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TECHNICAL EXPLANATION

OF THE

SENATE FINANCE COMMITTEE AMENDMENT TO H.R. 4210, WITH MINORITY VIEWS

FAMILY TAX FAIRNESS, ECONOMIC GROWTH, AND HEALTH CARE ACCESS ACT OF 1992

COMMITTEE ON FINANCE
UNITED STATES SENATE

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INTRODUCTION

This document provides a technical explanation of the provisions of the Senate Committee on Finance amendment to H.R. 4210. The committee amendment (referred to in the explanation as "the bill") is a substitute for the provisions of H.R. 4210 as passed by the House of Representatives.

The Committee on Finance approved the provisions ("Family Tax Fairness, Economic Growth, and Health Care Access Act of 1992") on March 3, 1992, and ordered the bill reported as amended.

This explanation of the provisions is intended to be the legislative history of the committee-reported bill, and it is the Committee on Finance's official explanation of the reported bill.

I. LEGISLATIVE BACKGROUND

Background on the Committee Amendment to H.R. 4210

The committee amendment ("Family Tax Fairness, Economic Growth, and Health Care Access Act of 1992") was approved by the Committee on Finance on March 3, 1992. The amendment (hereinafter referred to as "the bill") is in the nature of a substitute to H.R. 4210 as passed by the House on February 27, 1992. The tax provisions are in response to the President's request in the January 28, 1992, State of the Union Address for prompt action (by March 20, 1992) on tax incentive proposals to stimulate the economy. On February 6, 1992, the President presented health care proposals to the Congress.

The provisions of the committee-reported bill are divided into five titles:

Title I—Fair Tax Treatment of Working Families;
Title II—Promotion of Long-Term Economic Growth;
Title III—Higher-Income Taxpayers Pay Fair Share;
Title IV—Simplification Provisions; and
Title V—Taxpayer Bill of Rights.

Hearings

The Committee on Finance and its Subcommittees held several public hearings during the 102nd Congress (1991 and 1992) related to the provisions included in the committee-reported bill.

Committee hearings

The Committee on Finance held a hearing on middle-income tax relief and economic growth on November 26, 1991. The committee held hearings on the President's Fiscal Year 1993 Budget and related tax proposals on February 12–13, and 19, 1992. The committee held a hearing on the Fiscal Year 1993 Budget on health care on February 18, 1992, and a hearing on S. 1872 (health care reform) on February 20, 1992.

The committee held a hearing on S. 612 ("Savings and Investment Incentive Act of 1991," relating to IRAs) on May 16, 1991.

Subcommittee hearings

The Subcommittee on Taxation held a hearing on June 12, 1991, on S. 90 (tax-exempt bonds for infrastructure activities), S. 150 (tax-exempt bonds for higher education activities), S. 649 (repeal of luxury excise tax on boats), and S. 913 (tax-exempt bond simplification provisions). The Subcommittee on Taxation also held a hearing on the alternative minimum tax (AMT) on February 19, 1992.

The Subcommittee on Energy and Agricultural Taxation held hearings on June 13–14, 1991, on proposals relating to renewable energy and energy conservation tax incentives: S. 26 and S. 129 (ex-

clusion for certain employer-provided transportation); S. 141, S. 466, S. 661, and S. 731 (extension of business energy tax credits); and S. 326 (employer deduction for employee parking).

The Subcommittee on Medicare and Long-Term Care held a hearing on September 25, 1991, on retired miners' health benefits.

The Subcommittee on Private Retirement Plans and Oversight of the Internal Revenue Service held a hearing on September 27, 1991, on S. 1364 ("Employee Benefits Simplification and Expansion Act of 1991") and S. 318 ("PRIME Retirement Account Act of 1991"). This subcommittee also held a hearing on "Taxpayer Bill of Rights 2" on February 21, 1992. The Taxpayer Bill of Rights 2 was introduced in S. 2239.

II. EXPLANATION OF PROVISIONS

TITLE I — FAIR TAX TREATMENT OF WORKING FAMILIES

1. Tax Credit for Taxpayers with Children under Age 16 (sec. 1001 of the bill and new sec. 25A of the Code)

Present Law

Present law provides no income tax credit to taxpayers on the basis of whether taxpayers have a child residing with them. However, present law permits a personal exemption deduction from gross income for each of the taxpayer's dependent children. For 1992, the amount of this deduction is $2,300 for each exemption claