, are the parties whose tax liability is affected by the determination that a bond issued as tax-exempt is taxable. The IRS may have to invest significant resources in learning the names

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[764] The taxpayer's identification number, generally, for individuals is the taxpayer's Social Security number. Sec. 7701(a)(41).

[765] Sec. 6049.

[766] Secs. 6721 and 6722.

[767] Treas. Reg. sec. 1.6001-1(a).

[768] Sec. 6049.

of the bondholders whose liability is affected by such a determination. Most issuers contract with a third-party to make interest payments to bondholders. Present law requires the IRS to begin judicial proceedings to obtain bondholder names from third parties.[769]

Description of Proposal

Option 1

Under the proposal, issuers of tax-exempt bonds are required to file information returns identifying the amount of interest payments in a calendar year and the name, address, and TIN of the person to whom interest is paid. The recordkeeping requirement imposed on issuers as persons required to file information returns may be satisfied by contracting with a third party to maintain the necessary information at the time bonds are issued.

Option 2

An alternative proposal is to require the production of payee information from the issuer of any tax-exempt bond upon request of the IRS. Similar to the first option, the proposal permits issuers to satisfy the requirement by contracting with a third party to maintain and provide the necessary records.

Under either option, penalty provisions for failure to file correct information returns[770] and for failure to furnish correct payee statements,[771] would be amended to apply to interest on tax-exempt bonds.

Effective Date

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

Discussion

The first option requires issuers to report annually the names, addresses, and TINs of payees and the amount of interest paid on tax-exempt bonds. Present law requires taxpayers to report the amount of tax-exempt interest received during the taxable year, but issuers of tax-exempt obligations are not required to file information returns with respect to interest paid. The proposal ensures that taxpayers have sufficient information to meet present-law reporting requirements. In addition, as discussed above, the amount of tax-exempt interest received is important to a number of tax determinations. Providing taxpayers with this information will reduce erroneous reporting and enhance tax compliance. Although the proposal imposes a new administrative requirement and cost on issuers of State and local bonds, issuers or their agents are currently required to know the holders of outstanding bonds in order to make scheduled

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[769] Sec. 7609(f) (relating to requirements for a "John Doe" summons).

[770] Sec. 6721.

[771] Sec. 6722.

interest payments. Therefore, the reporting requirement should not be unduly burdensome or costly. Moreover, imposing information reporting requirements on State and local governments is not novel. State and local governments generally are required to make information returns with respect to taxable payments.[772] The administrative burden imposed on State and local governments by the proposal should be no greater than that imposed by present-law reporting requirements for other types of payments. The burden is not disproportionate to the benefit State and local governments receive in the form of the Federal tax exemption for State and local bonds.

The information return requirement of the proposal subjects issuers to present-law recordkeeping requirements for such information. To lessen the administrative burdens imposed on issuers, the proposal permits issuers to satisfy the recordkeeping requirement by contracting with a third party to maintain the necessary records.

Rather than filing payee information returns on an annual basis, the second option is to require issuers of all State and local bonds to maintain interest payee information for production upon request of the IRS. Requiring issuers of tax-exempt bonds to maintain information regarding interest payments (i.e., payee names, addresses, TINs, and amount of interest received) and produce that information upon request of the IRS, will lessen the administrative burdens confronted by the IRS in the examination of tax-exempt bond transactions. This additional recordkeeping requirement may create a burden on some issuers. In addition, the burden is likely to be greatest for small issuers with fewer resources to implement recordkeeping controls. However, issuers or parties acting on their behalf must know the identity of bondholders to make scheduled interest payments. Further, as with the first option, the proposal will lessen the administrative burden by permitting issuers to satisfy the requirement by contracting with a third party to maintain the necessary records and produce them upon request by the IRS.

Either an information reporting requirement or information production requirement will require a penalty regime to ensure compliance. The penalty provisions for failure to file correct information returns and for failure to furnish correct payee statements could be amended to apply to tax-exempt bonds under either alternative.

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[772] See secs. 6041A and 6049.

C. Clarify Limitations on Indian Tribes' Use of Tax-Exempt Bond Proceeds (sec. 7871)

Present Law

Under present law, gross income does not include interest on State or local bonds.[773] State and local bonds are classified generally as either governmental bonds or private activity bonds. Governmental bonds are bonds the proceeds of which are primarily used to finance governmental facilities or the debt is repaid with governmental funds. Private activity bonds are bonds in which the State or local government serves as a conduit providing financing to nongovernmental persons. For these purposes, the term "nongovernmental person" includes the Federal government and all other individuals and entities other than States or local governments.[774] Interest on private activity bonds is taxable, unless the bonds are issued for certain purposes permitted by the Code and other requirements are met.[775]

In many cases, State or local bonds are issued to provide financing to a third party (a "conduit borrowing"). In a conduit borrowing, a State or local government issues bonds and loans the proceeds to a conduit borrower who then repays the loan in such amounts, and at such times to allow the issuer to make debt service payments on the bonds.

Although not States or subdivisions of States, Indian tribal governments are provided with a tax status similar to State and local governments for specified purposes under the Code.[776] Among the purposes for which a tribal government is treated as a State is the issuance of tax-exempt bonds. However, bonds issued by tribal governments are subject to limitations not imposed on State and local government issuers. Tribal governments are authorized to issue tax-exempt bonds only if substantially all of the proceeds are used for essential governmental functions or certain manufacturing facilities.[777]

Reasons for Change

Indian tribal governments may only issue tax-exempt bonds to finance essential governmental functions or certain manufacturing facilities. Despite this limitation, there have been reports of transactions in which State or local governments issued tax-exempt bonds as a conduit borrowing and loaned the proceeds to Indian tribes to finance the construction of gambling casinos. The transactions reportedly ranged in size from $10 million to over $300

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[773] Sec. 103.

[774] Sec. 141(b)(6); Treas. Reg. sec. 1.141-1(b).

[775] Secs. 103(b)(1) and 141.

[776] Sec. 7871.

[777] Sec. 7871(c).

million.[778] These transactions were promoted as tax-exempt because legal opinions were provided concluding that the restrictions on bonds financing the activities of tribal governments do not apply where the tribe is the conduit (rather than direct) borrower of bond proceeds. Moreover, the use of conduit borrowings have been promoted as a method for avoiding the essential governmental function requirement for bonds issued by Indian tribal governments.

Description of Proposal

Under the proposal, section 7871, which allows Indian tribes to finance projects with tax-exempt bonds subject to certain limitations, is amended to clarify that it applies whether an Indian tribal government is a conduit borrower or an issuer of tax-exempt bonds.

Effective Date

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

Discussion

In 1982, Congress passed the Indian Tribal Government Tax Status Act (the "Act") adding section 7871 to the Code and permitting tribal governments to issue tax-exempt bonds for limited purposes.[779] Prior to the Act, the IRS had taken the position that obligations issued by a tribal government were not tax exempt under section 103, in part, because tribes exercise their authority by virtue of Federal rather than State authority.[780] Congress, however, recognized that many tribal governments have financing needs and perform governmental functions similar to State and local governments and, thus, should have the ability to issue tax-exempt bonds to finance certain governmental functions.[781] The legislative history to the Act indicates that tribal governments' authority to issue bonds should be limited to the financing of essential governmental functions such as "schools, streets, and sewers."[782] Moreover, the legislative history clearly states that tribal governments are prohibited from issuing all types of private activity bonds.

As part of the Omnibus Budget Reconciliation Act of 1987 ("OBRA 1987"), Congress amended section 7871 to expressly provide that tribal governments' authority to issue tax-exempt bonds is limited to the financing of activities "customarily performed by State and local governments with general taxing powers."[783] The additional restrictions were in response to

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[778] See Susanna Duff Barnett, "$145.5M Cabazon Deal Under Scrutiny, IRS Steps Up Probe of Indian Tribes," *The Bond Buyer*, (August 6, 2004), at 1.

[779] Pub. L. No. 97-473, sec. 202(a) (1983).

[780] Rev. Rul. 68-231, 1968-1 C.B. 48

[781] S. Rep. No. 97-646 (1982).

[782] H.R. Rep. No. 97-984, at 16-17 (1982).

[783] Sec. 7871(e).

concerns that tribal government bonds were being issued for purposes that were commercial, rather than governmental in nature. The legislative history to OBRA 1987 provides both an explanation of the concerns Congress was addressing and clarification of tribal governments' authority to issue bonds:

> Issuance of bonds to finance commercial or industrial facilities (e.g., private rental housing, cement factories, or mirror factories) which bonds technically may not be private activity bonds is not included within the scope of the essential governmental function exception . . . [T]he committee wishes to stress that only those activities that are customarily financed with governmental bonds (e.g., schools, roads, government buildings, etc.) are intended to be within the scope of this exception, notwithstanding that isolated instances of a State or local government issuing bonds for another activity may occur.[784]

Section 7871 places clear limitations on the ability of Indian tribes to issue tax-exempt bonds and the conduit financing transactions discussed above are attempts to circumvent present law. Thus, the proposal clarifies that the essential governmental function requirements of section 7871 apply whether an Indian tribal government is a direct issuer of tax-exempt bonds or a conduit borrower of bond proceeds. The proposal ensures that Indian tribes cannot use tax-exempt conduit financing for activities that cannot be directly financed with tax-exempt bonds issued by an Indian tribe.[785]

In some cases, Indian tribes may borrow funds at a lower rate through a conduit borrowing than if they were to issue bonds directly. Therefore, the proposal has no impact on the ability of Indian tribes to enter into legitimate conduit borrowing transactions with States or local governments. Rather, the proposal simply clarifies the intent of Congress and provides that Indian tribes must use the proceeds of tax-exempt bonds in the same manner whether they are direct issuers of such bonds or conduit borrowers.

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[784] H.R. Rep. No. 100-391, at 1139 (1987). OBRA 1987 also amended section 7871 to permit limited issuance of tribal bonds for manufacturing activities.

[785] Section 7701(f) may also provide the Secretary authority to issue regulations addressing the substance of these transactions.

D. Eliminate Private Payment Test for Stadium Bonds (sec. 141)

Present Law

In general

Under present law, gross income does not include interest on State or local bonds. State and local bonds are classified generally as either governmental bonds or private activity bonds. Governmental bonds are bonds the proceeds of which are primarily used to finance governmental functions or the debt is repaid with governmental funds. Private activity bonds are bonds in which the State or local government serves as a conduit providing financing to nongovernmental persons (e.g., private businesses or individuals). The exclusion from income for State and local bonds does not apply to private activity bonds, unless the bonds are issued for certain purposes ("qualified private activity bonds") permitted by the Code and other Code requirements are met.

Private activity bond tests

In general

The Code defines a private activity bond as any bond that satisfies (1) the private business use test and the private security or payment test ("the private business test"); or (2) "the private loan financing test."[786]

Two-part private business test

Under the private business test, a bond is a private activity bond if it is part of an issue in which:

(1) More than 10 percent of the proceeds of the issue (including use of the bond-financed property) are to be used in the trade or business of any person other than a governmental unit ("private business use test"); and

(2) More than 10 percent of the payment of principal or interest on the issue is, directly or indirectly, secured by (a) property used or to be used for a private business use or (b) to be derived from payments in respect of property, or borrowed money, used or to be used for a private business use ("private payment test").[787]

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[786] Sec. 141.

[787] The 10-percent private business test is reduced to five percent in the case of private business uses (and payments with respect to such uses) that are unrelated to any governmental use being financed by the issue.

A bond is not a private activity bond unless both parts of the private business test (i.e., the private business use test and the private payment test) are met.

A contract between a private management or other service company and a governmental unit to operate bond-financed governmental facilities may result in private business use depending on the terms of the contract.[788] In general, a management contract gives rise to private business use if the compensation under the contract is based on net profits. Contracts for service incidental to the facility's primary functions, such as janitorial, office equipment repair and similar services, are not considered management contracts. Certain contracts involving hospital-admitting privileges, operation of public utility property, and expense reimbursements are not treated as management contracts.

For purposes of the private payment test, both direct and indirect payments made by any private person treated as using the financed property are taken into account. Payments by a person for the use of proceeds generally do not include payments for ordinary and necessary expenses (within the meaning of section 162) attributable to the operation and maintenance of financed property.[789]

Private loan financing test

A bond issue satisfies the private loan financing test if proceeds exceeding the lesser of $5 million or five percent of such proceeds are used directly or indirectly to finance loans to one or more nongovernmental persons.

Types of qualified private activity bonds

The list of activities that may be financed with qualified private activity bonds has increased to 20 from the 12 originally defined by the Revenue and Expenditure Control Act of 1968.[790] Under present law, a qualified private activity bond is a qualified mortgage, veterans' mortgage, small issue, student loan, redevelopment, 501(c)(3), or exempt facility bond.[791] To qualify as an exempt facility bond, 95 percent of the net proceeds must be used to finance: (1) airports; (2) docks and wharves; (3) mass commuting facilities; (4) high-speed intercity rail facilities; (5) facilities for the furnishing of water; (6) sewage facilities; (7) solid waste disposal facilities; (8) hazardous waste disposal facilities; (9) qualified residential rental projects; (10) facilities for the local furnishing of electric energy or gas; (11) local district heating or cooling facilities; (12) environmental enhancements of hydroelectric generating facilities; (13) qualified public educational facilities; or (14) qualified green building and sustainable design projects.

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[788] Treas. Reg. sec. 1.141-3(b)(4).

[789] Treas. Reg. sec. 1.141-4(c)(3).

[790] Pub. L. No. 90-364, sec. 107.

[791] Sec. 141(e).

Reasons for Change

In 1986, Congress eliminated a provision expressly allowing tax-exempt financing for sports facilities. Nevertheless, professional sports facilities continue to be financed with tax-exempt bonds despite the fact that privately owned sports teams are the primary (if not exclusive) users of such facilities. This is because present law permits the use of tax-exempt bond proceeds for private activities if either part of the two-part private business test is not met. In the case of bond-financed professional sports facilities, issuers have intentionally structured the tax-exempt bond issuance and related transactions to fail the private payment test. In most of these transactions, the professional sports team is not required to pay for more than a small portion of its use of the sports facility. As a result, the private payment test is not met and the bonds financing the facility are not treated as private activity bonds, despite the existence of substantial private business use.

Description of Proposal

The proposal eliminates the private payment test for professional sports facilities. Under the proposal, bonds issued to finance a professional sports facility are taxable private activity bonds if more than 10 percent of the proceeds of the issue (including use of the bond-financed property) are to be used in the trade or business of any person other than a governmental unit, regardless of the amount of private security or private payments received with respect to such use. A professional sports facility is defined as real property or related improvements used, in whole or in part, for professional sports. Use for professional sports includes any use by a nongovernmental person for sports exhibitions, games, or training which generates monetary benefit.

Effective Date

The proposal is effective for bonds issued after the date of enactment.[792]

Discussion

As part of the Tax Reform Act of 1986 (the "1986 Act"), Congress adopted the private activity bond rules in response to concerns that a significant amount of proceeds from governmental bonds were being used to finance private activities.[793] The issuance of tax-exempt bonds to finance private activities was viewed as an inefficient use of the Federal subsidy that increased the cost of financing traditional government activities.[794] Therefore, Congress expressed its intent to restrict the diversion of governmental bond proceeds for private purposes not specifically authorized to receive tax-exempt financing.

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[792] Transitional rules may be necessary for facilities approved for financing on the date of enactment but for which bonds had yet to be issued.

[793] S. Rep. No. 99-313, at 826 (1986).

[794] H.R. Rep. No. 99-426, at 514 (1985); S. Rep. 99-313, at 825-26 (1986).

Present law, however, permits tax-exempt financing of facilities primarily used by private persons if bonds fail either prong of the private business test; the private business use test or the private payment test.[795] By requiring that both the use and payment tests be met before a bond is a taxable private activity bond, Congress effectively authorized the issuance of tax-exempt bonds to finance private activities in situations in which the taxpayers, rather than private parties, are the obligors on the debt. As a result, present law permits the use of bond proceeds for private activities that Congress has not specifically approved to benefit from the indirect Federal subsidy provided through tax exemption.

For example, prior to the 1986 Act, the Code expressly allowed tax-exempt financing for sports facilities. The 1986 Act discontinued this express authority by eliminating a provision that treated sports facilities as exempt activities eligible for tax-exempt financing.[796] Municipalities, however, continue to subsidize sports facilities using tax-exempt bonds. This is because stadiums qualify for tax-exempt financing under present law even if the bonds providing such financing exceed either the 10 percent private business use test or the 10 percent private payment test, but not both. Use by a professional sports team almost always will cause the private business use test to be met, so a stadium bond (to be tax-exempt) must be structured so that debt service is primarily paid from sources other than stadium revenues or other private payments.[797] Because only one prong of the private business test is satisfied in such cases, the bonds are not treated as private activity bonds.[798] In effect, present law virtually requires that if a stadium is to be financed with tax-exempt bonds, a municipality must enter an arrangement granting a professional sports team use of the stadium at terms substantially more favorable than market value.

The proposal addresses the ability of municipalities to transfer the benefits of tax-exempt financing to professional sports teams by eliminating the private payment test for the financing of professional sports facilities. Under the proposal, bonds issued to finance a professional sports facility are private activity bonds if more than 10 percent of the proceeds of the issue are to be used in the trade or business of any person other than a governmental unit, without regard to whether the bonds were secured by private payments. Arguably, the proposal is simply corrective because Congress previously eliminated the provision allowing sports facilities to be treated as exempt activities and, thus, intended to disallow the tax-exempt financing of such facilities. However, the 1986 Act has no express prohibition on financing sports facilities with

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[795] The original House bill that led to the 1986 Act would have repealed the ten percent security or payment test, leaving only the ten percent use test. H.R. Rep. No. 99-426, at 520 (1985).

[796] Pub. L. No. 99-514 (1986).

[797] This may be accomplished by securing the repayment of the bonds with generally applicable taxes, which, under Treas. Reg. Sec. 1.141-4(e), are not taken into account for purposes of the private security or payment test.

[798] There is also no loan to a private person in these transactions that would meet the private loan financing test.

tax-exempt governmental bonds. Thus, whether such prohibition was contemplated and intended by the elimination of the prior-law authorization for sports facilities financings may be subject to interpretation. In adopting the two-part private business test, it might be argued that Congress intended to allow tax-exempt financing for any facility, including stadiums, provided the private activity bond limitations are followed.

On the other hand, sports facility financings are anomalous; the relative scarcity of professional sports teams enables team owners to convince State and local officials to pledge public funds (e.g., through tax-exempt financing) either to lure teams to an area or to entice them to stay. Present law encourages these arrangements by requiring the repayment of bonds to derive from sources other than the sports facility or the professional team if such a facility is to be financed with tax-exempt obligations. By offering tax-exempt financing, however, State and local governments use the Federal subsidy to compete with other municipalities for professional sports teams. Moreover, pledging public funds to the repayment of tax-exempt bonds not only permits issuers to avoid the restrictions on private business use, but also causes more of the benefit of tax-exempt financing to be transferred to private parties in these transactions, a result that is inconsistent with the purpose of the subsidy.

With respect to governmental bonds, present law generally permits State and local governments to determine the types of projects for which tax-exempt financing is appropriate. By prohibiting a particular type of facility, the proposal imposes some restrictions on the ability of States and local governments to make these independent determinations. Nevertheless, the tax exemption for State and local bonds represents a Federal subsidy. There are numerous examples in the Code of circumstances in which Congress determined it appropriate to limit the subsidy. The limitation imposed by the proposal is appropriate because it prevents tax-exempt financing of one type of facility, professional sports facilities, for which there is generally substantial private business use. Finally, the proposal does not prevent States and local governments from subsidizing sports facilities through the use of public funds; it merely prevents the use of the Federal subsidy in such cases.

The transfer of tax-exempt financing benefits to private parties is not unique to stadium bonds and, thus, the private payment test could be eliminated for all bonds. Tax-exempt governmental bonds are issued to finance a variety of privately used facilities including, corporate industrial parks and parking garages. Similar to stadium financings, bonds financing these privately used facilities typically may be structured to fail the private payment test. As discussed above, the ability to finance private activities with tax-exempt governmental bonds reduces the efficiency and equity of the Federal subsidy. In addition to transferring the benefit of the subsidy to private parties, tax-exempt financing for private activities increases the volume of tax-exempt bonds and, thus, increases the cost of financing essential governmental services. Although specified activities may be financed under the qualified private activity bond rules, Congress expressed its intent that tax-exempt bonds for private persons should be limited, to the extent possible, to activities for which financing specifically has been approved. Eliminating the private payment test for all bonds would limit the ability of State and local officials to divert governmental bond proceeds to private activities and improve the efficiency of the subsidy.

Conversely, the current two-part private business test provides State and local governments with flexibility to finance unspecified facilities if they make a determination to

subsidize the facilities with public payments. For example, State and local governments often utilize the skills of private businesses to assist in the provision of government services by entering into public-private partnerships. Public-private partnerships are entered either because the issuer does not customarily provide the services offered by the arrangement or the issuer can achieve cost savings through the use of a private provider. Moreover, a number of facilities are used simultaneously by both private parties and the public, which raises difficult questions as to the measurement of the private business use of such facilities. Under present law, public-private facilities that serve a legitimate governmental purpose can be structured to fail the private payment test, thus, eliminating the question whether the privately used portion of a facility would cause bonds to be taxable. Although many of these concerns could be addressed through private use allocation rules, existing rules would need to be reexamined, and possibly new rules adopted if a one-part private business test were implemented for all tax-exempt bonds. The current proposal is limited to professional sports facilities because it reflects Congressional intent to restrict the tax-exempt financing of such facilities, and because sports facilities have been identified as one type of facility primarily used by private businesses.

E. Require Allocation of Volume Cap to Mortgage Credit Certificates Based on Allocation of Volume Cap to Mortgage Bonds (secs. 25 and 143)

Present Law

In general

Under present law, gross income does not include interest on State or local bonds. State and local bonds are classified generally as either governmental bonds or private activity bonds. Governmental bonds are bonds the proceeds of which are primarily used to finance governmental functions or the debt is repaid with governmental funds. Private activity bonds are bonds in which the State or local government serves as a conduit providing financing to nongovernmental persons (e.g., private businesses or individuals). The exclusion from income for State and local bonds does not apply to private activity bonds, unless the bonds are issued for certain permitted purposes ("qualified private activity bonds").[799]

Qualified mortgage bonds

The definition of a qualified private activity bond includes a qualified mortgage bond.[800] Qualified mortgage bonds are issued to make mortgage loans to qualified mortgagors for the purchase, improvement or, rehabilitation of owner-occupied residences. Typically, these bonds are issued by State or local housing agencies that use the proceeds either to purchase or originate mortgage loans at below market rates. The debt service on qualified mortgage bonds and other administrative costs generally are repaid from mortgage payments from individuals who receive loans from the bond proceeds, investment income from bond proceeds, and fees that may be charged to program participants (i.e., lenders, developers, and mortgagors).

The Code imposes several limitations on qualified mortgage bonds which include income limitations for homebuyers, purchase price limitations for the home financed with bond proceeds, and a requirement that the homebuyer not have an ownership interest in a principal residence in the preceding three years (the "first time homebuyer" requirement). Generally 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 bonds 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 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

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[799] Secs. 103(b)(1) and 141.

[800] Sec. 143(a).

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 average area purchase price for targeted area residences.

Part or all of the interest subsidy provided by qualified mortgage bonds is recaptured if the borrower experiences substantial increases in income and disposes of the subsidized residence within nine years after purchase.

The Code also contains special arbitrage rules that permit issuers of qualified mortgage bonds to recover issuance and program costs. Generally, tax-exempt bond proceeds may not be invested in investments that exceed the bond yield by more than one-eighth of one percentage point (.125 percent). However, qualified mortgage bond proceeds may be invested in mortgages with an effective interest rate that does not exceed the bond yield by more than one and one-eighth percentage points (1.125 percent).

Volume cap for qualified mortgage bonds

The amount of qualified private activity bonds that can be issued annually by all authorized issuers in a State is limited by the State's ceiling. A State's ceiling is allocated among the authorized issuers within a State to determine the maximum amount of qualified private activity bonds that each authority is permitted to issue in a calendar year ("volume cap"). Most qualified private activity bonds, including qualified mortgage bonds, are subject to volume cap limitations. Most States have set up agencies or programs for allocating volume cap. If an issuing authority's volume cap for a calendar year exceeds the aggregate amount of tax-exempt private activity bonds issued during the year, the authority may elect to treat all (or any portion) of the excess as a carryforward for one or more carryforward purposes. The issuing authority is required to identify the purpose for which the carryforward is elected and specify the portion of the carryforward which is to be used for that purpose. The Code defines "carryforward purpose" to mean four different purposes, including issuing qualified mortgage bonds or mortgage credit certificates.[801] Carryforwards are valid for three years.

Mortgage credit certificates

Qualified governmental units can elect to exchange all or a portion of their qualified mortgage bond authority for authority to issue mortgage credit certificates ("MCCs").[802] MCCs entitle homebuyers to a nonrefundable income tax credit for a specified percentage of interest paid on mortgage loans on their principal residences. The tax credit provided by the MCC may be carried-forward for three years. Once issued, a MCC generally remains in effect as long as

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[801] Sec. 146(f)(5).

[802] Sec. 25(c)(2).

the residence being financed is the certificate-recipient's principal residence. MCCs generally are subject to the same eligibility and targeted area requirements as qualified mortgage bonds.

Each MCC is required to represent a credit for at least 10 percent (but not more than 50 percent) of interest paid or incurred during the taxable year on qualifying mortgage indebtedness. The actual dollar amount of an MCC depends on the amount of qualifying interest paid during any particular year and the applicable certificate credit percentage. If the credit percentage exceeds 20 percent, however, the dollar amount of the credit received by the taxpayer for any year may not exceed $2,000. The three-year carry-forward is not permitted for amounts in excess of the $2,000. The recapture rules for qualified mortgage bonds also apply to MCCs if the homeowner experiences substantial increases in income and disposes of the subsidized residence within nine years after purchase.[803]

When a homebuyer receives an MCC, the homebuyer's deduction for interest on the qualifying indebtedness is reduced by the amount of the credit. For example, a homebuyer receiving a 50-percent credit, and making $4,000 of qualifying mortgage interest payments in a given year, would receive a $2,000 credit and a deduction for the remaining $2,000 of interest payments.

The aggregate amount of MCCs distributed by an electing issuer cannot exceed 25 percent of the volume of qualified mortgage bond authority exchanged by the State or local government for authority to issue MCCs. For example, a State that was authorized to issue $200 million of qualified mortgage bonds, and that elected to exchange $100 million of that bond authority, could distribute an aggregate amount of MCCs equal to $25 million.

Reasons for Change

MCCs provide a more efficient and stable mechanism for delivering the tax subsidy to potential homebuyers than qualified mortgage bonds. Despite this, the program is not widely used. For example, in 2002, $4.6 billion of qualified mortgage bonds were issued, representing about 15 percent of States' private activity bond volume, compared to $356.2 million of MCCs, representing about one percent of 2002 private activity bond capacity.[804] The efficiencies that may be achieved through increased use of MCCs warrant requiring issuers to dedicate a portion of bond authority to the issuance of MCCs.

Description of Proposal

The proposal requires State and local issuing authorities to dedicate volume cap to the issuance of MCCs in an amount that would permit the issuance of one dollar of MCCs for every four dollars of qualified mortgage bonds issued. Issuers are still required to exchange bond authority for MCC authority at present law rates. To illustrate, the proposal requires an issuer that has received an allocation of volume cap to issue $200 million of qualified mortgage bonds

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[803] Sec. 25(i).

[804] See Susanna Duff Barnett, "Carryforward Cap Record: States Keep $18.4B of Private Activity Authority," *The Bond Buyer* (May 26, 2004), at 1.

to allocate $100 million of that bond authority to the issuance of $25 million of MCCs (based on the present-law rate of exchange). Therefore, under the proposal, the issuer is permitted to issue $100 million of qualified mortgage bonds and $25 million of MCCs.

The second element of the proposal is to raise the dollar limitation on the maximum annual credit that may be claimed when the MCC rate is greater than 20 percent from $2,000 to $3,000. This makes the MCC program more usable for homebuyers.

Effective Date

The proposal requiring issuers to dedicate a portion of volume cap to the issuance of MCCs based on the amount of volume cap allocated to qualified mortgage bonds is effective for allocations made after the first December 31st that is at least six months after the date of enactment.

The proposal to increase the maximum annual credit is effective for elections to issue MCCs made after the date of enactment.

Discussion

The primary purpose for the subsidy for qualified mortgage bonds, mortgage assistance to lower-income homebuyers, has not been efficiently and effectively achieved. Much of the benefit of the subsidy provided by qualified mortgage bonds accrues to the bondholders and pays the administrative costs of running the programs.

In 1984, Congress provided States and localities the alternative of distributing MCCs in lieu of issuing a specified amount of mortgage bonds. Congress indicated that the nature of tax-exempt financing makes it difficult to target the subsidy provided by qualified mortgage bonds to those most in need of housing assistance. This is because qualified mortgage bonds spread the subsidy between the homebuyer, bondholders, issuers, and other financial parties to the transaction.[805]

MCCs, in contrast, are allocated by State or local housing agencies and do not require access to debt or equity markets. Typically, homebuyers receive credits directly from State or local housing agencies after qualifying for a mortgage from a conventional lender. The holder of the MCC takes a tax credit for a specified percentage of home mortgage interest paid during the taxable year. In this way, MCCs direct the full subsidy to homebuyers. Thus, MCCs may provide State and local issuing authorities greater flexibility in targeting the subsidy to those individuals who are most in need. The MCC also provides a more uniform subsidy for all homeowners. For example, low-income homeowners are less likely to itemize deductions. Increased use of MCCs would also extend the subsidy to those homeowners who currently use the standard deduction and do not benefit from the mortgage interest deduction.

Despite the benefits MCCs can provide, the program generally is underutilized. Relatively small amounts of MCCs are issued compared to the volume of qualified mortgage

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[805] H.R. Rep. No. 98-432, at 360 (1983).

bonds that are issued for single-family housing. For example, MCC issuances in 2002 represented just one percent of States' private activity bond capacity, whereas qualified mortgage bond issuances represented about 15 percent of private activity bond capacity in that year. One reason for the disparity in volume is that issuers are required to exchange mortgage bond authority for the authority to issue MCCs. Issuers may be reluctant to forgo the opportunity to issue qualified mortgage bonds because they have the ability to defray the costs of issuing such bonds and administering mortgage programs through the arbitrage permitted under present law. There is no similar method for issuers to recover the costs of issuing MCCs and, thus, issuers bear the administrative costs of issuing MCCs in lieu of qualified mortgage bonds.

However, the costs associated with issuing MCCs are low compared to issuing qualified mortgage bonds. MCCs do not require access to the credit markets and provide a fairly simple alternative to the complex and expensive process (e.g., underwriter's costs and counsel fees) of issuing bonds. In addition, MCCs arguably provide a more stable delivery of the tax subsidy. The decision to issue qualified mortgage bonds is interest rate sensitive. Housing finance agencies typically are willing to issue qualified mortgage bonds when interest rates plus permitted arbitrage allow sufficient earnings to recover the costs of issuing the bonds and administering the mortgage program. In contrast, MCCs, lacking the arbitrage potential of qualified mortgage bonds, are less sensitive to interest rate changes and would provide a more predictable method for delivering the subsidy. The issuance history of some States demonstrates that MCCs provide a viable alternative to the issuance of qualified mortgage bonds, despite the lack of a mechanism for recovering costs. For example, California allocated nearly $700 million of qualified private activity bond authority to single-family housing programs in 2003 and nearly 38 percent of that was allocated to issuing MCCs.[806] In 2002, approximately 30 percent of the bond authority that California allocated to single-family programs was allocated to MCCs.[807] The experience in California suggests that MCCs are a workable alternative to qualified mortgage bonds.

Because MCCs can deliver the same amount of subsidy, if not more, to targeted individuals than qualified mortgage bonds (for example, issuers can adjust the credit rate on MCCs to provide more or less of a subsidy, depending on the targeted individuals), it is more efficient to require issuers to dedicate a portion of their bond authority to the issuance of MCCs in relation to the amount of authority allocated to qualified mortgage bonds. Increased use of MCCs will provide a more uniform subsidy for homebuyers and will reduce the spreading of the subsidy to other financial parties. Increased use of MCCs also will provide a more stable method for delivering the subsidy to homebuyers in interest rate environments where qualified mortgage bonds would not be economically viable.

To make MCCs more usable for homebuyers, the proposal also raises the dollar limitation on the maximum annual credit that may be claimed from $2,000 to $3,000. The

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[806] California Debt Limit Allocation Committee, *Estimated Public Benefits, Single-Family Housing Program Pool, Summary 2003.*

[807] California Debt Limit Allocation Committee, *Estimated Public Benefits, Single-Family Housing Program Pool, Summary 2002.*

$2,000 cap has not been raised since the MCC program was adopted in 1984. Since that time, housing prices have increased significantly and the Treasury recently revised the average area purchase price safe-harbors to reflect this increase.[808] Raising the dollar limitation will make it more likely for holders, even those purchasing homes in areas with lower average purchase prices, to receive something closer to the full amount of the credit when the credit rate exceeds 20 percent.

[808] Rev. Proc. 2004-18, 2004-9 I.R.B. 529.

F. Eliminate Advance Refunding of Governmental Bonds and 501(c)(3) Bonds (sec. 149(d))

Present Law

Section 103 generally provides that gross income does not include interest received on State or local bonds. State and local bonds are classified generally as either governmental bonds or private activity bonds. Governmental bonds are bonds the proceeds of which are primarily used to finance governmental facilities or the debt is repaid with governmental funds. Private activity bonds are bonds in which the State or local government serves as a conduit providing financing to nongovernmental persons (e.g., private businesses or individuals).[809] Bonds issued to finance the activities of charitable organizations described in section 501(c)(3) ("qualified 501(c)(3) bonds") are one type of private activity bond. The exclusion from income for interest on State and local bonds only applies if certain Code requirements are met.

A refunding bond is defined as any bond used to pay principal, interest, or redemption price on a prior bond issue (the refunded bond). The Code contains different rules for "current" as opposed to advance refunding bonds. A current refunding occurs when the refunded bond is redeemed within 90 days of issuance of the refunding bonds. Conversely, a bond is classified as an advance refunding if it is issued more than 90 days before the redemption of the refunded bond.[810] Proceeds of advance refunding bonds are generally invested in an escrow account and held until a future date when the refunded bond may be redeemed.

Although there is no statutory limitation on the number of times that tax-exempt bonds may be currently refunded, the Code limits advance refundings. Generally, governmental bonds and qualified 501(c)(3) bonds may be advance refunded one time.[811] Private activity bonds, other than qualified 501(c)(3) bonds, may not be advance refunded at all.[812] Furthermore, in the case of an advance refunding bond that results in interest savings (e.g., a high interest rate to low interest rate refunding), the refunded bond must be redeemed on the first call date 90 days after the issuance of the refunding bond that results in debt service savings (the "first call requirement").[813]

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[809] Sec. 141.

[810] Sec. 149(d)(5).

[811] Sec. 149(d)(3). Bonds issued before 1986 and pursuant to certain transition rules contained in the Tax Reform Act of 1986 may be advance refunded more than one time in certain cases.

[812] Sec. 149(d)(2).

[813] Sec. 149(d)(3)(A)(iii) and (B); Treas. Reg. sec. 1.149(d)-1(f)(3). A "call" provision provides the issuer of a bond with the right to redeem the bond prior to the stated maturity.

Reasons for Change

Advance refunding bonds represent an inefficient subsidy from the Federal government to State and local governments and section 501(c)(3) organizations because they result in two or more issues of tax-exempt bonds outstanding simultaneously for the financing of a single activity. For example, if tax-exempt bonds are issued to finance a building and a second issue of tax-exempt bonds is issued to advance refund the first bonds, the Federal government bears a revenue loss on both issues of bonds, resulting in a double subsidy for the same building.[814] Providing multiple subsidies for a single activity also increases the volume of outstanding tax-exempt bonds, thus increasing borrowing costs on other issuers of tax-exempt debt.

Description of Proposal

The proposal eliminates advance refundings of governmental bonds and 501(c)(3) bonds.

Effective Date

The proposal is effective for the advance refunding of bonds issued after the date of enactment. This would permit advance refunding of bonds outstanding on the date of enactment under present law limitations.

Discussion

Typically, the issuer of a tax-exempt bond uses an advance refunding (or current refunding) to take advantage of market interest rates that are lower than the interest rate prevailing when the refunded bond was issued. An advance refunding allows the issuer to lock-in lower interest expense during a period when the refunded bond cannot be redeemed prior to maturity.[815]

From the Federal government's perspective, the primary concern with advance refunding bonds is that it results in two or more issues of tax-exempt bonds outstanding with respect to a single facility (e.g., the construction of a city hall). Because the proceeds of advance refunding bonds are invested in an escrow account until the refunded debt may be redeemed, an "[a]dvance refunding results in multiple issues of bonds outstanding simultaneously and thereby results in multiple indirect Federal subsidies attributable to tax-exempt financing for a single activity."[816]

The ability to issue tax-exempt advance refunding bonds also subsidizes the call protection that issuers of State and local bonds typically provide. For example, some of the factors that impact the interest cost on a bond issue are the credit rating, the years to maturity,

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[814] This is unlike refinancing a home mortgage loan where the original loan is retired at the time of the refinancing.

[815] Either a current or advance refunding may also be used to remove covenants associated with a refunded bond.

[816] S. Rep. No. 99-313, at 828 (1986).

and the presence or absence of a call provision. An issuer's interest costs are generally lower when bonds are issued with call protection, which is a defined period that a bond cannot be redeemed. This is because an investor typically will accept a lower interest rate if that interest rate is guaranteed for the call protection period. Long-term fixed rate tax-exempt bonds are commonly issued with a "no call" period extending ten years from the date of issue. During that no-call period, it is not possible to do a current refunding and the ability to do an advance refunding on a tax-exempt basis may prove valuable to the issuer should interest rates decline. Taxpayers, however, bear the cost when call provisions provided by issuers result in longer periods in which two issues of tax-exempt bonds remain outstanding simultaneously.[817]

Congress eliminated advance refundings for most private activity bonds based on the rationale that they are inefficient and increase borrowing costs on other issuers of tax-exempt debt.[818] Present law permits one advance refunding of governmental bonds and qualified 501(c)(3) bonds. Elimination of the remaining category of tax-exempt advance refunding bonds will equalize the treatment for all tax-exempt bonds. The proposal also lessens the volume of outstanding tax-exempt bonds, thus, making the subsidy of tax-exemption generally more efficient.

State and local government finance officers have argued that advance refundings provide a valuable and frequently used financing tool for most municipal issuers. While it is true that issuers may achieve interest rate savings under the current rules, these interest rate savings are not without cost to the general taxpayer. The interest subsidy created through tax exemption costs the Federal government and other issuers when multiple sets of bond are outstanding for the same facility. As a result of the proposal, issuers also may allow themselves greater flexibility to currently refund bonds by reducing the length of call protection provided when bonds are originally issued.

The proposal is effective for the advance refunding of bonds issued after the date of enactment. Bonds that are currently outstanding are likely to have been structured with the expectation they could be advance refunded at a later date. Thus, the proposal allows issuers to advance refund bonds outstanding on the date of enactment under present law limitations.

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[817] See H.R. Rep. No. 99-426, at 518 ("The ability to advance refund certain types of bonds under present law encourages tax-exempt borrowers to agree to covenants and other terms that other borrowers would reject").

[818] H.R. Rep. No. 99-426, at 518 (1985).

X. EXCISE TAXES

A. Modify the Federal Excise Tax on Communications Services (secs. 4251-4254)

Present Law

In general

A three-percent Federal excise tax is imposed on amounts paid for communications services (sec. 4251). Communications services are defined as "local telephone service," "toll telephone service," and "teletypewriter exchange service."[819] 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 IRS, which then must attempt to collect the tax.[820]

Local telephone service is defined as 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 local system.[821]

Toll telephone service is defined as 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 a wide area telephone service, or "WATS") which, for a periodic charge (determined as a flat amount or upon the basis of total elapsed transmission time), entitles the subscriber to an unlimited number of telephone calls to or from an area outside the subscriber's local system area.

Special rules, enacted in 1997, apply to the sale of "prepaid telephone cards." These cards are subject to tax when a telecommunications carrier sells them to a non-

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[819] "Teletypewriter exchange service" refers to a data system that provides access from a teletypewriter or other data station to a teletypewriter exchange system and the privilege of intercommunication by that station with substantially all persons having teletypewriter or other data stations in the same exchange system. While it is understood that the system to which the definition was initially intended to apply is no longer in use, the definition may fit other services provided now or that may be provided in the future.

[820] In general, the amount of tax is based on the sum of charges for taxable services included in the bill. If the person who renders the bill groups individual items for purposes of rendering the bill and computing the tax, then the tax base with respect to each such group is the sum of all items within that group. The tax on any remaining items not included in any such group is based on the charge for each item separately.

[821] The access to substantially all persons having telephone stations constituting a part of the local system is sometimes referred to as access to the public switched telephone network.

telecommunications carrier (rather than when communication services are provided to the consumer). The base to which the tax is applied is the face amount of the card.

Exemptions

Present law provides for the following exemptions:

- Public coin-operated service from the tax on local telephone service, and to the extent that the charge is less than 25 cents, from the toll telephone service tax.[822]

- Service for the collection of news by the public press, news ticker, or radio broadcasting services (providing a news service as part of or similar to that of the public press), from the toll telephone service tax. (Local telephone service provided to the press is subject to tax.)

- Private communication service for which a separate charge is made, from the local telephone service tax.[823]

- Service provided to international organizations and the American National Red Cross.

- Toll telephone service provided to members of the Armed Services who are stationed in combat zones.

- Certain toll telephone service to common carriers (i.e., public transportation companies), telephone or telegraph companies, or radio broadcasting stations or networks in the conduct of these businesses.

- Installation charges (including wires, poles, switchboards, or other equipment).

- Telephone service provided to non-profit hospitals.

- Telephone service provided to State and local governments.

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[822] If coin-operated toll service is taxable, the tax is computed to the nearest multiple of five cents.

[823] Private communication service is defined as: (1) service that entitles the customer to exclusive or priority use of a communication channel or group of channels, or an intercommunication system for the customer's stations; (2) switching capacity, extension lines and stations, or other associated services provided in connection with services described in (1); and (3) channel mileage connecting a telephone outside a local service area with a central office in the local area.

Unlike the other exemptions, the special treatment for private communication service is accomplished by means of an exclusion from the definition of local telephone service rather than as a stated exemption.

- Telephone service provided to nonprofit educational organizations.
- Telephone service provided to the government of the United States.

Private communications services exclusion

The exclusion for private communications services was added by the Excise Tax Reduction Act of 1965 in order to equalize the tax treatment of internal local communications systems, such as a private branch exchange system, purchased by businesses, and similar services leased to businesses by telephone companies. Prior to 1965, leased systems were subject to tax if they could access a local telephone exchange, whereas purchased systems were not taxed. Equalization of treatment was achieved by exempting leased systems from tax. Equipment purchased by businesses for long distance internal communications is free of tax, just as local systems are.

Toll telephone service controversy

As stated above, toll telephone service is defined as 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 a wide area telephone service, or "WATS") which, for a periodic charge (determined as a flat amount or upon the basis of total elapsed transmission time), entitles the subscriber to an unlimited number of telephone calls to or from an area outside the subscriber's local system area.

In a series of recent cases, the IRS has had only limited success in sustaining the tax on toll telephone services where the charges for such services are assessed on an individual call basis and do not vary in amount with both elapsed transmission time and distance.[824] The conjunctive (time and distance) requirement of present law is not literally met by charges for toll telephone services that vary solely by elapsed transmission time. On August 9, 2004, the IRS issued Notice 2004-57 confirming that it "will continue to assess and collect the tax under section 4251 on all taxable communications services, including those communications services similar to those at issue in the cases."[825]

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[824] Compare *Reese Brothers, Inc. v. United States*, No. 03-745 (W.D. Pa. Nov. 30, 2004); *National Railroad Passenger Corp. v. United States*, 2004 U.S. Dist. LEXIS 18907 (D.D.C. Sept. 20, 2004); *Fortis, Inc. v. United States*, 2004 U.S. Dist. LEXIS 18686 (S.D.N.Y. Sept. 16, 2004); and *Office Max, Inc. v. United States*, 309 F. Supp. 984 (N.D. Ohio 2004), *appeal docketed,* No. 04-4009 (6th Cir. Aug. 19, 2004) *with American Bankers Insurance Group v. United States*, 308 F. Supp. 1360 (S.D. Fla. 2004) (reading "and" disjunctively as "or" in the definition of toll telephone service), *appeal docketed*, No. 04-10720-EE (11th Cir. February 12, 2004); and Rev. Rul. 79-404, 1979-2 C.B. 382 (finding that a service qualifies as toll telephone service even though the charge for calls between remote maritime stations and stations in the United States vary with elapsed transmission time only).

[825] Notice 2004-57, 2004-35 I.R.B. 376. The Notice also stated that persons (taxpayers) paying for taxable communications services are required to pay the tax to a collecting agent (i.e.,

Overview of history of the Federal communications excise tax

The first Federal excise tax on telephone service was enacted in 1898 to help finance the Spanish-American War. That tax was repealed in 1902 and was not re-enacted until World War I required additional revenues. The World War I telephone tax was repealed in 1924 and was re-enacted in 1932. All of these initial telephone taxes applied only to toll (long distance) service. In 1941, prior to the advent of World War II, the tax was extended to general local service.

A Federal excise tax on telephone service has been in effect in every year since 1941, despite enactment of periodic legislation to repeal or phase out the tax. In the Excise Tax Reduction Act of 1965, Congress scheduled a phase-out, beginning with a reduction in the then 10-percent rate[826] for both local and toll service to three percent after 1965. Additional reductions of one percentage point per year were scheduled thereafter until there would have been no tax effective on January 1, 1969. However, the scheduled reductions were repealed in 1966 (effective April 1, 1966), and the 10-percent rate was re-instated. A delayed phase-out schedule was enacted in 1968, to begin in 1970. This phase-out schedule also was postponed, with a one-percentage point per year phase-out finally going into effect on January 1, 1973.

In 1973, the tax rate declined from 10 percent to nine percent as the first step in this phase-out, which was to be completed beginning in 1982. However, the Omnibus Reconciliation Act of 1980 delayed the repeal by one year (until 1983); and the Economic Recovery Tax Act of 1981 further delayed repeal for two additional years. After reaching a rate of one percent, the rate was increased again to three percent in 1983, and after being extended at that rate several times, the three-percent rate was made permanent by the Revenue Reconciliation Act of 1990.

Reasons for Change

The present communications excise tax provisions were enacted before the development of most modern technology -- the growth of computers and new electronic means of communication. The proliferation of wireless communications technology and the Internet, and in particular broadband access, has blurred the lines between "data" and "voice" and between the functions of transmission and application.[827] Consequently, service providers have found it

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the service provider). Taxpayers were directed to preserve any claims for overpayment by filing administrative refund claims with the IRS. In addition, the Treasury Department recently issued final, temporary, and proposed regulations relating to the obligations of persons that receive payments for communications services (or air transportation) subject to excise tax when persons liable for tax refuse to pay. T.D. 9149, 2004-38 I.R.B. 494; REG-163909-02, 2004-38 I.R.B. 499.

[826] At their highest, the tax rates were 15 percent on general local service and 25 percent on toll service costing more than 24 cents per message. These rates were in effect from 1944 until 1954.

[827] The complications resulting from these developments became evident during the recent legislative debates relating to the regulation and State and local taxation of Voice Over Internet Protocol (VOIP) services. See, e.g., VOIP Regulatory Freedom Act of 2004, S. 2281,

increasingly difficult to determine which services are taxable communications services and which are nontaxable information services.[828]

The basis for the toll (long distance) telephone tax has not kept up in many instances with the many ways that long distance services are charged today. For example, long distance calling plans may be purchased now by paying a fixed monthly fee for a limited (or even an unlimited) number of minutes usable nationwide. In addition, both local and long distance telephone services may be bundled together or with nontaxable services, including data (e.g., text messaging, or wireless internet).

The exclusion for private communication services has also been overtaken by new technologies and marketing practices. It is possible for larger businesses to purchase telephone equipment (including private lines or microwave relays in some cases) and thereby significantly reduce their communications costs by reducing 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. In addition, private communications systems or services partially or wholly excluded from the telephone tax can be used to facilitate long distance services.[829]

Description of Proposal

In general

The proposal is presented below as three options. Option 3 represents a more fundamental change to the tax than Option 2, which in turn represents a more fundamental

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108th Cong., 2d Sess. (2004) (introduced April 5, 2004 with restriction on State and local taxation of VOIP applications; reported out of Committee on Commerce, Science, Transportation on November 19, 2004 without such restriction); Internet Tax Nondiscrimination Act, Pub. L. No. 108-435, amending Internet Tax Freedom Act, sec. 1108 (generally permitting taxation of voice services utilizing Internet protocol), codified as amended at 47 U.S.C. sec. 151 note (2004).

VOIP is the use of software, hardware, or network equipment for real-time two-way or multidirectional voice communications over the public Internet or a private network utilizing Internet protocol, or any successor protocol, in whole or in part, to connect users notwithstanding (i) the underlying transmission technology used to transmit the communications; (ii) whether the packetizing and depacketizing of the communications occurs at the customer premise or network level; or (iii) the software, hardware, or network equipment used to connect users. See VOIP Regulatory Freedom Act of 2004, H.R. 4129, 108th Cong., 2d Sess., sec. 10(a)(6) (2004).

[828] For example, AT&T has claimed that adding an advertisement heard by users when they dial the main number to make a call using prepaid calling cards transforms the cards from a communications service subject to certain regulatory fees to an exempt information service. See *Wall Street Journal*, January 7, 2005, at A3.

[829] See, e.g., Rev. Rul. 79-405, 1979-2 C.B. 383.

change than Option 1. Each of the options assumes that the current three-percent rate is applied to the relevant tax base.

Option 1: Modify the definitions of toll and local telephone services

Under this option, the communications excise tax is imposed upon both local and non-local (long distance) voice telephone services, regardless of whether the charges are fixed or vary with distance, elapsed transmission time, both, or some other criteria. Definitions are clarified to remove any distinction between the calculation of taxes on local and long distance telephone services, and to clarify that the tax is intended to apply to landline and wireless (including satellite) voice communications services.

Option 1 contemplates no additional changes to the communications excise tax provisions. No view is expressed regarding whether VOIP is a taxable communications service or a nontaxable information service.

Option 2: Modernize the excise tax on voice communications services

Option 2 incorporates the changes to the tax under Option 1 and makes further changes to the law. Under Option 2, a voice communications service is taxable regardless of its technical form. For example, the tax applies to voice communications services using landlines, analog and digital wireless, satellite and VOIP, or any combination. It is not necessary that the voice communications service provide the capability to access the public switched telephone network (required under present law) to be taxable.

In general, a service component is classified as a taxable communications service if the primary purpose of the service component is the transmission of real-time voice communications. The content of the communications or the capability for generating, acquiring storing, transforming, processing, retrieving, utilizing, or making information available via communications, is not a taxable communications service.[830] For example, a service in which a caller dials a "1-900" number for the purpose of receiving information is a nontaxable information service. However, the underlying telephone service provided to the information services provider by the communications provider is a taxable communications service.[831]

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[830] This distinction is generally consistent with 47 U.S.C. 153 (20), which defines an information service as "the offering of a capability for generating, acquiring storing, transforming, processing, retrieving, utilizing, or making information available via telecommunications." However, Options 2 and 3 do not expressly adopt the operative distinctions between telecommunications services and information services that may currently exist in the regulatory world. In addition, Options 2 and 3 of this proposal implicitly recognize that real-time voice communications may be transformed into data form to facilitate some or all of its physical transmission, and then reconstituted as voice. Such intermediate transformation should not affect the incidence of excise taxation, which is a tax upon the service received.

[831] This treatment is consistent with present law. See Rev. Rul. 89-84, 1989-1 C.B. 296. The telephone service that generally enables the caller generally to place the "1-900" call (as well as other calls) is also a taxable communications service.

To avoid controversy, certain service components are expressly classified as taxable communications services: enhanced voice service features, such as conference calling, three-way calling, call forwarding, caller ID and voice mail services, as well as other ancillary services taxable under present law.[832] Directory listings (whether "white pages" or "yellow pages"), however, are classified as information services.[833] Provision of a "regular" phone line or circuit that may be used for facsimile, for teletypewriter, or for connection to a "dial-up" Internet access provider is treated as a taxable communications service unless the line or circuit cannot be used for real-time voice communications. Provision of broadband (where the amount for such service is separately itemized from VOIP) or dial-up Internet access service (where not connected to the public switched telephone network) is not taxable.

The billing and bundling rules generally remain as under present law. However, to be excluded or exempted from the communications excise tax, a nontaxable service component must be separately stated on the customer's bill. The Treasury Department is granted the regulatory authority to determine if the communications component of a service is de minimis, if an offered service constitutes a service component, and if a service component is a communications service or an information service.[834]

Option 2 modifies certain present-law exemptions. Present-law exemptions for the press, common carriers (e.g., trucking companies), and radio broadcasting stations and networks are expanded to cover all communications excise taxes (rather than only taxes on toll telephone services).[835] Separately itemized service components provided by one communications provider to another communications provider are exempt from excise tax to the extent that the recipient uses such services to provide services to its customers. The exemption for public coin-operated service is modified such that such calls are exempted to the extent of the minimum amount charged by the coin-phone service for a local call. The rest of the exemptions (except for private communications services) are unchanged.

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[832] Voice mail services are generally classified as private communications services under present law. See Priv. Ltr. Rul. 9006014 (November 7, 1989). Such classification would not change under the proposal, to the extent such services are provided within the scope of the private communications services exemption, as modified under the proposal.

[833] White pages directory listings are classified as taxable local telephone services under present law. Yellow pages listings, however, are classified as nontaxable advertising. See Rev. Rul. 72-616, 1972-2 C.B. 575.

[834] For example, in the case of a private voice network bundled with a video game, the Treasury Department might determine that the access to the bundled private voice network is de minimis because access to a similar, but unbundled, private voice network is available at no charge.

[835] If Option 2 or 3 is enacted, it may be timely to revisit whether these and other exemptions are still warranted.

The private communication services exclusion is significantly modified. Under Option 2, the exclusion continues to apply as under present law, but is geographically limited to taxable communications either (a) within a Core Based Statistical Area,[836] or (b) within one building or between buildings located on a contiguous plot of land. Rules similar to the rules of the Mobile Communications Sourcing Act[837] are applicable to cross-border services.

Option 3: Expand the tax base to all voice and data communications

Option 3 incorporates the changes to the tax under Option 2 (including changes to the tax under Option 1) and makes further changes to the law. Under Option 3, the communications excise tax base is generally expanded to include all data communications services to end-users. The taxable base includes local and long distance voice services, VOIP, analog and digital cellular and satellite telephone services, cable and satellite television services (to the extent the charge is for communications), broadband and dial-up Internet access services, paging services, and other data communications services.

In general, a service component is classified as a communications service if the primary purpose of the service component is the transmission of communications, as contrasted with the content of the communications or the capability for generating, acquiring, storing, transforming, processing, retrieving, utilizing, or making information available via communications. The billing and bundling rules are similar to those of Option 2. For example, cable and satellite television is considered to consist of a taxable communications service component bundled with a nontaxable information (content) component.[838]

Unlike Option 2, communications capacity ("bandwidth") is taxable, whether provided, for example, as a service, as a lease, or as the sale of "lit" (activated) fiber optic cable or installed "dark" (inactivated) fiber.

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[836] A Core Based Statistical Area is a geographical area containing a recognized population nucleus and adjacent communities that have a high degree of integration with that nucleus. See Office of Management and Budget, *Standards for Defining Metropolitan and Micropolitan Statistical Areas*, 65 Fed. Reg. 82,228 (2000). Lists of these areas are published periodically by the Office of Management and Budget, based on information from the Census Bureau.

[837] Pub. L. No. 106-252 (2000) (codified at 4 U.S.C. secs. 116-126). This legislation generally relates to the methodology for allocating and apportioning mobile communications revenue for purposes of State and local taxation.

[838] The communications component of cable and satellite television consists of the portion of the "basic" service provided by the taxpayer attributable to the communications, i.e., the capability to access the provider's content. Enhanced features, such as pay-per-view and "premium" channels, are not taxable services, but are, instead, incremental information services.

Effective Date

Option 1 of the proposal is effective for services rendered after the date of enactment. Option 2 or 3 of the proposal is effective for services rendered on or after the first day of the first calendar quarter beginning 60 days after the date of enactment.

No inference is intended as to the treatment of any issues or controversies arising under present law.

Discussion

Overview

There is no compelling policy argument for imposing taxes on communications services. Indeed, in 1987 the Department of the Treasury recommended letting the tax expire.[839] Any excise tax distorts consumer decisions, and taxing new services and new technologies makes them more expensive, and, therefore, may slow their development.[840] The last significant revision of the tax occurred in 1965. Consequently, many of the rules are now so obsolete due to intervening developments in technology and marketing 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.[841]

On the other hand, the excise tax on communications services raises a significant amount of revenue. According to the IRS, the communications excise tax raised approximately $5.8 billion in 2003.[842] Assuming that the communications excise tax continues in force, however,

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[839] Office of Tax Analysis, U.S. Department of the Treasury, *Report to the Congress on Communication Services Not Subject to Federal Excise Tax* (1987). The specific mandate for the Report in section 8061 of Public Law 99-509, The Omnibus Budget Reconciliation Act of 1986, was to study the various exemptions of the communications excise tax, and to describe a method under which the tax could be extended to private communications services.

[840] Indeed, some have argued that the costs imposed on society by taxing telecommunications are quite large in terms of the distortion of choice. See, e.g., Jerry Hausman, "Taxation by Telecommunications Regulation," National Bureau of Economic Research, Working Paper No. 6260 (1997).

[841] The Joint Committee staff recommended repealing the tax in its 2001 Simplification Study. See 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), Vol. II at 504-506, April 2001. The primary reason for the recommendation was the obsolescence of the law due to technological changes. If the tax was not eliminated, the Study recommended updating the Code to reflect current technology and granting broad regulatory authority to the Treasury Department to allow it to continually update the tax base to reflect future technological changes.

[842] This was the total excise tax collected by, or reported to, the IRS in fiscal year 2003. See IRS, *Statistics of Income Bulletin* (Fall 2004), Vol. 24, No. 2, Table 21 at 345.

the policies of fairness and efficiency require that the tax apply as consistently as possible to similar services with as little administrative costs as possible.[843]

Option 1

This option involves making only limited changes to certain tax rules and is targeted to resolve a particular set of controversies that currently place the administration and collection of the communications tax on toll telephone service in substantial doubt. Option 1 will end the controversy regarding the dual requirements of elapsed transmission time and distance, and should eliminate other uncertainties regarding the application of the present-law definition of toll telephone services by more closely conforming such definition to the range of current industry billing practices. Option 1 does not address other current major issues, for example, issues relating to access to the local telephone system, private communications services, and the full or mixed use of new technologies such as VOIP. However, it might be possible to selectively address these or other discrete issues within the scope of an expanded Option 1, by adding selected features from Option 2.

Many of the arguments advanced by those who believe the tax should be repealed are also arguments against Option 1. Future controversies will almost certainly develop as technologies are developed and implemented and the market changes. Since these changes are occurring now, Option 1 is likely to be only a short-run measure.

Option 2

This option is based on the premise that the current communications tax on voice services can be adapted to the technology and the markets of the early 21st century. Option 2 attempts to resolve current controversies such as the time/distance controversy and the coverage of services provided through multiple technologies, including VOIP. In addition, the option recognizes that the broad exclusion for private communications services, the requirement of access to the local telephone system, and the application of certain exemptions solely to toll (long distance) services no longer operate efficiently and equitably in light of technical developments and the practical difficulties in distinguishing between local and long distance services.

At the same time, Option 2 does not tax data, Internet access, and bandwidth, and therefore does not "tax the Internet." In addition to the voice/data dichotomy, distinctions are drawn between communications services and information services. While such distinctions may generally parallel regulatory distinctions, they may not follow them in a particular case.

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[843] In recognition of the many changes in the communications services industry, on July 19, 2004, IRS and Treasury issued an Advanced Notice of Proposed Rulemaking, in which comments and suggestions were requested describing the various technologies, services and methods of transmission currently available for transmitting data and voice communications and how they should be treated under the communications excise tax rules. See Announcement 2004-61, 2004-29 I.R.B. 67. There is significant doubt, however, whether the IRS and Treasury have the statutory authority to resolve many of the issues currently arising under those rules.

Similarly, cross-border rules are adapted from the Federal law specifying the apportionment methodology for mobile communications for State and local consumption tax purposes.

Option 2 also recognizes that service providers may bundle their customer offerings in a variety of ways. Such bundling may be functional in nature, such as voice accompanied by and integrated with data, or the bundling may be in the nature of marketing or discounts (e.g., a nontaxable data service "thrown in for free" when taxable voice service is purchased). The Treasury Department is given the authority to make the necessary determinations regarding these very fact-specific issues.

Option 2 may not be a complete solution to the problems inherent in present law. It does not address technological changes and practices that may make certain nontaxable data services a close substitute for taxable voice services. It therefore tends to favor such data services over voice services, and therefore may inhibit the growth of taxable voice services relative to nontaxable data services. While this distinction also exists under present law, its impact may grow significantly in the future.

Option 3

This option is based on the premise that taxation of voice services and not data and internet services creates an economic distortion. Voice and data are becoming interchangeable and integrated parts of modern communications. For example, cellular phones send and receive text messages and may access the Internet as well as transmit and receive voice communications. Cellular phones are being manufactured that may operate using VOIP through "Wi-Fi"[844] access, as well as through more traditional means. As voice phone service migrates to using Internet protocol, there may be no way to distinguish "packets" of voice and "packets" of data. It is also expected that users will integrate their Internet data and voice applications. Consequently, both data and voice are taxable services under this option.

Extending the tax to all communications requires taxing Internet access, bandwidth capacity, and the transmission of cable and satellite television, as these are close substitute means for delivery of information and other content. This will make the distinction between communications services (including data) and information services increasingly important. While it may be relatively simple at this time for a cable company to apportion its revenue between the transport of information and the information itself, it may become more difficult as technology develops. In addition, the resale exemption is intended to prevent double taxation of the communications component of services.

While Option 3 will still leave distortions in the market between communications services and other goods and services, Option 3, unlike Option 2, should minimize or eliminate distortion in the markets for different communications services.

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[844] "Wi-Fi" is a wireless local area network product through which one may access the Internet, based on IEEE 802.11 specification.

B. Equalize Alcohol Excise Taxes (secs. 5001, 5041, and 5051)

Present Law

In general

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.

Distilled spirits

Distilled spirits[845] produced in or imported into the United States are taxed at the rate of $13.50 per proof gallon.[846] The Code defines a proof gallon as a United States gallon of proof spirits, or the alcoholic equivalent thereof. Generally, a proof gallon is a U.S. liquid gallon consisting of 50 percent alcohol.[847] Wines containing more than 24 percent alcohol by volume are taxed as distilled spirits.

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[845] The terms "distilled spirits," "alcohol spirits," and "spirits" mean that substance known as ethyl alcohol, ethanol, or spirits of wine in any form (including all dilutions and mixtures thereof from whatever source or by whatever process produced). Sec. 5002(a)(8).

[846] Sec. 5001(a).

[847] Specifically, a United States gallon of proof spirits is a liquid that contains one-half its volume of ethyl alcohol of a specific gravity of 0.7939 at 60 degrees Fahrenheit (referring to water at 60 degrees Fahrenheit as unity). For example, 80 proof vodka is 40 percent alcohol by volume.

Wine

Wine produced or imported into the United States is taxed at the following rates per wine gallon:

Wine (sec. 5041)[848]	
Still wines --	
No more than 14 percent alcohol	$1.07 per wine gallon
More than 14 percent but not more than 21 percent alcohol	$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

A "wine gallon" means a United States gallon of liquid measure equivalent to the volume of 231 cubic inches.[849] On lesser quantities, the tax is paid proportionately.

Beer

Beer brewed, produced, and removed for consumption or sale in the United States, or imported, is taxed at a rate of $18.00 per barrel (31 gallons).[850] The $18 per barrel rate equals

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[848] 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. For hard apple cider production, the amount of the credit is 5.6 cents per wine gallon. For example, the credit reduces the effective tax rate of $1.07 per wine gallon to $0.17 per wine gallon (the rate that applied before 1990 when the credit was enacted). The credit is phased out by one percent for each 1,000 gallons produced in excess of 150,000 gallons. The credit has been the subject of a challenge under the General Agreement on Trade and Tariffs ("GATT"). In addition, Industry Circular No. 2003-7 noted that certain persons were attempting to use "alternating proprietorships" to split the production of one large proprietor into several smaller businesses in order to take advantage of the credit. An alternating proprietorship is an arrangement where two or more persons take turns using the physical premises of a winemaking facility. Alcohol and Tobacco Tax and Trade Bureau, *Alternating Proprietors at Bonded Wine Premises*, Industry Circular 2003-7 (December 10, 2003).

[849] Sec. 5041(d).

approximately 58 cents per gallon. Generally, beer is a fermented beverage containing one-half of one percent or more of alcohol by volume, brewed or produced from malt, wholly or in part, or from any substitute therefor.

Credit for wine content and for flavors content

Present law includes a tax credit ("the section 5010 credit") that reduces the distilled spirits tax rate for the alcohol content of a final product that is derived from the alcohol in wine or a flavor added to the product. For example, 40 percent of the alcohol in a final distilled spirits product may be derived from a wine content and 60 percent from the original distilled spirits. Under section 5010, the wine portion would be taxed at $1.07 per wine gallon and the distilled spirits portion at $13.50 per proof gallon.

Reasons for Change

On a per ounce basis, distilled spirits are taxed at roughly 21 cents per ounce of alcohol, still wines at 8 cents per ounce of alcohol (assuming an average alcohol content of 12 percent), and beer at 10 cents per ounce of alcohol (assuming alcohol content of 4.5 percent). The differential rates for alcohol products influence production decisions, as producers try to take advantage of the lower wine and beer rates. This in turn has led to compliance problems involving the section 5010 credit, and controversy over the proper tax classification of certain beverages.

Description of Proposal

The proposal imposes a uniform tax based on the alcohol content contained in the product. The rate of tax is based on proof gallon. Because the rate of tax would not depend on the source of the alcohol, the section 5010 credit is eliminated. The proposal taxes all alcohol at $8.40 per proof gallon. It is estimated that this rate would produce a revenue neutral effect when compared with present law.

As under present law, domestic wineries having aggregate annual production not exceeding 250,000 gallons are entitled to a tax credit equal to 90 cents per gallon on the first 100,000 gallons of wine (other than champagne and other sparkling wines) removed in a calendar year. In a manner similar to present law, for domestic brewers producing less than two million barrels of beer during the calendar year, the proposal imposes a reduced rate of tax on the first 60,000 barrels of beer removed each year.

The tables below compare the rates under present law and the proposal by using proof gallons as the standard measure for all alcohol, and also by using present law standards of measurement (i.e. proof gallon, wine gallon, and barrel).

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[850] Sec. 5051. 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 two million barrels of beer during the calendar year. This reduced rate provision was the subject of a GATT challenge.

Per Proof Gallon Comparison

Alcohol Beverage	Present Law Equivalent Per Proof Gallon Rate	Proposed Rate
Beer (assuming 4.5-percent average alcohol content)	$6 per proof gallon	$8.40 per proof gallon
Wine (12-percent alcohol by content)	$4.46 per proof gallon	$8.40 per proof gallon
Wine (14-percent alcohol by content)	$5.41 per proof gallon	$8.40 per proof gallon
Champagne and other sparkling wines (assuming 12-percent alcohol by content)	$14.17 per proof gallon	$8.40 per proof gallon
Distilled Spirits	$13.50 per proof gallon	$8.40 per proof gallon

Per Present Law Standards of Measure

Alcohol Beverage	Present Law Statutory	Under the Proposal Comparable to Statutory Rate
Beer (assuming 4.5-percent average alcohol content)	$18 per beer barrel[851]	$23.44 per barrel
Wine (12-percent alcohol by content)	$1.07 per wine gallon	$2.02 per wine gallon
Wine (14-percent alcohol by content)	$1.57 per wine gallon	$2.44 per wine gallon
Champagne and other sparkling wines (assuming 12-percent alcohol by content)	$3.40 per wine gallon	$2.02 per wine gallon
Distilled Spirits	$13.50 per proof gallon	$8.40 per proof gallon

Effective Date

The proposal is effective on the first day of the first quarter beginning 60 days after the date of enactment.

[851] The present-law $7-per-barrel tax rate on the first 60,000 barrels of beer removed each year by domestic brewers producing less than two million barrels of beer during the calendar year is increased to $12.44 under the proposal. Thus, under the proposal, the rate applicable to small brewers is $11.00 per barrel lower than the standard rate, as under present law.

Discussion

Wine, beer, and distilled spirits are taxed because they contain alcohol. There is no tax policy reason for taxing alcoholic beverages differently based on whether it is a distilled spirit, wine, or beer.

Some may argue that the proposal unfairly penalizes beer and wine by substantially increasing the rate of tax on such products, while lowering the rates for distilled spirits. As a matter of chemical composition, alcohol remains alcohol regardless of whether it is produced through fermentation alone or fermentation followed by distillation. The difference in products results from the concentration of alcohol in the product rather than a difference in chemical composition. Further, if the rationale for the tax on alcohol, often referred to as a "sin" tax, is to recognize the costs to society associated with alcohol-related accidents and crimes, no alcoholic beverage should be thought of as deserving better treatment over other forms of alcohol.[852] However, the proposal does preserve the incentives for small producers. These incentives may be viewed as intended to encourage small businesses to enter the industry. On the other hand, as under present law, the rate differential may continue to encourage large producers to try to structure their businesses to qualify for rates for which they are ineligible.[853]

Present law's lack of neutrality as to alcohol type affects consumer choice and distorts production decisions. For example, there has been controversy over the proper classification of flavored malt beverages, in which the base of the beverage is made from fermented malts so as to obtain the tax rate applicable to beer, but as much as 95 percent of the alcohol content comes from a distilled spirit. The distilled spirit is used as a "flavor," and there is no requirement that the resulting product taste, or retain the characteristics of, a traditional beer although it is taxed like one.[854] In addition, the wine industry has developed "stripped down" and neutral wines that

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[852] See Congressional Budget Office, *Budget Options* (March 2003) at 231, noting that a study reported by the National Institute on Alcohol Abuse and Alcoholism estimated that the external economic costs of alcohol abuse exceeded $100 billion in 1998.

[853] As noted above, both the small producer credit for wine, and the reduced rate of tax for small brewers have been the subject of challenges under GATT.

[854] The Alcohol and Tobacco Tax and Trade Bureau ("TTB") released proposed regulations that would have taxed flavored malt beverages as spirits. See Alcohol and Tobacco Tax and Trade Bureau, Notice No. 4, 68 F.R. 14292 (March 24, 2003). To be classified as a beer, distilled spirit additives would be limited to one-half of one percent or less of the beverage content and the remaining 99.5 percent of the beverage content must come from the brewing process for the product to be classified as beer. The TTB proposal attracted significant attention. Over 15,000 comments were received by the TTB. On January 3, 2005, TTB issued a final rule. Alcohol and Tobacco Tax and Trade Bureau, TTB T.D.-21, *Flavored Malt Beverage and Related Regulatory Amendments*, 70 F.R. 193-237 (January 3, 2005). The final rule adopted a less stringent standard, allowing up to 49 percent of the alcohol content to come from flavors and nonbeverage ingredients for beers and malt beverages ("the 51/49 standard"). The final rule is effective January 3, 2006. TTB noted that it was important for it to act in order to protect both revenue and the consumer, and to prevent the unlimited use of alcohol derived from distilled

are produced only for purposes of blending with distilled spirits in order to obtain the section 5010 credit. For purposes of claiming the section 5010 credit, 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. 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 (which are not ordinarily used to produce wine) and that, in some cases, the wine is filtered to eliminate both color and flavoring. Thus, the resulting product does not resemble "wine" as typically consumed, but nonetheless is used to take advantage of the section 5010 credit.

Because all alcohol is taxed the same under the proposal, there would no longer be a need for the section 5010 credit. The GAO has noted that the section 5010 credit creates administrative problems, and that generally, Treasury's Alcohol and Tobacco Tax and Trade Bureau ("TTB") is unable to verify compliance with the requirements for this credit without extensive investigation.[855]

Present law allows wines to fall within specific ranges (for example, between 14 and 21 percent alcohol). The proposal requires a more precise measurement of the alcohol content in the wine. Because alcohol content may vary from batch to batch, the proposal may require more testing and effort on the part of wineries to correct the alcohol content of their wines. Brewers may make similar arguments. However, such testing already occurs, and therefore, additional testing, to the extent required, is not overly burdensome. Small brewers may not have the on-site equipment to accurately test the alcohol content of their beers, and such equipment may be expensive to acquire, but off-site testing facilities do exist for such purposes.

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spirits in the production of flavored malt beverages. Although the final TTB rule clarified the status of flavored malt beverages, by imposing uniform rates for all alcohol, the proposal should further eliminate a substantial number of disputes over whether or not a beverage falls into a specific tax category.

[855] General Accounting Office, GAO/GGD-90-123, *Alcohol Excise Taxes: Simplifying Rates Can Enhance Economic and Administrative Efficiency* (September 1990). The GAO report noted that laboratory tests cannot determine the source of the alcohol in a product, therefore, TTB is required to examine company records to determine exactly what ingredients were used to make a product. Inspecting records can be complex and time-consuming because the inspectors must trace the sources of all alcohol used in each beverage. The GAO also noted that inspectors do not have the authority to inspect distilled spirit plants in other countries, so TTB is unable to verify that wine or flavors have actually been added to imported products claiming the credit. *Id.* at 7-8.

C. Subject International Flights with Wholly Domestic Segments to the Segments Tax (secs. 4261 and 4262)

Present Law

Domestic air transportation

Most domestic air passenger transportation is subject to a two-part excise tax.[856] First, the Code imposes a tax at the rate of 7.5 percent of the amount paid for taxable transportation. Second, the Code imposes a flight segment tax of $3 (indexed annually for inflation) for each domestic segment of taxable transportation.[857] The segment tax is $3.20 per segment that begins during 2005.

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).

Taxable transportation is transportation that meets one of the following tests:

(1) It begins or ends in either the United States or at any place in Canada or Mexico not more than 225 miles from the nearest point on the continental United States boundary (the "225-mile zone"), or

(2) It is directly or indirectly from one port or station in the United States to another port or station in the United States, but only if it is not a part of uninterrupted international air transportation.

"Uninterrupted international air transportation" means transportation entirely by air that does not begin and end in the United States or in the 225-mile zone if there is not more than a 12-hour scheduled interval between arrival and departure at any station in the United States.[858] 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. Instead such flights are subject to the tax on international flights, discussed below.

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[856] Secs. 4261(a) and 4261(b).

[857] The flight segment component of the tax does not apply to segments to or from qualified "rural airports."

[858] Sec. 4262. Special rules apply for military personnel.

International air transportation

International flights are subject to a tax of $12.00 per arrival or departure in lieu of the taxes imposed on domestic air passenger transportation.[859] The tax rate is indexed for inflation annually, effective on each January 1. In 2005, the tax on international air transportation is $14.10 for each arrival and departure in the United States.[860] As noted above, international air transportation includes certain purely domestic transportation that is associated with an international journey ("uninterrupted international air transportation"). The international air transportation tax does not apply if all the transportation is subject to the 7.5 percent tax discussed above.

Reason for Change

Although an international flight may have wholly domestic segments, and utilize the same airport flight control resources as a purely domestic flight, such segments are exempt from the domestic segment tax.

Description of Proposal

The proposal imposes the segment tax on the domestic segments of an international flight. Under the proposal, transportation to a point outside the United States would not be subject to the segment tax from the last port or station in the United States. For example, a person purchasing a ticket in Washington, D.C. to fly to Paris via New York, would pay no segment tax on the part of the transportation from New York to Paris. The $3.20 segment tax would apply to the segment from Washington, D.C. to New York. The $14.10 international air transportation tax would continue to apply. Such flights would continue to be exempt from the 7.5-percent tax.

Effective Date

The proposal is effective for transportation beginning on or after the first day of the first quarter beginning 60 days after the date of enactment.

Discussion

Taxes on air transportation support the Federal Airport and Airway Trust Fund. Expenditures from the fund support the Federal Aviation Administration ("FAA"). Among other principal duties, the FAA regulates civil aviation and air traffic control. More than half of the agency's budget is devoted to expenditures for aviation safety.[861] Although an international

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[859] Sec. 4261(c).

[860] For a domestic segment that begins or ends in Alaska or Hawaii, a $7.00 tax applies only to departures. See Rev. Proc. 2004-71.

[861] The FAA estimated that 63 percent of the agency's budget in FY 2005 will be required to maintain and improve the agency's safety programs. Federal Aviation Administration, *Budget in Brief - Fiscal Year 2005* at 5. In FY 2004, the agency estimates it

flight with a purely domestic segment (Baltimore to Miami to Jamaica for example) requires the same FAA air traffic control resources as a solely domestic flight (Baltimore to Miami), the international flight is exempt from the domestic passenger taxes, paying only the international passenger tax. Calculating the 7.5 percent tax on a flight that is partially taxable and partially exempt adds complexity. However, the same cannot be said for the $3.20 segment tax, which is not based on the value of the ticket but is calculated based on takeoffs and landings within the United States.

Imposing the segment tax on international flights may be viewed as penalizing the carrier that makes stops within the United States as compared with one that offers nonstop international flights. However, by taking off and landing within the United States, the carrier making additional stops within the United States utilizes more FAA resources than a nonstop flight. In addition, there is inequity in that a passenger flying from Paris to New York to Washington D.C. pays no segment tax, while a passenger that boards the same plane in New York will pay a domestic segment tax on the same flight.

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spent slightly more than $6 billion on air traffic services. Federal Aviation Administration, *Administrator's Fact Book* (November 2004) at 33.

D. Modify the Federal Excise Tax on Sport Fishing Equipment (secs. 4161 and 4162)

Present Law

Under present law, an *ad valorem* excise tax is imposed on the sale by the manufacturer, producer, or importer of specified sport fishing equipment.[862] The general rate for this tax is 10 percent; the rate is reduced to three percent for electric outboard boat motors and fishing tackle boxes.[863] Taxable sport fishing equipment is defined as: fishing rods and poles (and component parts therefor); fishing reels; fly fishing lines; other fishing lines not over 130 pounds test; fishing spears; spear guns; spear tips; tackle items (including leaders, artificial lures, artificial baits, artificial flies, fishing hooks, bobbers, sinkers, snaps, drayles, and swivels); fish stringers; creels; bags, baskets, and other containers designed to hold fish; portable bait containers; fishing vests; landing nets; gaff hooks; fishing hook disgorgers; dressing for fishing lines and artificial flies; fishing tip-ups and tilts; fishing rod belts; fishing rodholders; fishing harnesses; fish fighting chairs; fishing outriggers; fishing downriggers; and electric outboard boat motors.[864] Parts or accessories that are sold on or in connection with taxable articles are also treated as taxable.[865]

Revenues from the excise tax on sport fishing equipment are deposited in the Sport Fish Restoration Account (the "Account") of the Aquatic Resources Trust Fund (the "Fund"). Monies in the Account are spent, subject to an existing permanent appropriation, to support Federal-State sport fish enhancement and restoration and coastal wetlands protection and restoration programs.[866]

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[862] Sec. 4161(a)(1).

[863] Sec. 4161(a)(2) and (a)(3). Prior to the enactment of section 333 of the American Jobs Creation Act of 2004 ("AJCA"), Pub. L. No. 108-357, a 10-percent rate applied to fishing tackle boxes.

[864] Sec. 4162(a).

[865] Sec. 4161(a)(4).

[866] In addition to the excise taxes on sport fishing equipment, certain other amounts are credited to or deposited in the Account. These amounts are: import duties imposed on fishing tackle, yachts and pleasure craft under the Harmonized Tariff Schedule of the United States; excise taxes on gasoline used as a fuel in the nonbusiness use of small-engine outdoor power equipment, to the extent that such taxes are deposited into the Highway Trust Fund (under present law, 13.5 cents per gallon of the total 18.3 cents per gallon gasoline excise taxes collected with respect to such use are deposited into the Highway Trust Fund); excise taxes on gasoline and special motor fuels used as fuel in motorboats, to the extent that such taxes are deposited into the Highway Trust Fund (under present law, 13.5 cents per gallon of the total 18.3 cents per gallon gasoline and special motor fuel excise taxes collected with respect to such use are deposited into the Highway Trust Fund), and are not paid from the Highway Trust Fund into

Reasons for Change

The excise tax on sport fishing equipment is complex and creates administrative burdens for both taxpayers and the IRS. In part, this is due to the large number of items subject to the tax. In addition, many of the items subject to the tax have close nontaxable substitutes, leading to highly factual determinations as to whether a particular item is or is not subject to the tax and to disputes between taxpayers and the IRS. The existence of close nontaxable substitutes also leads to erosion of the tax base as taxpayers shift from taxable items to nontaxable items and to competitive problems for manufacturers of items with close nontaxable substitutes. Narrowing the tax base with an accompanying increase in the tax rate should improve tax administration and compliance, provide more stable funding for the Account and Fund, and reduce competitive problems.

Description of Proposal

Under the proposal, the excise tax on sport fishing equipment is imposed only on fishing rods, poles, and reels. As under present law, parts or accessories that are sold on or in connection with taxable articles are also treated as taxable. To maintain the current level of revenue generated by the tax, the rate of tax imposed on taxable articles is adjusted to 21 percent.

Effective Date

The proposal is effective for articles sold by the manufacturer, producer, or importer on or after the first day of the first calendar quarter beginning 60 days after the date of enactment.

Discussion

The underlying policy of the sport fishing equipment excise tax is to link the tax burden with beneficiaries of specific Federal programs. Thus, under present law, the funding mechanism for sport fishing-related purposes follows this "benefit principle" by imposing tax on equipment used by fishermen, directing relevant tax collections to the Account, and authorizing relevant expenditures from the Account for sport fishing purposes.

Present law takes a relatively broad view of which items should be burdened with generating relevant tax collections. However, issues have arisen with several items included in the tax base. For example, the AJCA reduced the tax burden on fishing tackle boxes and eliminated the tax on sonar devices used to find fish in order to reduce disparities where similar products were taxed differently. The rationale for lowering the rate of excise tax on tackle boxes to three percent under the Act was that nontaxable tool boxes may be used in lieu of taxable tackle boxes.[867] The rationale for removing sonar fish finders from the list of taxable sport fishing equipment was that most types of these devices were already exempt from tax, while

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the Boat Safety Account of the Fund; and interest on investments made with Account funds. See secs. 9503(c)(4) and (5); 9504(a)(2) and (b); and 9602(b).

[867] AJCA, sec. 333, effective for articles sold by the manufacturer, producer, or importer after December 31, 2004. See H.R. Rep. No. 108-548, at 171 (2004).

others were taxed, depending on their technology.[868] Competitiveness and fairness issues have also been raised regarding other taxable sport fishing equipment items or components with close nontaxable substitutes or with alternative nontaxable uses. For example, a bait bucket, a taxable item, may contain a small marine life aeration system that is not taxable when sold separately as a fish tank aerator.[869]

Present law's attempt to tax nearly all identifiable items of fishing equipment leads to unnecessary administrative complexity for taxpayers and for the Government. Enforcement of taxes on numerous items requires a significant amount of Government resources for relatively small amounts of revenue. Requiring taxpayers and the IRS to make highly factual determinations as to which similar-use items are subject to the excise tax and which are not adds unwarranted complexity and controversy to the tax system.[870] In addition, some have raised concerns that further attempts to equalize treatment of similar-use items through piecemeal tax exemption or reduced tax rates could negatively impact the stability of funding for the Account and the Fund.

To simplify the tax on sport fishing equipment, the proposal limits taxable items to fishing rods, poles, and reels. Fishing rods, poles, and reels are used by almost all persons engaged in sport fishing and such equipment does not have alternative uses or close substitutes. In addition, taxes on these items currently comprise between 45 and 50 percent of the total collected excise taxes on sport fishing equipment. To maintain revenue and the Account at current levels, the proposal increases the tax rate on these items. By adopting a tax base for items for which there are not close substitutes, the proposal may more closely match the burdens of the tax with the benefits of the use of funds in the Account. Tax administration and compliance should be improved by narrowing the tax base to a limited number of equipment types. Narrowing the tax base with an accompanying increase in the tax rate should also provide more stable funding for the Account and the Fund and minimize opportunities for future controversies and base erosion.

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[868] AJCA, sec. 334, effective for articles sold by the manufacturer, producer, or importer after December 31, 2004. See H.R. Rep. No. 108-548, at 171-172 (2004). Fish finders may also be used as navigational aids, and some devices used primarily as navigational aids may also be used to find fish.

[869] The Internal Revenue Service has ruled that aeration systems designed to keep fish and marine life alive are taxable parts or accessories when sold on or in connection with portable bait containers. See Tech. Adv. Mem. 200022011 (February 23, 2000). Fish tank aerators, however, are not taxable. Rev. Rul. 85-150, 1985-2 C.B. 260.

[870] The Joint Committee staff cited the tackle box issue as an example of the complexity of the sport fishing excise tax, and has previously recommended the elimination of the sport fishing equipment excise tax. See 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), Vol. II, at 499-500, April 2001. This proposal assumes that Congress wants to maintain the current funding level under a benefit principle.

Many of the other items that are taxed under present law, and that would be exempt under the proposal, are not used as widely by all sport fishermen and their use may tend to increase with the income of the fishermen. As a result, some may argue that the proposal requires lower income sport fishermen to bear the burden of a larger share of the overall tax on fishing equipment than they do under present law. However, the tax under the proposal remains a proportional tax, with purchasers of more expensive rods, poles, and reels paying more tax than purchasers of less expensive equipment.

XI. ESTATE AND GIFT TAXATION

A. Limit Perpetual Dynasty Trusts (secs. 2631 and 2632)

Present Law

In general, present law imposes transfer taxes that are designed to tax transfers once each generation. These taxes are in the form of a gift tax for lifetime transfers, an estate tax for death time transfers, and a generation skipping transfer tax for transfers to persons more than one generation younger than the transferor. A generation skipping tax is imposed on all transfers, whether directly or indirectly, to "skip persons." A skip person includes a person who is two or more generations below the generation of the transferor or a trust, if all the interests are held by skip persons. The transferor generally is the individual who transfers property in a transaction that is subject to Federal estate or gift tax. Transfers that are subject to the generation skipping tax are direct skips (e.g., a transfer from a grandparent to a grandchild), taxable distributions (e.g., a distribution of income or corpus to a grandchild from a trust created by a grandparent), and taxable terminations (e.g., the death of a grandchild who was a beneficiary of a trust created by a grandparent).

Present law provides for a lifetime per-transferor exemption from the generation skipping transfer tax.[871] The amount of the generation skipping transfer tax exemption is $1,500,000 for generation skipping transfers made in 2005, $2,000,000 for generation skipping transfers made in 2006, 2007, or 2008, and $3,500,000 for generation skipping transfers made in 2009. In the case of a generation skipping trust, the exemption applies to distributions from, or terminations of interests in, that fraction of the trust that the portion of the exemption that is allocated to the trust bears to the value of trust's assets at its creation. Thus, if a generation skipping trust is created with $1.5 million and $1.5 million of the creator's generation skipping transfer tax exemption is allocated to that trust, no generation skipping transfer tax ever is imposed on any distributions from, or termination of interests in, that trust regardless of the number of generations of the trust's beneficiaries that are skipped.

Many States limit the length of time that assets can be held in trust for the benefit of beneficiaries who were not alive at the time of the creation of the trust. This limitation is

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[871] Every transferor is entitled to a generation skipping tax exemption that may be allocated to transfers made by the transferor either during the transferor's life or at death. The amount of the generation skipping transfer tax on a transfer technically is determined by multiplying the amount transferred by the applicable rate. The applicable rate is the maximum Federal estate tax rate multiplied by the inclusion ratio. The inclusion ratio is defined in turn as one minus the applicable fraction. The applicable fraction is a fraction the numerator of which is the generation skipping transfer exemption allocated to the trust (or the property transferred in a direct skip) and the denominator of which is the value of the property transferred to the trust (or involved in the direct skip) reduced by Federal or State estate and death taxes actually recovered from the trust (or transferred property) and any charitable deduction allowed for Federal estate and gift tax on the transfer.

generally referred to as the rule against perpetuities. The rule against perpetuities was a judicially created rule of English common law. In many cases, States adopted the rule against perpetuities when they adopted British common law as their basic law. The rule has been criticized as being inconsistent with the present capital market system, and because of its complexity and resulting uncertainty of application. In order to alleviate this uncertainty, some States have adopted the Uniform Statutory Rule Against Perpetuities. Under that uniform statute, "trust settlors may elect to create either a trust measured by lives in being at the creation of the trust plus 21 years or trust measured by ninety-years." [872] Other States have either repealed the rule against perpetuities, or provided an ability to opt out of the rule. In a State without a mandatory rule against perpetuities, it is possible to transfer assets to a trust created in that State, to which the transferor's generation skipping tax exemption has been allocated. The trust assets may grow for a potentially unlimited period of time without being subject to any transfer tax. Because of their potential long life and potential for substantial accumulation, such trusts generally are called "perpetual dynasty trusts."

Reasons for Change

Perpetual dynasty trusts are inconsistent with the uniform structure of the estate and gift taxes to impose a transfer tax once every generation. In addition, perpetual dynasty trusts deny equal treatment of all taxpayers because such trusts can only be established in the States that have repealed the mandatory rule against perpetuities.

Description of Proposal

The proposal prohibits the allocation of the generation skipping tax exemption to a "perpetual dynasty trust," except to the extent that the trust provides for distributions to beneficiaries in the generations of the transferor's children or grandchildren. Under the proposal, the generation-skipping tax exemption effectively is limited to an exemption of a skip of one generation. A "perpetual dynasty trust" is defined as a trust whose situs (place of creation) is a State that either (1) has repealed the rule against perpetuities, (2) allows the creator of a trust to elect to be exempt from the rule against perpetuities and the creator so elects, or (3) has modified its rule against perpetuities to permit creation of interests for individuals more than three generations younger than the interest's creator. If the situs of a trust is moved from a State that has retained the rule against perpetuities to a State that has repealed the rule against perpetuities, the inclusion ratio thereafter will be changed to one.

Effective Date

The proposal is effective for transfers made after the date of enactment.

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[872] Jesse Dukeminier, "The Uniform Statutory Rule Against Perpetuities and the GST Tax: New Perils for Practitioners and New Opportunities," *Real Property Probate & Trust Journal*, 30 (1995) at 185.

Discussion

As Congress stated both when it originally imposed a tax on generation skipping transfers in 1976 and again when it revised the generation skipping tax in 1986, the purpose of imposing gift, estate and generation skipping tax was "not only to raise revenue, but to do so in a manner that has as nearly as possible a uniform effect."[873] Similarly, the Congress stated that it "believed that the tax law should basically be neutral and that there should be no tax advantage available in setting up trusts."[874] The imposition of a generation skipping tax was believed necessary to achieve the uniformity of imposing a transfer tax once every generation. A $1 million exemption from the generation skipping tax originally was provided when the generation skipping tax was revised in 1986. The size of the generation-skipping transfer tax exemption was increased beginning in 2002 to be equal to the amount of effective exemption for estate and gift taxes. Thus, the exemption from the generation skipping transfer tax is scheduled to increase to $3.5 million by 2009. When Congress originally enacted a tax on generation skipping transfers, it noted that "[m]ost States have a rule against perpetuities which limits the duration of a trust."[875]

Since that time, a number of States have either repealed the rule against perpetuities or provided an ability to opt out of such limitations. Thus, it is possible to transfer a relatively large initial amount of assets to a trust created in such States and to which the transferor's entire generation skipping tax exemption has been allocated. Potentially unlimited growth in the trust assets may occur, while the assets are not subject to any transfer tax even though the trust's beneficiaries have changed many generations. These "perpetual dynasty trusts" can be used to frustrate the uniform application of transfer tax that was envisioned when the generation skipping tax was enacted. This lack of uniformity is compounded by the fact that perpetual dynasty trusts can be created only in the limited number of States that have repealed or modified the rule against perpetuities.

The proposal would result in greater uniformity by limiting exemption from the generation skipping transfer tax for perpetual dynasty trusts. The proposal is consistent both with the purpose of enacting a generation skipping transfer tax, and with the operation of the present transfer tax system, which generally imposes a tax once every generation by limiting the amount of assets that can be placed beyond the present-law transfer taxes. The proposal also is consistent with the generation skipping tax exemption, in that it permits an exemption from the generation skipping transfer tax for transfers to the transferor's grandchildren. The proposal avoids the possible constitutional limitations of alternative proposals to limit the transfer tax advantage of perpetual dynasty trusts (e.g., impose an *ad valorem* tax every set number of years on perpetual dynasty trusts). In addition, the proposal is consistent with the purposes of the rule

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[873] Joint Committee on Taxation, *General Explanation of the Tax Reform Act of 1986* (JCS-10-87), May 4, 1987, at 1263.

[874] Joint Committee on Taxation, *General Explanation of the Tax Reform Act of 1976* (JCS-33-76), December 29, 1976, at 565.

[875] *Id.*

against perpetuities to prevent perpetuation of wealth disparities, promote alienability of property, and make property productive.[876] The proposal does not prevent an individual from creating a trust in a State that has repealed the rule against perpetuities. Thus, the proposal does not prevent the creation of a trust in a State if that State otherwise would be the best State in which to create a trust. The proposal does, however, eliminate a Federal transfer tax advantage for creating a trust in a State that has repealed the rule against perpetuities.

[876] Brian Layman, "Comment: Perpetual Dynasty Trusts: One of the Most Powerful Tools in the Estate Planner's Arsenal," *Akron Law Review*, 32 (1999), at 747.

B. Determine Certain Valuation Discounts More Accurately for Federal Estate and Gift Tax Purposes (secs. 2031, 2512, and 2624)

Present Law

In general

The value of property subject to transfer taxes is the fair market value of the property being transferred on the date of transfer.[877] The fair market value is 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 to sell and both having reasonable knowledge of relevant facts.[878]

If actual sales prices and bona fide bid and asked prices are lacking, the fair market value of stock in a closely held business is determined by looking to various factors including: the company's net worth; its prospective earning power and dividend-paying capacity; the goodwill of the business; the economic outlook in the nation and in the particular industry; the company's position in the industry and its management; the degree of control of the business represented by the block of stock to be valued; and the values of securities of corporations engaged in the same or similar lines of businesses.[879]

Discounts

In general

Courts and the IRS have recognized that for various reasons interests in an entity (shares in a corporation or interests in a partnership, for instance) may be worth less than the owner's proportionate share of the value of the entity's assets. For example, the value of a 50-percent shareholder's stock might differ from the value of 50 percent of the assets owned by the corporation in which the stock is held. Some (but not all) of the valuation discounts used under present law are discussed below.[880] In many cases courts apply more than one discount. The

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[877] Secs. 2031 (estate tax), 2512 (gift tax), and 2624 (generation-skipping transfer tax). Fair market value is determined on the date of the gift in the case of the gift tax or on the date of the decedent's death (or on the alternative valuation date if the executor so elects) in the case of the estate tax.

[878] Treas. Reg. secs. 20.2031-1(b) and 25.2512-1.

[879] Treas. Reg. secs. 20.2031-2(f)(2) and 25.2512-2(f)(2); Rev. Rul. 59-60, 1959-1 C.B. 237.

[880] Other valuation discounts that courts have recognized include a blockage discount (if the sale of a block of assets, such as 80 percent of the stock of a public company, would depress the market for that asset); a key man (thin management) discount (if the value of a business declines due to the loss of a key manager); and a capital gain (or *General Utilities)* discount (to reflect the tax on gain from the eventual sale of assets acquired by gift or held by a corporation).

theories of some discounts overlap, and court decisions sometimes blur the distinctions between those discounts.

Minority (or lack of control) discount

Numerous courts and the IRS have recognized that shares of stock or other ownership interests in a closely-held business entity that represent a minority interest are usually worth less than a proportionate share of the value of the assets of the entity.[881] Minority discounts arise from a division of control because the holder of a minority interest cannot control the ongoing direction of the business entity, the timing and amount of income distributed by the entity to its owners, or the liquidation of its assets. Minority discounts often result in reductions in the value of transferred property from 15 percent to 40 percent.[882]

Marketability (or illiquidity) discount

Recognizing that closely held stock and partnership interests often are less attractive to investors and have fewer potential purchasers than publicly traded stock, courts and the IRS grant discounts to reflect the illiquidity of such interests. Courts sometimes combine marketability and minority discounts into a single discount,[883] but the discounts reflect different concerns. Whereas the minority discount compensates for lack of control over an interest, the marketability discount compensates for the limitations upon free exit inherent in interests for which no public market exists. The marketability discount may be appropriate whether valuing a controlling or a minority ownership interest.[884] Generally, the size of the marketability discount is reduced as the donor's or decedent's control of the corporation or partnership increases. However, the discount has been applied to a 100-percent ownership interest in a closely-held

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[881] See Rev. Rul. 93-12, 1993-2 C.B. 202; *Propstra v. United States,* 680 F.2d 1248 (9th Cir. 1982); *Ward v. Commissioner,* 87 T.C. 78 (1986); *Estate of Leyman v. Commissioner,* 40 T.C. 100 (1963). More recently, a minority discount was allowed even where the total shares owned by related persons constituted a majority interest. For example, in *Estate of Bright v. United States*, 658 F.2d 999 (5th Cir. 1981), the court upheld a minority discount on stock transferred to a trust even though the other principal shareholder of the corporation was trustee of the trust and father of its beneficiary.

[882] See David T. Lewis and Andrea Chomakos, *The Family Limited Partnership Deskbook: Forming and Funding FLPs and Other Closely Held Business Entities* (ABA Publishing 2004) at 11.

[883] E.g., *Central Trust Co. v. United States,* 305 F.2d 393 (Ct. Cl. 1962); *Estate of Titus v. Commissioner,* T.C. Memo 1989-466.

[884] Controlling shares in a nonpublic corporation, which do not qualify for a minority discount, may nonetheless receive a marketability discount because there is no ready private placement market and because transaction costs would be incurred if the corporation were to publicly offer its stock.

corporation.[885] Marketability discounts often result in reductions in the value of transferred property of 20 to 30 percent[886] in addition to any applicable minority discount.[887] Marketability discounts often are created by placing assets in a limited partnership. Marketability discounts created through the use of a limited partnership permit the donee or legatee to recreate value by liquidating the partnership or having a partner's interest redeemed by the partnership.

Fragmentation (or fractional interest) discount

Fragmentation discounts are similar to minority discounts. This discount arises from the lack of control inherent in joint ownership of an asset (e.g., a gift of an undivided fractional interest in real estate).[888] Fragmentation discounts often result in reductions in the value of transferred property of 15 to 60 percent.[889]

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[885] See, e.g., *Estate of Bennett v. Commissioner*, T.C. Memo 1993-34, in which the Tax Court concluded that in determining the discount, the corporate form could not be ignored. ("Here, we have a real estate management company whose assets are varied and nonliquid. We think that the corporate form is a quite important consideration here: there is definitely a difference in owning the assets and liabilities of Fairlawn directly and in owning the stock of Fairlawn, albeit 100 percent of the stock. We think some discounting is necessary to find a buyer willing to buy Fairlawn's package of desirable and less desirable properties.").

[886] There is no established formula to compute the size of a discount. One measure of the size of a discount, applicable when valuing a controlling interest, is the total cost of registering securities with the Securities and Exchange Commission, i.e., converting nonliquid securities into liquid ones. Other factors considered are the size of any costs and the amounts realizable on a private placement or secondary offering, the opportunity cost of losing access to the invested funds, and the discounts applied in comparable transactions involving sales of comparable closely held businesses.

[887] The United States Tax Court has noted that the application of a minority discount and a marketability discount is multiplicative rather than additive. According to the Court, the minority discount should be applied first and then the marketability discount should be applied to that figure. For example, a 20-percent minority discount and a 40-percent marketability discount should result in a 52-percent discount (20 percent + (40 percent x 80 percent)), not a 60-percent discount. See *Estate of Bailey v. Commissioner*, T.C. Memo 2002-152.

[888] Because the holder of a fractional interest in real property has the power to compel partition (a remedy not available to minority holders of other interests), the discount should reflect the cost of partition and the value of the interest secured thereby. See Boris I. Bittker & Lawrence Lokken, *Federal Income Taxation of Estates, Gifts, and Trusts*, para. 135.3.4 (2d ed. 1993). Courts, however, often apply a minority discount instead. See, e.g., *LeFrak v. Commissioner*, T.C. Memo 1993-526.

[889] See, e.g., *Estate of Van Loben Sels v. Commissioner*, T.C. Memo 1986-501.

Investment company discount

The investment company discount arises because the market values of closed-end mutual funds and investment companies often are less than the net asset values of those funds and companies. These discounts can be as high as 50 percent and may overlap with the marketability discount.[890]

Reasons for Change

Under present law, valuation discounts can significantly reduce the estate and gift tax values of transferred property. Minority and marketability discounts in particular often create substantial reductions in value. In some cases these reductions in value for estate and gift tax purposes do not accurately reflect value. For example, a taxpayer may make gifts to a child of minority interests in property and claim lack-of-control discounts under the gift tax even though the taxpayer or the taxpayer's child controls the property being transferred. A taxpayer also may contribute marketable property such as publicly-traded stock to a partnership (such as a family limited partnership) or other entity that he or she controls and, when interests in that entity are transferred through the estate, claim marketability discounts even though the heirs may be able to liquidate the entity and recover the full value by accessing the underlying assets directly.

Description of Proposal

In general

The proposal provides rules for determining the value of property for Federal transfer tax purposes. These rules limit the availability of minority and marketability discounts. In certain situations the proposal also may have an effect on other discounts such as the investment company discount and the fragmentation discount. The property interests to which the proposal applies include shares of stock of a corporation, interests in a partnership or limited liability company, and other similar interests in a business or investment entity or in an asset. The proposal has two parts, aggregation rules and a look-through rule. Under the proposal, step transaction principles are used to determine whether two or more transfers are treated as a single transfer. Moreover, any interest in an asset owned by the spouse of a transferor or transferee is considered as owned by the transferor or transferee.

The aggregation and look-through rules described below generally apply to all gifts made during life without consideration, transfers at death, generation-skipping events, and any transfer of an asset by gift for an amount of consideration less than the value determined under those rules. The rules described below are not intended, however, to change the principles of present law concerning whether transfers made in the ordinary course of business are, or are not, treated as gifts.[891]

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[890] For example, the Tax Court in *Estate of Folks v. Commissioner*, T.C. Memo 1982-43, granted the taxpayer a 50-percent investment company discount and then applied to the resulting value a 50-percent marketability discount, resulting in a total discount of 75 percent.

[891] See, e.g., *Estate of Anderson v. Commissioner*, 8 T.C. 706 (1947), acq. 1947-2 C.B. 1.

Aggregation rules

Basic aggregation rule

Under the proposal, the value for Federal estate, gift, and generation-skipping transfer tax purposes of any asset transferred by a transferor (a donor or decedent) generally is a pro-rata share of the fair market value of the entire interest in the asset owned by the transferor just before the transfer (the "basic aggregation rule").

> Example 1.–Mother owns 80 percent of the interests in a limited liability company ("LLC"). LLC's value is $100,000, and Mother's 80-percent interest has a value of $80,000.[892] Mother makes related gifts of 20-percent interests to each of her two children. Under the proposal, the value of each 20-percent interest for transfer tax purposes is one-quarter (20/80) of the value of Mother's 80-percent interest, or $20,000. Because this value is a pro-rata share of the value of Mother's controlling interest, the value does not reflect a minority discount.[893]

> Example 2.–Mother owns a 40-percent interest in LLC. The value of this 40-percent interest is $32,000, reflecting a 20-percent minority discount. Mother dies. This 40-percent interest passes through Mother's estate in equal shares to two children who did not previously own any interests in the LLC. Under the proposal, the value of each 20-percent share for transfer tax purposes is $16,000, one-half (20/40) of Mother's interest at death.[894]

Transferee aggregation rule

A special rule applies if a donor or a decedent's estate does not own a controlling interest in an asset just before a transfer of all or a portion of the asset to a donee or heir and, in the hands of the donee or heir, the transferred asset is part of a controlling interest. In that case, the estate, gift, and generation-skipping transfer tax value of the asset transferred is a pro-rata share of the fair market value of the entire interest in the asset owned by the *donee or heir* (not by the transferor) after taking into account the gift or bequest (the "transferee aggregation rule").

> Example 3.–The facts follow those in Examples 1 and 2 except that instead of making gifts and bequests to different children, Mother transfers interests in LLC only to one child. Thus, during her life Mother makes a single gift of a 40-percent interest to one child. After application of the basic aggregation rule, this gift has a value of $40,000, one half (40/80) of the value of Mother's entire 80-percent interest. At the time of

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[892] For illustrative purposes only, the $80,000 value, and the values described in all subsequent examples, disregard the possible existence of a control premium. The $80,000 value also assumes a marketability discount does not apply.

[893] The result is the same even if, just before the gifts, Mother owned only 65 percent of the LLC and her husband owned 15 percent.

[894] The result for a minority discount is the same as under present law.

her death, assume that an 80-percent interest in the LLC is still worth $80,000, but that Mother's remaining 40-percent interest is worth only $32,000, reflecting a minority discount. After application of the transferee aggregation rule, the 40-percent interest transferred to the child has a value of $40,000, one-half the $80,000 value of child's 80-percent interest after the bequest. Because the child has a controlling interest after the transfer, the value of the bequest for transfer tax purposes does not incorporate a minority discount.

Look-through rule

If, after application of the aggregation rules described above, a transferred interest in an entity is part of a controlling interest owned (before the transfer) by the transferor or (after the transfer) by the transferee, a look-through rule may apply to determine the value of that transferred interest. Under the look-through rule, if at least one-third of the entity's assets (by value) consists of marketable assets, the value of a transferred interest in that entity for Federal estate, gift, and generation-skipping transfer tax purposes is the sum of (1) the net value of the entity's marketable assets allocable to that transferred interest and (2) the value of the transferor's interest in the entity attributable to nonmarketable assets. Marketable assets include cash, bank accounts, certificates of deposit, money market accounts, commercial paper, U.S. and foreign treasury obligations and bonds, corporate obligations and bonds, precious metals or commodities, and publicly traded instruments. Marketable assets do not include assets that are part of an active lending or financing business.[895]

If the look-through rule applies, the effect is to deny a marketability discount to the extent the entity holds marketable assets. In all cases in which the look-through rule applies, no minority discount is permitted because a condition of the look-through rule is that the transferred interest must be part of a controlling interest either before or after the transfer.

Example 4.–At her death, Aunt owns 80 percent of the interests in an LLC whose assets have a total value of $1 million. The LLC owns publicly-traded stock worth $600,000, real estate worth $200,000, and a laundromat business worth $200,000. Aunt's 80-percent interest in LLC passes through her estate to Niece. If it is assumed that a marketability discount, if available, is 25 percent, then under the proposal the estate tax value of this 80-percent interest is $720,000, computed in the following manner. Because 60 percent of the value of LLC's assets is represented by marketable assets (the publicly-traded stock) and because Aunt owns a controlling interest before the transfer, the look-through rule applies. The $720,000 value thus equals (1) 80 percent of the value of the publicly-traded stock, or $480,000 ($600,000 x 80 percent), plus (2) the value of Aunt's interest in the entity attributable to the real estate and laundromat business, or $240,000 (80 percent of $300,000 (with the $300,000 representing the value of the laundromat business and real estate after taking into account a 25-percent marketability discount)).[896]

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[895] For purposes of this proposal, rules similar to those of section 6166(b)(10)(B) apply.

[896] As in all of these examples, the possible existence of a control premium is ignored.

Example 5.–The facts are the same as in Example 4, except that the laundromat business is worth $1.2 million. The total value of LLC's assets is $2 million. Consequently, the value of the marketable assets equals only 30 percent of the value of the LLC, and the look-through rule does not apply. The estate tax value of this 80-percent interest is $1.2 million, which equals 80 percent of the value of the LLC (80 percent x $2 million = $1.6 million), less a 25-percent marketability discount ($400,000). No minority discount is available because the 80-percent interest is a controlling interest.

Example 6.–The facts are the same as in Example 4, except that Aunt owns only a 10-percent interest in the LLC and Niece does not own any interest in it before she inherits her Aunt's interest. Accordingly, the look-through rule does not apply because the 10-percent interest is not part of a controlling interest either before or after the transfer. Therefore, a minority discount is available. Assume the minority discount is 20 percent. The value of the 10-percent interest is therefore $60,000, which equals 10 percent of the value of the LLC ($100,000), less (1) a 20-percent minority discount ($20,000) and (2) a 25-percent marketability discount ($20,000) computed after application of the minority discount (that is, 25 percent of $80,000, the value remaining after taking into account the minority discount).

Effective Date

The proposal applies to transfers occurring and estates of decedents dying on or after the date of enactment.

Discussion

The proposal responds to the frequent use of family limited partnerships ("FLPs") and LLCs to create minority and marketability discounts. In a common planning technique, a taxpayer forms an FLP or LLC, contributes to that entity marketable securities, real estate, and other assets, and makes gifts of noncontrolling interests in the entity. At death, the taxpayer owns only a noncontrolling interest in the FLP or LLC (rather than the underlying assets). Under present law the gifts made during life may qualify for minority and marketability discounts, and the estate tax value of the taxpayer's interest in the FLP or LLC also may be substantially reduced by those discounts.[897] The proposal seeks to curb the use of this strategy frequently

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[897] Commentators have referred to this discounting as the "disappearing wealth" phenomenon: Wealth disappears from the transfer tax base even though no (or little) economic actual value is lost. See Mary Louise Fellows & William H. Painter, "Valuing Close Corporations for Federal Wealth Transfer Taxes: A Statutory Solution to the Disappearing Wealth Syndrome," 30 Stanford Law Review 895 (1978); James Repetti, "Minority Discounts: The Alchemy in Estate and Gift Taxation," 50 *Tax Law Review* (1995); Laura E. Cunningham, *Remember the Alamo: The IRS Needs Ammunition in its Fight Against the FLP*, 86 Tax Notes 1461 (2000).

Church v. United States, 85 A.F.T.R. 2d (RIA) 804 (W.D. Tex. 2000), *aff'd without published opinion*, 268 F.3d 1063 (5th Cir. 2001), provides a simple example of the creation of

employed to manufacture discounts that do not reflect the economics of the transfers during life and after death. More broadly, the proposal attempts to reduce the inefficiency caused by the creation of complicated structures that serve only to shelter value from taxation.

The proposed aggregation and look-through rules restrict a taxpayer's ability to claim minority and marketability discounts in certain situations in which those discounts do not accurately reflect the value of the property interests transferred. In general, the basic aggregation rule of the proposal determines the existence of a minority discount by taking into account the entire interest held by the transferor just before the transfer. This is because the focus of the estate and gift tax should be on the amount a transfer depletes the value of the transferor's holdings. Thus, no minority interest should apply if the transferor holds a controlling interest in the property just before the transfer. Although inconsistent with this theory, the transferee aggregation rule is proposed to prevent the strategic sequencing of multiple gifts made to the same donee. The aggregate value of a series of lifetime and testamentary gifts made by one donor to the same donee should not depend upon the order in which controlling and non-controlling interests are transferred to the donee.

The proposed look-through rule addresses abusive situations in which a marketability discount is inappropriate. If an entity whose interests are nonmarketable holds marketable assets, a marketability discount for an interest in the entity results in the undervaluing of the interest if the owner has a controlling interest in the entity and can easily access the marketable assets.

The proposal does not eliminate minority and marketability discounts in other contexts in which facts generally support those discounts. If, for example, neither the transferor nor the transferee owns a controlling interest in an entity, the estate and gift tax value of an interest in that entity may be determined by taking into account the lack of control. Similarly, where an entity's value primarily is attributable to nonmarketable assets, the estate and gift tax value of an interest in that entity may reflect that illiquidity.

The proposal is similar to, but refines, several previous legislative proposals. First, the basic aggregation rule is similar to a proposal made by the Treasury Department in 1984 as part

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discounts shortly before death. Mrs. Church, who was the mother of the plaintiff and was suffering from a terminal illness, and her two children together formed a limited partnership. In exchange for limited partnership interests, Mrs. Church contributed to the partnership her interest in a Texas ranch (valued at $380,038) together with $1,087,710 in publicly traded securities, while her two children contributed their undivided interests in the ranch. A corporation owned equally by the two children was the general partner of the partnership. Two days after the formation of the partnership, Mrs. Church died. The District Court found that the date-of-death value of Mrs. Church's limited partnership interest was $617,591, despite the fact that Mrs. Church transferred assets to the partnership worth $1,467,748 just two days earlier. The court upheld a 58-percent discount based upon the noncontrolling and illiquid nature of Mrs. Church's limited partnership interest.

of a broad report on tax reform.[898] The 1984 proposal, however, based the value of transferred property on the transferor's highest level of ownership after taking into account prior gifts. This tracing of ownership backward through all gifts made by a transferor during his or her lifetime would create significant administrative difficulties. The proposed basic aggregation rule, therefore, looks only to the transferor's ownership interest just before the transfer. To eliminate the advantage of strategic sequencing of gifts to the same donee, the proposal adds a donee aggregation rule. Second, the look-through rule is similar to the approach taken in the Fiscal Year 2000 Administration Budget Proposal.[899] That proposal would have required an interest in an entity to be valued at a proportionate share of the net asset value of the entity to the extent the entity held non-business assets. The proposal's look-through rule is narrower than the earlier Treasury proposal, on the theory that in certain cases it may be inappropriate to look through an interest in an entity if the entity primarily holds non-marketable assets.[900] Third, the proposal incorporates spousal attribution but does not include a broader family attribution approach taken by various legislative proposals. The proposal does not take this broader approach because it is not correct to assume that individuals always will cooperate with one another merely because they are related. Any proposal involving family attribution could include an exception based on family hostility, but that exception could entail significant administrative difficulties and might yield unintended incentive effects.

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[898] Department of the Treasury, *Tax Reform for Fairness, Simplicity, and Economic Growth,* vol. 2, General Explanation of the Treasury Department Proposals (November 1984) at 386-88.

[899] Department of the Treasury, *General Explanations of the Administration's Revenue Proposals* (February 1999) at 167. The Fiscal Year 2001 Administration Budget Proposal included the same proposal. See Department of the Treasury, *General Explanations of the Administration's Fiscal Year 2001 Revenue Proposals* (February 2000) at 184-85.

[900] The proposal also bases its application on the existence of marketable assets, not non-business assets. The definitions of those two terms may differ.

C. Curtail the Use of Lapsing Trust Powers to Inflate the Gift Tax Annual Exclusion Amount (sec. 2503)

Present Law

Under present law, gift tax is imposed on transfers of property by gift, subject to several exceptions. One major exception is the gift tax annual exclusion of section 2503(b). Under this exclusion, a donor can transfer up to $11,000 of property to each of an unlimited number of donees without incurring gift tax on such transfers.[901] In order to qualify for the exclusion, the property interests transferred must be present interests, as opposed to future interests (such as remainders). In addition, spouses are allowed to "split" gifts for purposes of applying the exclusion.[902] For example, at both spouses' election, a $22,000 gift from one spouse to a third person could be treated as being made equally by both spouses, and thus would be sheltered entirely by the spouses' combined annual exclusion amounts.

Gifts in trust are treated as made to the trust beneficiaries for purposes of applying the annual exclusion.[903] Accordingly, if the trust beneficiaries have no right to present enjoyment of the transferred property, the annual exclusion will not apply, as no present interest will have been transferred. However, the courts and the IRS have long agreed that a temporary right of withdrawal of trust property on the part of a beneficiary may serve to create a present interest, thus qualifying such a gift for the annual exclusion. This result obtains even if the right of withdrawal is of short duration, and even if all parties involved expect that the right will not be exercised, and thus the beneficiary will not actually "enjoy" the transferred property on a current basis as a practical matter.[904] For example, a married couple may establish a trust for the benefit of their minor child, and the general terms of the trust may allow distributions to the child only upon reaching age 25. This couple nevertheless can transfer $22,000 per year to the trust, fully sheltered by the annual exclusion, as long as the child is given a temporary power to demand distribution of each new amount transferred into the trust, even if it is highly improbable that the power will be exercised. These powers, and these arrangements in general, are referred to as "Crummey powers," and "Crummey trusts" (so named after a court case upholding one such arrangement).

While Crummey powers may be used in connection with simple transfers of cash or any other kind of asset into a trust, use of the powers is particularly common in the case of life insurance trusts. In these arrangements, a trust owns the life insurance policy, the insured makes periodic payments into the trust for the purpose of covering the premiums, and the trust

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[901] The statute provides an amount of $10,000, adjusted in $1,000 increments for inflation occurring after 1997. The inflation-adjusted amount for 2005 is $11,000.

[902] See sec. 2513.

[903] See *Helvering v. Hutchings,* 312 U.S. 393 (1941).

[904] See *Crummey v. Commissioner,* 397 F.2d 82 (9th Cir. 1968); Rev. Rul. 73-405, 1973-2 C.B. 321.

beneficiaries are given Crummey powers with respect to these periodic payments, in order to ensure that the payments qualify as transfers of present interests eligible for the gift tax annual exclusion.

In recent years, taxpayers have used Crummey powers to achieve benefits extending beyond the conversion of future interests into present interests. Specifically, taxpayers have taken the position that the holder of the Crummey power need not even be a vested beneficiary of the trust, which creates the possibility of using multiple annual exclusions (one for each Crummey power holder) for what ultimately will be a gift to a single donee, as a practical matter. The Tax Court has sustained this position.[905]

Reasons for Change

Recent arrangements involving Crummey powers have extended the "present interest" concept far beyond what the Congress likely contemplated in enacting the gift tax annual exclusion, resulting in significant erosion of the transfer-tax base.

Description of Proposal

In general

The proposal sets forth three options that the Congress may wish to consider for improving the tax treatment of Crummey powers.

Option 1

Under the first option, for purposes of determining the applicability of the annual exclusion, a holder of a Crummey power is not treated as the donee with respect to an amount transferred into trust unless such holder is also a direct, noncontingent beneficiary of the trust. The Treasury Secretary is given regulatory authority to disregard other Crummey powers in cases in which the holder of a power is given a relatively small vested interest in a trust, with a principal purpose of avoiding the application of this provision. This option is designed simply to prevent taxpayers from claiming multiple annual exclusions in connection with gifts that are intended and arranged to accrue to a single person.

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[905] See *Estate of Cristofani v. Commissioner,* 97 T.C. 74 (1991). Taxpayers still must exercise some caution in executing this strategy: under section 2514(e), the lapse of a Crummey power may itself be treated as a taxable gift from the power holder to the beneficiary of such lapse, but only if the property subject to the lapsed power exceeds the greater of $5,000 or five percent of the value of trust assets available to satisfy the power. To avoid the application of this rule, taxpayers either may limit their Crummey powers to $5,000 each, or may fund the underlying trust with at least $220,000 (such that an $11,000 Crummey power would not exceed five percent of trust assets).

Option 2

Under the second option, for purposes of determining the applicability of the annual exclusion, powers to demand the distribution of trust property are taken into account only if they cannot lapse during the holder's lifetime. This option effectively eliminates Crummey powers as a tax planning tool.

Option 3

Under the third option, for purposes of determining the applicability of the annual exclusion, powers to demand the distribution of trust property are taken into account only if: (1) there is no arrangement or understanding to the effect that the powers will not be exercised; and (2) there exists at the time of the creation of such powers a meaningful possibility that they will be exercised. This option requires a facts-and-circumstances analysis of every Crummey power and disregards those that are found to be essentially lacking in substance. In view of the prevalence of Crummey powers that essentially lack substance, the practical effect of this option would be to eliminate Crummey powers as a planning tool in a wide range of cases.

Effective Date

The first option is effective for transfers made after the date of enactment.

The second and third options are effective for transfers made to trusts that are established after the date of enactment.

Discussion

In general

Crummey arrangements are often essentially shams, and yet they are for the most part respected for gift tax purposes. While it is arguably troubling for any arrangement essentially lacking in substance to be given credence for any purpose under the tax law, it nevertheless may be appropriate to distinguish among various uses of Crummey powers. In many cases, even though the Crummey power is essentially a sham, the results may be considered unobjectionable, as the powers may be used simply to provide somewhat greater flexibility in making a gift in trust to a single person without running afoul of the present-interest constraint. In other cases, the results may be considered more objectionable, such as when the powers are used to claim multiple annual exclusions in connection with gifts that are intended and arranged to accrue to a single person.

Option 1

If Crummey powers held by individuals with no significant interest in the underlying trust assets are respected for purposes of determining the annual exclusion, then taxpayers are effectively free to mint multiple annual exclusions for what is in substance a gift through the trust to a single beneficiary. This power to mint exclusions is limited only by the number of friends and relatives that a donor can find and can trust not to exercise the withdrawal right during its brief existence. The use of Crummey powers for this purpose is an abuse of the annual

exclusion and may cause significant erosion of the transfer tax base. By requiring a Crummey power holder to be a significant, vested beneficiary of the underlying trust, the first option would curtail this abuse of Crummey powers. At the same time, this option would preserve the availability of the powers for the more limited purpose of allowing a donor to place practical constraints on a donee's enjoyment of a gift without running afoul of the present-interest limitation. This option would not affect standard life insurance trusts. Because this option narrowly targets abusive applications of Crummey powers, it is effective for transfers made after the date of enactment, regardless of whether the trust already existed prior to enactment.

Option 2

Crummey powers arguably have eviscerated the present-interest requirement. This requirement was originally designed to protect the integrity of the per-donee annual exclusion amount under the gift tax. As the *Cristofani* case illustrates, if an exclusion amount is allowed to attach to an interest that lapses, then it becomes possible for the benefit of the gift shielded by the exclusion ultimately to inure to some other person, resulting in an inappropriate multiplication of the exclusion amount. Narrowly targeted anti-abuse rules that leave Crummey powers basically intact--like the first option above--may leave open some avenues of abuse. The second option ensures that the benefit of a gift will inure only to the holder of a withdrawal power, by respecting that power for tax purposes only if it never lapses. On the other hand, as noted above, Crummey powers are well-established tools widely used for the purpose of making a gift in trust to a single person without running afoul of the present-interest constraint. Eliminating the powers could force a large number of individuals to revisit their family financial plans, although this problem would be mitigated significantly by grandfathering transfers made to existing trusts.

Option 3

Some may argue that Crummey powers are objectionable only insofar as they are effectively shams. According to this view, the case law on this subject is problematic only because it allows "wink and a nod" arrangements to dictate tax results, with little analysis of the surrounding facts and circumstances. It would arguably be inappropriate to disregard a lapsing withdrawal power that might actually be exercised as a practical matter, thus making the second option too aggressive according to this view. In such a case, possession of the power actually is tantamount to ownership of a present interest in property. The IRS and the courts are equipped to examine the substance of these arrangements, and doing so arguably would lead to appropriate, commonsense results: illusory powers would be given no tax effect, and real powers would be given tax effect. As a practical matter, if such a rule were applied vigorously, it would eliminate most common Crummey arrangements, as such arrangements generally involve powers that are not expected to be exercised. Thus, like the second option above, this option could force a large number of individuals to revisit their family financial plans (and thus, this option also would grandfather transfers to existing trusts). This option would present the administrative and compliance difficulties common to all rules that require facts-and-circumstances determinations.

D. Provide Reporting for a Consistent Basis Between the Estate Tax Valuation and the Basis in the Hands of the Heir (sec. 1014)

Present Law

The value of an asset for purposes of the estate tax is the fair market value at the time of death or at the alternate valuation date. The basis of property acquired from a decedent is the fair market value of the property at the time of the decedent's death or alternate valuation date, if elected by the executor. Under regulations, the fair market value of the property at the date of the decedent's death (or alternate date) is deemed to be its value as appraised for estate tax purposes.[906] However, the value of property as reported on the decedent's estate tax return provides only a rebuttable presumption of the property's basis in the hands of the heir. Unless the heir is estopped by his or her previous actions or statements with regard to the estate tax valuation, the heir may rebut the use of the estate's valuation as his or her basis by clear and convincing evidence. The heir is free to rebut the presumption in two situations: (1) the heir has not used the estate tax value for tax purposes, the IRS has not relied on the heir's representations, and the statute of limitations on assessments has not barred adjustments; and (2) the heir does not have a special relationship to the estate which imposes a duty of consistency.

For property acquired by gift, the basis of the property in the hands of the donee generally is same as it was in the hands of the donor. However, for the purpose of determining loss on subsequent sale, the basis of property in the hands of the donee is the lesser of the donor's basis or the fair market value of the property at the time of the gift.[907]

Reasons for Change

Providing an heir with fair market value information gives the heir records to improve reporting of income upon future realization of gain. Providing the IRS with the same information would better enable the IRS to challenge inappropriate attempts to underreport gain upon a subsequent realization of that gain.

Description of Proposal

The proposal requires that for any property acquired as a bequest from an estate which has a Federal estate tax liability, the executor is required to provide the heir and the IRS with a statement of the value of the asset reported for estate tax purposes. The value so reported is binding on the heir as his or her basis for the purpose of computing future gain or loss as provided under present law. The proposal does not apply to items of income in respect of a decedent or property that the executor of the decedent's estate sells.

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[906] Treas. Reg. sec. 1.1014-3(a).

[907] Sec. 1015(a).

Effective Date

The proposal is effective for transfers from estates for which the estate tax return is filed after the date of enactment.

Discussion

Under present law, generally the incentive exists for an executor to offer conservative estimates of the value of assets in an estate. For the purpose of determining gain or loss on an inherited asset, generally the heir would prefer a higher basis.[908] The government is potentially whipsawed by inconsistent valuations. For example, the IRS has ruled that while value as appraised for estate tax purposes provides a presumptive value for the basis of inherited property in the hands of a beneficiary, such estate tax valuation generally is not conclusive.[909] In a case discussed in a technical advice memorandum,[910] at the time of the decedent's death the taxpayer owned stock in two closely held corporations. On audit, the IRS proposed a higher value for the stock than the value the executor provided on the estate tax return. The estate subsequently argued for a lower valuation and the IRS agreed to an amount in between the two parties' initial valuations. Following a redemption of the inherited stock from the beneficiary, the beneficiary (in an amended return for the taxable year of redemption) claimed a basis in the stock that was higher than both the original estate tax return value and the agreed upon value.

Underlying the rebuttable presumption rule set forth in the technical advice memorandum is the theory that a taxpayer should not be estopped from claiming a basis different from the value determined by an executor for estate tax purposes where the taxpayer did not participate in the executor's determination or benefit from it. This theory represents an application of an estoppel principle that is used outside the context of the estate tax. Where, however, a taxpayer succeeds in presenting clear and convincing evidence of a higher basis than the value used for estate tax purposes, this principle conflicts with one rationale for the section 1014 basis step-up rule. Some analysts argue that the step-up of an asset's basis at death is an appropriate adjustment to prevent property transferred at death from being subject to both Federal income tax and estate tax. If the basis in the hands of the heir exceeds the value used for estate tax purposes, an exemption from income tax in excess of the appreciation in decedent's hands has been implicitly created. By helping to ensure consistency in value for estate and income tax purposes, the proposal at least mitigates the whipsawing of the government that may occur under present law.

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[908] This preference is especially clear in the case of a spouse of the decedent. That spouse will not bear the burden of an estate tax on his or her bequest. Other beneficiaries generally will bear the burden of the estate tax and therefore may have competing preferences.

[909] In Rev. Rul. 54-97, 1954-1 C.B. 113, the IRS concluded, "Except where the taxpayer is estopped by his previous actions or statements, such value [the value of the property as determined for estate tax purposes] is not conclusive but is a presumptive value which may be rebutted by clear and convincing evidence."

[910] Tech. Adv. Mem. 199933001 (January 7, 1999).

In general, in the computation of capital gain or loss, establishing basis in property is a problem area for taxpayers and the IRS, because the basis in the property only becomes important for determining tax liability when the asset is sold, often many years after the asset is acquired. Taxpayers may lose records in the interim. The difficulty would be particularly acute where the taxpayer did not purchase the asset in question and thereby would have no records (e.g., receipts or other purchase documentation) to begin with. Thus, another rationale for the basis step-up rule of present law section 1014 is to provide administrative simplicity for the heir and the IRS because the heir's fair market value basis will potentially already have been determined for estate tax purposes. The proposal achieves this administrative advantage by having basis reported at the time an asset is bequeathed, thereby establishing a record comparable to purchase documentation. Present law arguably fails to achieve this advantage, both because the executor is not required to report the estate tax value to the heir, and because the heir is not required in all cases to use such value in determining basis.

Under the proposal there would be instances in which the value of an asset reported by an executor to an heir differs from the ultimate value of the asset used for estate tax purposes. For example, if the IRS challenges an estate valuation and prevails, the executor will have reported to the heir a valuation that is "too low" and the heir may arguably be overtaxed on a subsequent sale of the asset. This same problem exists under present law to the extent the initially reported estate tax value is presumptively the heir's basis. To provide complete consistency between estate tax valuation and basis in the hands of an heir may be impractical as ultimate determination of value for estate tax purposes may depend upon litigation and an heir may sell an asset before the determination of value for estate tax purposes.

By requiring the value of an asset reported for estate tax purposes to be reported and used by the heir in determining basis, however, the proposal has the salutary effect of encouraging a more realistic value determination in the first instance. This salutary effect would be lost if there were a relief mechanism for heirs and estates (and recoupment for the government) if the basis used by heirs differs from the fair market value ultimately determined for estate tax purposes.[911] Thus, the proposal does not contain any such relief mechanism.

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[911] Compare *Ford v. United States,* 276 F.2d 17 (Ct. Cl. 1960) (permitting taxpayers for income tax purposes to use a basis for inherited assets greater than the fair market value reported for estate tax purposes; two dissenting judges argued that the government was entitled to recoupment from the taxpayers for previous underpayment of estate taxes based on a lower property valuation).

E. Modify Transfer Tax Provisions Applicable to Section 529 Qualified Tuition Accounts (sec. 529)

Present Law

Overview

Section 529 provides specified income tax and transfer tax rules for the treatment of accounts and contracts established under qualified tuition programs.[912] A qualified tuition program is a program established and maintained by a State or agency or instrumentality thereof, or by one or more eligible educational institutions, which satisfies certain requirements and under which a person may purchase tuition credits or certificates on behalf of a designated beneficiary that entitle the beneficiary to the waiver or payment of qualified higher education expenses of the beneficiary (a "prepaid tuition program"). In the case of a program established and maintained by a State or agency or instrumentality thereof, a qualified tuition program also includes a program under which a person may make contributions to an account that is established for the purpose of satisfying the qualified higher education expenses of the designated beneficiary of the account, provided it satisfies certain specified requirements (a "savings account program").

In general, prepaid tuition contracts and tuition savings accounts established under a qualified tuition program involve prepayments or contributions made by one or more individuals on behalf of a designated beneficiary, with decisions with respect to the contract or account to be made by an individual who is not the designated beneficiary. Qualified tuition accounts or contracts generally require the designation of a person (generally referred to as an "account owner") whom the program administrator (oftentimes a third party administrator retained by the State or by the educational institution that established the program) may look to for decisions, recordkeeping, and reporting with respect to the account or contract. The person or persons who make the contributions to the account need not be the same person who is regarded as the account owner. Thus, in practice, qualified tuition accounts or contracts generally involve a contributor, a designated beneficiary, an account owner (who oftentimes is not the contributor or the designated beneficiary), and an administrator of the account or contract.[913] Under many qualified tuition programs, the account owner generally has control over the account or contract, including the ability to change designated beneficiaries and to withdraw funds at any time and for any purpose, without the consent of the designated beneficiary. As a result, in many qualified tuition programs, neither the contributor nor the designated beneficiary has legally

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[912] For purposes of this description, the term "account" is used interchangeably to refer to a prepaid tuition benefit contract or a tuition savings account established pursuant to a qualified tuition program.

[913] Section 529 refers to contributors and designated beneficiaries, but does not define or otherwise refer to the term account owner, which is a commonly used term among qualified tuition programs.

enforceable protections designed to assure that the account will be used to provide education or other benefits to the designated beneficiary.

Section 529 does not provide for any quantitative limits on the amount of contributions, account balances, or prepaid tuition benefits relating to a qualified tuition account, other than to require that the account provide adequate safeguards to prevent contributions on behalf of a designated beneficiary in excess of those necessary to provide for the qualified higher education expenses of the beneficiary. Many qualified tuition programs impose limits on the maximum amount of contributions that may be made, or account balances that may accrue, for the benefit of a designated beneficiary.[914]

Generally applicable transfer tax provisions[915]

A gift tax is imposed on lifetime transfers and an estate tax is imposed on transfers at death. A taxpayer may exclude $11,000 (for 2005) of gifts made to any one donee during a calendar year. The annual exclusion does not apply to gifts of future interests (e.g., reversions or remainders). Married individuals may treat gifts made to any one donee as having been made one-half by such donor and one-half by his or her spouse, effectively allowing a married couple to exclude $22,000 (for 2005) of gifts made to any one donee during a calendar year.

The gift tax applies to a transfer by way of gift whether the transfer is in trust or otherwise, whether the gift is direct or indirect, and whether the property is real or personal, tangible or intangible.[916] If a trustee has a beneficial interest in trust property, a transfer of the property by the trustee is not a taxable transfer if it is made pursuant to a fiduciary power the exercise or nonexercise of which is limited by a reasonably fixed or ascertainable standard which is set forth in the trust instrument. For example, a power to distribute corpus for the education of the beneficiary generally is a power limited by such a standard, whereas a power to distribute corpus for the happiness of the beneficiary is not.[917]

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[914] For example, a qualified tuition program might provide that contributions to all accounts established for the benefit of a particular designated beneficiary may not exceed a specified limit (e.g., $250,000), or that the maximum account balance for all accounts established for the benefit of a particular designated beneficiary may not exceed a specified limit. In the case of prepaid tuition contracts, the limit might be expressed in terms of a maximum number of semesters.

[915] The principles described in this section are certain of the generally applicable gift, generation-skipping transfer, and estate tax rules that generally apply to taxpayers to determine transfer tax consequences. As is described below, the generally applicable transfer tax provisions are modified by present-law section 529 with respect to qualified tuition accounts.

[916] Treas. Reg. sec. 25.2511-1(a).

[917] Treas. Reg. sec. 25.2511-1(g)(2).

For estate tax purposes, the value of the decedent's gross estate includes the value of all property to the extent of the decedent's interest therein at the time of his or her death,[918] including the value of certain interests in property transferred by the decedent during his or her life (sections 2035 through 2038), and special kinds of property and powers held by the decedent or on the life of the decedent (sections 2039 through 2042, including powers of appointment governed by section 2041).[919] For example, section 2036 provides for the inclusion of transferred property with respect to which the decedent retained the income or the power to designate who shall enjoy the income of the property, and section 2038 provides for the inclusion of transferred property if the decedent had at the time of his or her death the power to change the beneficial enjoyment of the property.

A generation-skipping transfer ("GST") tax generally is imposed on transfers, either directly or through a trust or similar arrangement, to a "skip person" (i.e., a beneficiary in a generation more than one generation below that of the transferor). In general, if an outright gift is not subject to gift tax because of application of the gift tax annual exclusion, then it will not be subject to GST tax.

Absent the specific transfer tax provisions of section 529, the generally applicable gift, GST, and estate tax provisions would apply to qualified tuition accounts.

Income tax treatment of qualified tuition accounts

A qualified tuition program, including a savings account or a prepaid tuition contract established thereunder, generally is exempt from income tax. Contributions to a qualified tuition account (or with respect to a prepaid tuition contract) are not deductible to the contributor or includible in income of the designated beneficiary or account owner. Earnings accumulate tax-free until a distribution is made. If a distribution is made to pay qualified higher education expenses, no portion of the distribution is subject to income tax.[920] If a distribution is not used to pay qualified higher education expenses, the earnings portion of the distribution is subject to Federal income tax,[921] and a 10-percent additional tax (subject to exceptions for death, disability, or the receipt of a scholarship).[922] A change in the designated beneficiary of an account or

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[918] Sec. 2033.

[919] Treas. Reg. sec. 20.2031-1(a).

[920] Sec. 529(c)(3)(B). Any benefit furnished to a designated beneficiary under a qualified tuition account is treated as a distribution to the beneficiary for these purposes. Sec. 529(c)(3)(B)(iv).

[921] Sec. 529(c)(3)(A) and (B)(ii).

[922] Sec. 529(c)(6).

prepaid contract is not treated as a distribution for income tax purposes if the new designated beneficiary is a member of the family of the old beneficiary.[923]

Gift and GST tax treatment of qualified tuition accounts

Section 529 modifies the generally applicable gift and GST tax provisions that otherwise would apply to qualified tuition accounts.[924] A contribution to a qualified tuition account (or with respect to a prepaid tuition contract) is treated as a completed gift of a present interest from the contributor to the designated beneficiary. Such contributions qualify for the per-donee annual gift tax exclusion, and, to the extent of such exclusions, also are exempt from the GST tax. A contributor may contribute up to five times the per-donee annual gift tax exclusion amount to a qualified tuition account and, for gift tax and GST tax purposes, treat the contribution as having been made ratably over the five-year period beginning with the calendar year in which the contribution is made.

A distribution from a qualified tuition account or prepaid tuition contract generally is not subject to gift tax or GST tax. Those taxes apply, however, to a change of designated beneficiary if the new designated beneficiary is in a generation below that of the former beneficiary or is not a member of the family of the former beneficiary.[925]

Estate tax treatment of qualified tuition accounts

Section 529 modifies the generally applicable estate tax provisions that otherwise would apply to qualified tuition accounts.[926] Qualified tuition program account balances or prepaid tuition benefits generally are excluded from the gross estate of any individual. Amounts distributed on account of the death of the designated beneficiary, however, are includible in the

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[923] Sec. 529(c)(3)(C)(ii). For this purpose, "member of family" means, with respect to a designated beneficiary, the spouse of such beneficiary, or an individual who bears one of the following relationships to such beneficiary: a son, daughter, or a descendant of either; a stepson or stepdaughter; a sibling or stepsibling; a father, mother, or ancestor of either; a stepfather or stepmother; a son or daughter of a brother or sister; a brother or sister of a father or mother; and a son-in-law, daughter-in-law, father-in-law, mother-in-law, brother-in-law, or sister-in-law, or the spouse of any such individual; and the first cousin of such beneficiary. Sec. 529(e)(2).

[924] Sec. 529(c)(2) and (5).

[925] Prior to enactment of section 406(a) of the Working Families Tax Relief Act of 2004, P.L. No. 108-311, a new beneficiary was not explicitly required to be a member of the family of the former beneficiary in order to avoid imposition of the gift and GST taxes upon a change of beneficiary. Section 406(a) of the Act amended section 529(c)(5) to provide that gift and GST taxes are imposed on a change of designated beneficiary unless (1) the new beneficiary is of the same or a higher generation than the former beneficiary, and (2) the new beneficiary is a member of the family of the former beneficiary. The amendment made by the Act was effective as if included in the Taxpayer Relief Act of 1997.

[926] Sec. 529(c)(4).

designated beneficiary's gross estate. If a contributor elected the special five-year allocation rule for gift tax annual exclusion purposes, any amounts contributed by the contributor that are allocable to the years within the five-year period remaining after the year of the contributor's death are includible in the contributor's gross estate.

Reasons for Change

Present law regarding the transfer tax treatment of section 529 accounts is unclear in many situations, and in other situations imposes transfer taxes in a manner that is inconsistent with otherwise applicable transfer tax provisions. In addition, the present-law section 529 transfer tax rules do not adequately reflect the structural changes that have occurred to qualified tuition programs over the past few years, many of which have been designed to provide maximum flexibility to the program's account owners, rather than assure that account funds will be used to fund educational expenses of a designated beneficiary.

Description of Proposal

Modify special transfer tax provisions of section 529

In general

The proposal modifies the special transfer tax (gift, GST, and estate tax) provisions of present-law section 529, and generally subjects qualified tuition accounts to otherwise applicable transfer tax provisions. In general, a contribution to a qualified tuition account is not treated as a completed gift, and is includible in the estate of the contributor or account owner, unless the terms governing the account satisfy certain requirements. The proposal defines an account owner as the person whom the program administrator may look to for decisions, recordkeeping, and reporting with respect to the qualified tuition account. The present-law income tax rules applicable to qualified tuition accounts do not change.

Contributions treated as completed gifts to designated beneficiary

Under the proposal, an amount contributed to a qualified tuition account is treated as a completed gift of a present interest to the designated beneficiary (and becomes includible in the estate of the designated beneficiary) at the time of the contribution only if: (1) the designated beneficiary is living at the time the account is established; (2) only the designated beneficiary may terminate the account or change the designated beneficiary during the designated beneficiary's lifetime, and such termination or change of beneficiary may not occur prior to the designated beneficiary's attaining age 18, receiving a high school diploma, or becoming learning disabled; (3) if the designated beneficiary dies before attaining age 18, the personal representative of the deceased beneficiary may designate a successor designated beneficiary who is a member of the family (and of the same generation as) the designated beneficiary, or terminate the account; and (4) a distribution upon termination of the account may be made to or for the benefit of a person (including to an educational institution) other than the designated beneficiary only if (a) such other person is irrevocably designated at the time the contract is executed, or is a member of the family of (and in the same generation as) the designated

beneficiary,[927] and is a person other than the contributor and account owner; and (b) such distribution may be made only if the designated beneficiary dies, becomes learning disabled, certifies that the designated beneficiary has reached the age of 18 and will not attend a college or university, has received a scholarship in an amount equal to or greater than the amount of the distribution, or certifies that the account balance or prepaid benefit exceeds the designated beneficiary's actual educational expenses. If such conditions are satisfied, then the contribution is treated as a completed gift of a present interest by the contributor (whether the account owner or a person other than the account owner) to the designated beneficiary, the contributor may elect to take the contribution into account as a gift ratably over the five-year period beginning with the year of the contribution,[928] and no further transfer tax consequences apply upon a change of account owner, a change of designated beneficiary, or a distribution from the account.

Example.–Mother establishes a qualified tuition account and designates her living child (Child) as the designated beneficiary. The account's terms provide that Mother is the account owner, but that only Child may terminate the account or change the designated beneficiary, and that any distribution other than to or for the benefit of Child must satisfy the other conditions described above. Mother makes a $55,000 contribution to the account in Year 1. In Year 5, a distribution of $25,000 is made from the account for Child's benefit and paid to an eligible educational institution. Under the proposal, Mother's contribution is treated as a completed gift of a present interest by Mother to Child in Year 1, and Mother may elect to treat the gift as made ratably over the five-year period (i.e., $11,000 per year) beginning with Year 1. If Child's grandparent (Grandfather), rather than Mother, makes the contribution to the account, then Grandfather is treated as making the completed gift to Child and may elect the application of the special five-year rule. The distribution in Year 5 is not a transfer for transfer tax purposes.

Amounts treated as includible in estate of account owner

In those circumstances involving qualified tuition accounts that do not satisfy the requirements described above, a completed gift to the designated beneficiary does not occur until an amount is distributed from the qualified tuition account to or for the benefit of the designated beneficiary. In such cases, the transfer tax consequences of a contribution to a qualified tuition account depend upon whether the contribution is made by the account owner or by a person other than the account owner. Contributions made by the account owner are not a completed gift and remain includible in the account owner's estate. Contributions made by a person other than the account owner are governed by generally applicable transfer tax principles, and may constitute a completed gift of a present interest to the account owner at the time of the contribution that

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[927] The proposal contemplates that an account need not provide for irrevocable designations of distributees at the time the account is established, and may permit changes to the person designated as entitled to receive a distribution upon termination of the account if the person is a member of the family (and in the same generation as) the designated beneficiary.

[928] In such a case, no additional gift is treated as made at the time the account is used for the benefit of the designated beneficiary, whether for educational or other purposes.

become includible in the account owner's estate.[929] A completed gift of a present interest by the account owner occurs at the time an amount is distributed from the account to or for the benefit of a person other than the account owner (e.g., the designated beneficiary), whether for educational or other purposes.[930] In these cases, a change of account owner is a completed gift to the new account owner (not eligible for the special five-year rule), but a change of designated beneficiary is not a completed gift.

Example.–Mother establishes a qualified tuition account and designates her living child (Child) as the designated beneficiary. The account's terms provide that Mother is the account owner, and that Mother may terminate the account, change the designated beneficiary, and direct that a distribution be made other than to or for the benefit of Child. Mother makes a $55,000 contribution to the account in Year 1. In Year 5, a distribution of $25,000 is made from the account for Child's benefit and paid to an eligible educational institution. Under the proposal, Mother's contribution in Year 1 is not a completed gift by Mother to Child, and the account remains includible in Mother's estate. If Child's grandparent (Grandfather), rather than Mother, makes the contribution to the account, Grandfather is treated as making a completed gift of a present interest to Mother (rather than to Child), and Grandfather may not elect the application of the special five-year rule. The $25,000 distribution from the account for the benefit of Child constitutes a completed gift of a present interest by Mother to Child (not eligible for the special five-year rule) at the time of the distribution, and may be excludable as a qualified transfer within the meaning of section 2503(e)(2) if paid for Child's tuition.

Effective Date

The proposal applies to contributions (and earnings thereon) made in taxable years beginning after the date of enactment. The proposal does not apply to contributions made on or before the effective date (and earnings thereon). Separate accounting of such contributions is required.

Discussion

Recent changes in qualified tuition account program design

Present-law section 529 is unclear with respect to the transfer tax consequences of certain events pertaining to qualified tuition accounts, imposes transfer taxes in a manner that is inconsistent with otherwise applicable transfer tax principles, and creates opportunities for abuse by taxpayers who may establish such accounts with no intention of providing education benefits to others. In addition, present-law section 529 affords taxpayers who establish qualified tuition

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[929] In such cases, the special five-year rule is not available to permit the contributor to treat the gift as made to the account owner ratably over a five-year period, because the benefit of the five-year rule is limited to those instances where the account is irrevocably dedicated for the benefit of the designated beneficiary.

[930] At the time of such a distribution, an exclusion from gift tax is available if the distribution satisfies the requirements of section 2503(e) (i.e., is made as tuition to an educational organization).

accounts a combination of income tax and transfer tax benefits that is more favorable than those available for other tax-favored accounts, such as individual retirement accounts and health savings accounts. Although other tax-favored accounts obtain income tax benefits similar to those available for section 529 accounts, qualified tuition accounts are unusual in that section 529 permits a taxpayer to avoid estate, gift and GST taxes even if (as is the case in many qualified tuition programs) the taxpayer effectively retains control of the qualified tuition account.

Section 529 was enacted in 1996.[931] Since then, qualified tuition programs have increased significantly, both in the number of accounts and aggregate funds, with more than $35 billion invested in such programs as of early 2004.[932] Some have estimated the number of section 529 accounts at approximately five million,[933] and program assets soon approaching $50 billion.[934] Others have predicted that total assets in qualified tuition programs will reach $300 billion by 2010.[935]

In 1986, the State of Michigan adopted the first prepaid tuition program in the United States.[936] The Michigan prepaid tuition program prohibited the account owner from changing the designated beneficiary, and limited the ability of the account owner to use the funds other

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[931] Pub.L. No. 104-188, sec. 1806(a) (effective for tax years ending after August 20, 1996).

[932] Opening Statement of Chairman Michael G. Oxley, House Financial Services Committee, Subcommittee on Capital Markets, Insurance, and Government Sponsored Enterprises, *Investing for the Future: 529 State Tuition Savings Plans*, June 2, 2004.

[933] Statement of Charles Toth on Behalf of The College Savings Foundation and Securities Industry Association Before the United States Senate Committee on Finance on the Role of Higher Education Financing in Strengthening U.S. Competitiveness in a Global Economy, July 22, 2004 (citing Financial Research Corporation, Quarterly Update April 2004, and reporting that most of the growth in program assets has occurred since 2001, from $8.5 billion at the end of 2001 to over $40 billion in the first quarter of 2004).

[934] Morningstar Investment Research Firm estimates that investors have assets totaling more than $47 billion in section 529 accounts. Morningstar Testimony to the House Financial Services Committee, Subcommittee on Capital Markets, Insurance, and Government Sponsored Enterprises, June 2, 2004.

[935] Opening Statement of Ranking Democratic Member Paul E. Kanjorski, House Financial Services Committee, Subcommittee on Capital Markets, Insurance, and Government Sponsored Enterprises, *Investing for the Future: 529 State Tuition Savings Plans*, June 2, 2004 (citing Financial Research Corporation).

[936] *State of Michigan and Michigan Education Trust v. U.S.*, 40 F.3d 817, 818 (6th Cir. 1994).

than for the beneficiary's education expenses.[937] The current Michigan prepaid tuition program retains these restrictions. Under the current Michigan prepaid tuition program, only a student who is at least 18 years of age or has obtained a high school diploma may terminate a prepaid tuition account and compel a distribution of the account balance.[938] A parent or purchaser of the prepaid contract may not terminate the account for any reason other than if the student has died or has become learning disabled. If the student reaches age 18 or receives a high school diploma, the student has the option of transferring the account to an immediate family member or terminating the account to obtain a refund paid to a refund designee established at the time the account was established.[939] A student who receives a scholarship or other type of tuition assistance may receive the excess account funds not needed to pay for the student's educational expenses. Use of the prepaid tuition account for other purposes is not permitted under the program.

As of January 2004, there were 17 State prepaid tuition programs, and 51 State savings programs.[940] Few qualified tuition programs impose requirements designed to meaningfully restrict beneficiary changes or limit use of the account or contract to qualified higher education expenses. Present-law section 529 provides the same transfer tax outcomes for all qualified tuition accounts, without regard to the rights and controls retained by the contributor or account owner. The proposal provides for uniform transfer tax treatment for all plans that satisfy the proposed requirements that treat a contribution as a completed gift of a present interest. The transfer tax consequences for accounts established under programs that do not satisfy the proposed requirements would depend upon the particular terms and restrictions applicable to the account.

The Administration's Fiscal Year 2005 Budget included a proposal to modify certain of the rules regarding qualified tuition accounts. The explanation of the Administration's proposal stated that "[c]urrent law regarding the transfer tax treatment of section 529 accounts is unclear and in some situations imposes tax in a manner inconsistent with generally applicable transfer tax provisions... In addition, the lack of any limits on who can be named a [designated

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[937] Priv. Ltr. Rul. 8825027 (describing the account terms as follows: individual A contributes amounts to trust to be used to provide educational benefits to B, an irrevocably designated beneficiary; cash refund of prepaid amount may be made to C, a person irrevocably designated by A at the time the contract is executed, but only if B dies, is denied admission to a Michigan public educational institution, or certifies that B has reached the age of 18 and will not attend a college or university, or if the State program is determined to be actuarially unsound).

[938] A student who is mentally disabled or under 18 years of age must be represented by a legal guardian.

[939] The refund designee may be the student or another person designated at the time the account was established. A change of beneficiary of the prepaid tuition account may be accomplished only through these limited account transfer provisions.

[940] National Association of Student Financial Aid Administrators (NASFAA) State Plan Summary Chart, *available at* www.nasfaa.org/PDFs/2002/CSP0202.pdf.

beneficiary] creates opportunities for the unintended and inappropriate use of section 529 plans. For example, taxpayers may seek to use section 529 accounts as retirement accounts, with all the tax benefits but none of the restrictions and requirements of qualified retirement accounts, or to avoid gift and GST taxes by changing the [designated beneficiary] of existing section 529 accounts."[941] The Administration stated that the law "should be clarified to provide taxpayers with certainty as to the tax consequences of a transfer and to eliminate the inappropriate imposition of transfer taxes."[942]

Subjecting qualified tuition accounts to generally applicable transfer tax provisions would reduce the potential for abuse by taxpayers who establish such accounts with no intention of ultimately providing education benefits to other persons, and would put qualified tuition accounts on a more level playing field with other tax incentive vehicles such as IRAs, while retaining the substantial income tax benefits provided by the present-law section 529 provisions for qualified tuition accounts. Under the proposal, a taxpayer could treat the contribution of amounts to a qualified tuition account as a completed gift, excludable from his or her estate, only if he or she relinquished control over the use and enjoyment of the account. Other potential solutions offered to prevent abuse of the accounts, such as imposing aggregate quantitative per-contributor or per-beneficiary limits on contributions or account balances, would be difficult to administer because they would require coordination of recordkeeping and reporting by the various State-sponsored and private qualified tuition programs. In addition, the present-law provisions cannot be made consistent with generally applicable transfer tax principles without materially altering the structural design of most qualified tuition programs.

Transfer tax deficiencies of present-law section 529

Section 529 does not explicitly address the transfer tax consequences of certain events that are commonplace under existing qualified tuition programs. For example, section 529 does not address the transfer tax consequences of a change of account owners of a qualified tuition account. It is unclear whether a change of account owner is to be regarded as a completed gift of a present interest from the former account owner to the new account owner, or as having no tax consequences because a completed gift had been made to the designated beneficiary. Further, section 529 does not identify which party is responsible for payment of the transfer tax when it is imposed (i.e., in instances involving a change of designated beneficiary to a person who is in a

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[941] Department of the Treasury, *General Explanations of the Administration's Fiscal Year 2005 Revenue Proposals*, February 2005, 136-37.

[942] *Id.* The Administration's proposal generally would modify certain income tax, gift tax, generation-skipping transfer tax, and estate tax rules with respect to changes in designated beneficiaries of qualified tuition accounts, impose new eligibility rules for designated beneficiaries, require that a qualified tuition account be a custodial arrangement maintained for the benefit of a designated beneficiary, and impose new excise taxes on amounts that are used other than for qualified higher education expenses. For a description and analysis of the Administration's proposal, see Joint Committee on Taxation, *Description of Revenue Provisions Contained in the President's Fiscal Year 2005 Budget Proposal*, (JCS-3-04), February 2004, 306-17.

generation lower than the former beneficiary). In such cases, it is not clear whether the gift tax should be imposed on the former designated beneficiary, the original contributor, the account owner, or perhaps on the account. This lack of clarity creates complexity for taxpayers in arranging their affairs, and for the IRS in attempting to administer the present-law rules.

In addition, section 529 departs from otherwise generally applicable transfer tax principles in at least five ways. First, present-law section 529 treats a contribution to a qualified tuition account as a completed gift of a present interest to the designated beneficiary,[943] even though in most instances the designated beneficiary possesses no rights to control the qualified tuition account or withdraw funds, and such control (including the right to change beneficiaries or to withdraw funds, including for the benefit of someone other than the designated beneficiary) is vested in the account owner.[944] Second, a change of designated beneficiary to a new beneficiary who is in a generation lower than the former beneficiary constitutes a taxable gift, even though the new designated beneficiary would not, under otherwise applicable transfer tax principles, be regarded as receiving a completed gift. Third, an account owner is not required to include in the account owner's estate the amount held in a qualified tuition account, even if the account owner possesses at his or her death the right to withdraw funds for the benefit of someone other than the designated beneficiary or to change the designated beneficiary.[945] Fourth, a distribution from a qualified tuition account is not treated as a taxable gift unless the distributee is of a generation lower than the designated beneficiary.[946] Fifth, under present-law section 529, there is no express requirement that the multiple annual present interest exclusion is

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[943] Sec. 529(c)(2).

[944] Absent section 529, such contributions generally would not be treated as completed gifts to the designated beneficiary under otherwise applicable transfer tax principles. Under otherwise applicable transfer tax principles, the designated beneficiary's lack of control over the qualified tuition account generally would be regarded as a future interest, and any completed gift of a present interest would be regarded as having been made from the contributor to the account owner (rather than to the designated beneficiary). In cases where the contributor and the account owner are the same person, no gift would take place under generally applicable transfer tax principles.

[945] Under otherwise applicable estate tax principles, the account owner generally would be regarded as possessing rights with respect to the qualified tuition account that cause the account balance to be includible in the account owner's estate for Federal estate tax purposes. See, e.g., secs. 2036 and 2038.

[946] Under otherwise applicable principles, such distributions would be a taxable gift by the account owner unless the account owner has an obligation to provide such benefits (e.g., the beneficiary is a dependent of the account owner and is obligated to provide education support under State law) or the distribution is a direct purchase of tuition from the school by the qualified tuition account (and would be excludable under section 2503(e)). This exclusion for distributions made to a person who is of a generation of the same generation of the designated beneficiary seems to apply even if the distribution is used by the designated beneficiary other than for qualifying educational expenses.

available only if there is a present intent to allow the designated beneficiary to receive the benefits of the qualified tuition account.[947]

For example, under present-law section 529, a taxpayer might establish 20 separate qualified tuition accounts for 20 separate designated beneficiaries, and immediately deposit $55,000 in each account.[948] By doing so, the taxpayer may treat the full amount of each contribution as a completed gift to the designated beneficiary, elect the section 529 five-year annual exclusion treatment for each of the contributions, and exclude the entire $1.1 million (up to $2.2 million under gift-splitting) from estate, gift, and GST taxes.[949] Under present law, the taxpayer may be the account owner with respect to each of these accounts, which under many qualified tuition programs permits the taxpayer to control the account through changes in the designated beneficiary and the withdrawal of funds for any purpose. The taxpayer has avoided the imposition of the estate, gift, and GST taxes even if the account ultimately is not used for education purposes.[950] The taxpayer also may avoid imposition of the GST by designating beneficiaries who are in generations more than one generation below the generation of the taxpayer. Because section 529 imposes no restrictions on the identity or number of persons for whom qualified tuition accounts may be established, or to which contributions may be made, it has been suggested that the literal application of section 529 could permit a closely-held business employer to establish qualified tuition accounts for each of its employees, and later change the beneficiaries of the accounts to a single individual, without incurring transfer taxes on the transfers to the accounts.[951]

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[947] Thus, a contributor may make contributions eligible for multiple $11,000 annual exclusions by naming multiple beneficiaries of multiple qualified tuition accounts, even if the contributor has no present intent to allow the named beneficiaries (or any beneficiaries) to receive any benefits from the accounts.

[948] The taxpayer might deposit $110,000 in each account if he or she is married and elects with the spouse to gift-split for annual exclusion purposes.

[949] A taxpayer who makes the special five-year ratable allocation annual exclusion election is required to include a portion of the contribution in his or her estate if he or she dies within five years of making the contribution.

[950] The distribution of the funds for uses other than qualifying educational expenses will be subject to income tax, and an additional 10-percent tax, however, on the earnings portion of the distribution.

[951] Letter from Carlyn S. McCaffrey of the American College of Trust and Estate Counsel to the Internal Revenue Service, February 25, 2003, Q/A-21 Abusive Situations (providing a similar example in the employer-employee context, and noting that section 529 might permit a father that owns a business to transfer $1,000,000 gift tax-free to his son through the use of section 529 accounts initially established for employees, and stating that the College does not believe that Congress intended to undermine the integrity of the gift tax system by enacting section 529).

Some might argue that the proposal effectively eliminates transfer tax benefits for most qualified tuition programs, and that retention of the special transfer tax principles of present law is desirable to encourage savings for educational purposes. Others might argue that the proposal does not go far enough to maximize the likelihood that the account ultimately is used for educational purposes, and would endorse the imposition of an excise tax (in addition to the present-law additional 10-percent tax) in cases where monies are withdrawn for noneducational purposes. Such an excise tax might be limited to cases where the withdrawal is for the benefit of someone other than the initial designated beneficiary, because in such cases additional transfer tax benefits (such as through generation skipping) might have been derived from the arrangement.

ESTIMATED REVENUE EFFECTS OF
OPTIONS TO IMPROVE TAX COMPLIANCE AND REFORM TAX EXPENDITURES [1]

Fiscal Years 2005 - 2014

[Billions of Dollars]

Provision	Effective	2005	2006	2007	2008	2009	2010	2011	2012	2013	2014	2005-14
I. Tax Procedure and Administration												
1. Impose withholding on certain payments made by government entities	[2]	---	---	5.1	0.2	0.2	0.2	0.2	0.2	0.2	0.2	6.4
2. Require partial payments with submissions of offers-in-compromise	[3]	---	0.1	0.2	0.2	0.2	0.2	0.2	0.2	0.3	0.3	1.8
3. Clarify standards of scrutiny for certain transactions with characteristics of tax shelters [4]	teio/a DOE	---	0.6	0.7	0.7	0.8	0.8	0.9	1.1	1.1	1.2	7.8
II. Individual Income Tax												
1. Provide uniform treatment for dependent care benefits	tyba DOE	---	0.9	1.3	1.3	1.4	1.5	1.4	1.5	1.5	1.6	12.4
2. Combine Hope and Lifetime Learning credits and above-the-line deduction for higher education expenses [5]	tyba DOE	---					*Revenue Neutral*					
3. Repeal exclusion for qualified tuition reductions	tyba DOE	---	0.1	0.2	0.2	0.2	0.2	0.2	0.2	0.2	0.2	1.9
4. Deny refundable child credit when section 911 exclusion is elected	tyba DOE	---	[6]	0.1	0.1	0.1	0.1	0.1	[6]	[6]	[6]	0.4
5. Repeal the deduction for interest on home equity indebtedness	ipodia DOE	---	0.3	0.8	1.3	1.9	2.5	3.1	3.9	4.3	4.4	22.6
6. Limit the exclusion for rental value of a residence rented for fewer than 15 days	tyba DOE	---	[7]	[7]	[7]	[7]	[7]	[7]	[7]	[7]	[7]	0.1
7. Extend pro-rata basis allocation requirement to all part-gift, part-sale transactions	tmo/a DOE	---	[6]	[6]	[6]	[6]	[6]	[6]	[6]	[6]	[6]	0.1
8. Simplify taxation of minor children	tyba DOE	---	0.1	0.1	0.1	0.1	0.2	0.2	0.2	0.2	0.3	1.6
III. Employment Taxes												
1. Provide consistent FICA treatment of salary reduction amounts	wfspi cyba DOE	---	10.3	15.2	16.2	17.3	18.5	19.6	20.9	22.2	23.7	164.0
2. Conform calculation of FICA taxes and SECA taxes	tyba DOE	---	0.3	0.4	0.4	0.4	0.5	0.5	0.5	0.5	0.5	3.9
3. Extend Medicare payroll tax to all State and local government employees	wfspi cyba DOE	---	0.7	0.9	0.8	0.7	0.7	0.5	0.4	0.3	0.2	5.4
4. Modify FICA tax exception for students	[8]	---	0.3	0.3	0.4	0.4	0.4	0.4	0.4	0.4	0.4	3.3
5. Apply employment taxes to sales incentive payments made by manufacturers	sipfspi cyba DOE	---	[6]	[6]	[6]	[6]	[6]	[6]	[6]	[6]	[6]	0.4
6. Modify determination of amounts subject to employment or self-employment tax for partners and S corporation shareholders	[9]	---	4.5	6.0	6.1	6.4	6.6	6.7	6.8	7.0	7.3	57.4

Provision	Effective	2005	2006	2007	2008	2009	2010	2011	2012	2013	2014	2005-14
IV. Pensions and Employee Benefits												
1. Conform definition of qualified medical expenses	epoii tyba DOE	---	[6]	[6]	[6]	[6]	0.1	0.1	0.1	0.1	0.1	0.5
2. Limit deduction for personal use of company aircraft and other entertainment expenses	eia DOE	---	[6]	[6]	[6]	[6]	[6]	[6]	[6]	[6]	[6]	0.1
3. Limit deduction for income attributable to property transferred in connection with the performance of services to amount included in income by the service provider	topma DOE	---	[6]	[6]	[6]	[6]	[6]	[6]	[6]	0.1	0.1	0.3
4. Provide that payments in redemption of stock held by an ESOP not deductible as dividends	pma DOE	---	0.2	0.4	0.4	0.4	0.4	0.4	0.4	0.4	0.3	3.4
5. Provide greater conformity for section 403(b) and section 401(k) plans	pyba DOE	---	0.1	0.1	0.1	0.1	0.1	0.1	0.1	0.1	0.1	0.8
6. Extend early withdrawal tax to eligible deferred compensation plans of State and local governments	di tyba DOE	---	0.1	0.2	0.2	0.2	0.2	0.2	0.2	0.2	0.2	1.5
7. Modify prohibited transaction rules for individual retirement arrangements ("IRAs") to reduce tax shelter transactions	to/a DOE	---	[10]	[10]	[10]	[10]	[10]	[10]	[10]	[10]	[10]	[7]
8. Repeal pick-up rules for employee contributions to State or local governmental retirement plans	ecmi tyba DOE	---	0.1	0.3	0.4	0.6	0.7	0.7	0.7	0.7	0.7	4.8
V. Corporate and Partnership Provisions												
1. Modify extraordinary dividend rules for common stock	do/a DOE	---	[7]	[7]	[7]	[7]	[7]	[7]	[7]	[7]	[7]	[6]
2. Reduce tax-indifferent shareholder's basis in stock by nontaxed portion of extraordinary dividend	do/a DOE	---	[6]	[6]	[6]	[6]	[6]	[6]	[6]	[6]	[6]	0.2
3. Modify active business and control requirements for section 355 corporate divisions	do/a DOE	---	[6]	[6]	[6]	[6]	[6]	[6]	[6]	[6]	[6]	0.3
4. Modify application of unrelated business income tax to S corporation shareholders	tyba DOE	---	[7]	[7]	[7]	[7]	[7]	[7]	[7]	[7]	[6]	[6]
5. Modify safe harbor for allocation of nonrecourse deductions and exclude nonrecourse liabilities from outside basis	[11]	---	0.2	0.4	0.4	0.3	0.3	0.2	0.1	0.1	0.1	2.2
6. Modify adjustment rules for basis of undistributed partnership property	dma DOE	---	[7]	[7]	[7]	[7]	[7]	[7]	[7]	[7]	[7]	[6]
7. Treat guaranteed payments to partners as payments to nonpartners	tyba DOE	---	0.3	0.2	[7]	[7]	[7]	[7]	[7]	[7]	[7]	0.5
VI. International Provisions												
1. Amend the employer-provided housing exclusion and impose a stacking rule with respect to non-excludable income	tyba DOE	---	0.1	0.2	0.2	0.2	0.2	0.3	0.3	0.3	0.3	2.2
2. Amend rules for determining corporate residency	2ya DOE	---	[6]	[6]	[6]	[6]	0.1	0.1	0.1	0.2	0.2	0.9

Provision	Effective	2005	2006	2007	2008	2009	2010	2011	2012	2013	2014	2005-14
3. Modify entity classification rules to reduce opportunities for tax avoidance	[12]	---	[6]	0.1	0.1	0.1	0.1	0.2	0.2	0.2	0.2	1.2
4. Adopt a dividend exemption system for foreign business income	[13]	---	2.7	5.3	5.6	5.8	6.4	6.7	7.1	7.4	7.8	54.8
VII. Other Business Provisions												
1. Disallow deduction for interest on indebtedness allocable to tax-exempt obligations	tybo/a DOE	---	[6]	[6]	[6]	0.1	0.1	0.1	0.1	0.1	0.1	0.7
2. Modify recapture of section 197 amortization	dopa DOE	---	[6]	[6]	[6]	[6]	[6]	[6]	[6]	[6]	[6]	0.2
3. Modify application of income forecast method of depreciation	ppisa DOE	---	[6]	[6]	[6]	[6]	[6]	[6]	[6]	[6]	[6]	0.1
4. Apply luxury automobile limitations to sport utility vehicles	ppisa DOE	---	0.1	0.1	0.2	0.2	0.1	0.1	0.1	0.1	0.1	1.1
5. Disallow deduction for interest on debt allocable to tax-exempt income of insurance companies	iao/a DOE	---	[6]	[6]	0.1	0.1	0.1	0.2	0.2	0.2	0.2	1.2
6. Eliminate double deduction of mining exploration and development costs under the minimum tax	tyba DOE	---	[6]	[6]	[6]	[6]	[6]	[6]	[6]	[6]	[6]	0.3
VIII. Exempt Organizations												
1. Require five-year review of exempt status of public charities and private foundations and annual notice by organizations not required to file information returns	[14]	---	[10]	[10]	[10]	[7]	[7]	[7]	[7]	[7]	[7]	[6]
2. Impose termination tax on conversions of assets of charities	loctoa DOE	---	[7]	[7]	[7]	[7]	[7]	[7]	[7]	[7]	[7]	[6]
3. Tax involvement by exempt organizations in tax-shelter transactions	[15]	---	[6]	[6]	[6]	[6]	[6]	[6]	[6]	[6]	[6]	0.4
4. Reform intermediate sanctions and extend certain reforms to private foundations	tyba DOE	---	[7]	[7]	[7]	[7]	[6]	[6]	[6]	[6]	[6]	0.2
5. Increase the amount of excise taxes imposed on public charities, social welfare organizations, and private foundations	tyba DOE	---	[7]	[7]	[7]	[7]	[7]	[7]	[7]	[7]	[7]	[6]
6. Modify charitable deduction for contributions of conservation and façade easements	cmi tyba DOE	---	[6]	0.1	0.1	0.1	0.1	0.1	0.1	0.1	0.1	1.0
7. Limit charitable deduction for contributions of clothing and household items	cmi tyba DOE	---	0.1	0.2	0.2	0.2	0.2	0.2	0.2	0.2	0.2	1.9
8. Reform rules for charitable contributions of property	cmi tyba DOE	---	0.1	0.3	0.3	0.3	0.3	0.3	0.3	0.3	0.3	2.5
9. Require public disclosure of Form 990-T and related certification requirements	rfa DOE	---	[7]	[7]	[7]	[7]	[7]	[7]	[7]	[7]	[7]	[6]
10. Expand the base of the tax on private foundation net investment income	tyba DOE	---	[6]	[6]	[6]	[6]	[6]	[6]	[6]	[6]	[6]	0.2
11. Limit tax-exempt status of fraternal beneficiary societies that provide commercial-type insurance	tyba DOE	---	[6]	0.1	0.1	0.1	0.1	0.1	0.1	0.1	0.1	0.5

Provision	Effective	2005	2006	2007	2008	2009	2010	2011	2012	2013	2014	2005-14
12. Establish additional exemption standards for credit counseling organizations	[16]	---	[10]	[10]	[7]	[7]	[7]	[7]	[7]	[7]	[7]	0.1
IX. Tax-Exempt Bond Provisions												
1. Impose loan and redemption requirements on pooled financing bonds	bia DOE	---	[6]	[6]	[6]	[6]	0.1	0.1	0.1	0.1	0.1	0.5
2. Amend information reporting requirements to include interest on tax-exempt bonds	bia DOE	---	[6]	[6]	[6]	[6]	[6]	[6]	[6]	[6]	[6]	[6]
3. Clarify limitations on Indian tribes' use of tax-exempt bond proceeds	bia DOE	---	[6]	[6]	[6]	[6]	[6]	[6]	[6]	[6]	[6]	0.1
4. Eliminate private payment test for stadium bonds	bia DOE	---	[6]	[6]	[6]	0.1	0.1	0.1	0.1	0.1	0.1	0.7
5. Require allocation of volume cap to mortgage credit certificates based on allocation of volume cap to mortgage bonds	[17]	---	[6]	[6]	[6]	[6]	[6]	[6]	[6]	[6]	[6]	0.1
6. Eliminate advance refunding of governmental bonds and 501(c)(3) bonds	aro bia DOE	---	[6]	0.1	0.3	0.6	1.0	1.4	1.9	2.3	2.8	10.5
X. Excise Taxes												
1. Modify the Federal excise tax on communications services:												
a. Option 1 - Modify the definitions of toll and local telephone services	sra DOE	---	[6]	[6]	[6]	[6]	[6]	[6]	[6]	[6]	[6]	0.1
b. Option 2 - Modernize the excise tax on voice communications services	[18]	---	[6]	0.1	0.1	0.2	0.2	0.3	0.3	0.4	0.5	2.0
c. Option 3 - Expand the tax base to all voice and data communications	[18]	---	0.8	1.1	1.1	1.2	1.3	1.3	1.4	1.5	1.5	11.2
2. Equalize alcohol excise taxes	[19]	---					*Revenue Neutral*					
3. Subject international flights with wholly domestic segments to the segments tax	[20]	---	[6]	[6]	[6]	0.1	0.1	0.1	0.1	0.1	0.1	0.5
4. Modify the Federal excise tax on sport fishing equipment	[21]	---					*Revenue Neutral*					
XI. Estate and Gift Taxation												
1. Limit perpetual dynasty trusts	tma DOE	---	[7]	[7]	[7]	[7]	[6]	[6]	[6]	[6]	[6]	0.3
2. Determine certain valuation discounts more accurately for Federal estate and gift tax purposes	[22]	---	0.4	0.4	0.4	0.4	0.3	[6]	0.5	0.6	0.6	3.6
3. Curtail the use of lapsing trust powers to inflate the gift tax annual exclusion amount:												
a. Option 1 - Disregard Crummey powers held by non-beneficiaries	tma DOE	---	[7]	[7]	[7]	[7]	[7]	[6]	[6]	[6]	[6]	0.2
b. Option 2 - Disregard all Crummey powers	tmttea DOE	---	0.1	0.1	0.1	0.1	0.1	0.1	0.1	0.1	0.1	0.7
c. Option 3 - Disregard Crummey powers lacking substance	tmttea DOE	---	[7]	[7]	[7]	[7]	[7]	[6]	[6]	[6]	[6]	0.2
4. Provide reporting for a consistent basis between the estate tax valuation and the basis in the hands of the heir	[23]	---	[7]	[7]	[7]	[7]	[7]	[7]	[7]	[7]	[7]	[6]

Provision	Effective	2005	2006	2007	2008	2009	2010	2011	2012	2013	2014	2005-14
5. Modify transfer tax provisions applicable to section 529 qualified tuition accounts	ci tyba DOE	---	[7]	[7]	[7]	[7]	[7]	[7]	[7]	[7]	[7]	0.1

Joint Committee on Taxation

NOTE: Details may not add to totals due to rounding. Date of enactment is assumed to be October 1, 2005.

Legend for "Effective" column:

aro = advance refunding of
bia = bonds issued after
ci = contributions in
cmi = contributions made in
cyba = calendar years beginning after
di = distributions in
dma = distributions made after
DOE = date of enactment
do/a = distributions on or after
dopa = dispositions of property after
ecmi = employee contributions made in
eia = expenses incurred after
epoii = expenses paid or incurred in
iao/a = investments acquired on or after
ipodia = interest paid on debt incurred after
loctoa = liquidations or conversion transactions occurring after
pma = payments made after
ppisa = property placed in service after
pyba = plan years beginning after
rfa = returns filed after
sipfspi = sales incentive payments for services performed in
sra = services rendered after
teio/a = transactions entered into on or after
tmo/a = transfers made on or after
to/a = transfers on or after
topma = transfers of property made after
tma = transfers made after
tmttea = transfers made to trusts established after
tyba = taxable years beginning after
tybo/a = taxable years beginning on or after
wfspi = wages for services performed in
2ya = 2 years after

[1] Estimates are based on the Congressional Budget Office's 2004 baseline, which represents the fiscal year 2005-2014 budget period, and would change if estimated against the new baseline and new budget period. Estimates do not include potential interaction effects among the proposals.
[2] Effective for payments made after the first December 31st that is at least six months after the date of enactment.
[3] Effective for offers-in-compromise submitted to the IRS after 60 days after the date of enactment.
[4] Estimate assumes understatement penalty provisions similar to section 404 of the Senate Amendment to H.R. 4520 (108th Cong.). See H.R. Rep. 108-755, 108th Cong. 2d Sess. (2004) at 670-71.
[5] Because of the unique nature of present law with respect to education tax benefits, the proposal is revenue neutral under a different set of baseline assumptions as described under the proposal. The proposal would not be revenue neutral if scored relative to present law.
[6] Gain of less than $50 million.
[7] Gain of less than $10 million.
[8] The proposal relating to codification of the regulations is effective on the date of enactment. The proposal relating to the application of an annual dollar limit on the student exception is effective with respect to wages for services performed in calendar years beginning after the date of enactment.
[9] Effective for taxable years of partners or S corporation shareholders beginning after the date of enactment.
[10] Gain of less than $1 million.
[11] Modified safe harbor provision is effective for partnership taxable years beginning after the date of enactment. Exclusion of nonrecourse liabilities from outside basis is effective for nonrecourse liabilities incurred after the date of enactment.
[12] Effective for taxable years beginning one year or more after the date of enactment.
[13] Generally effective for taxable years of foreign corporations beginning after the date of enactment, and for taxable years of U.S. shareholders with or within which such taxable years of such foreign corporations end. The rules dealing with foreign branches are effective for taxable years of U.S. corporations beginning after the date of enactment.
[14] The five-year review is effective for organizations receiving favorable exempt status determinations within 10 years prior to the date of enactment and for organizations receiving favorable exempt status determinations on or after the date of enactment. The annual notice to small organizations not filing information returns is effective for notices with respect to annual periods beginning after the date of enactment.

[Footnotes for the Table are continued on the following page]

Footnotes for the Table continued:

[15] Generally effective for transactions that are prohibited after the date of enactment, except that no tax applies with respect to income that is properly allocable to the period ending on the date that is 90 days after the date of enactment.
[16] Effective for taxable years beginning after date of enactment, regardless of when the organization was formed or received a determination letter that it was an exempt organization.
[17] Effective for allocations to issue qualified mortgage bonds and mortgage certificates in the first calendar year beginning at least six months after the date of enactment.
[18] Effective for services rendered on or after the first day of the first calendar quarter beginning 60 days after the date of enactment.
[19] Effective on the first day of the first quarter beginning 60 days after the date of enactment.
[20] Effective for transportation beginning on or after the first day of the first quarter beginning 60 days after the date of enactment.
[21] Effective for articles sold by the manufacturer, producer, or importer on or after the first day of the first calendar quarter beginning 60 days after the date of enactment.
[22] Effective for transfers occurring and estates of decedents dying on or after the date of enactment.
[23] Effective for transfers from estates for which the estate tax return is filed after the date of enactment.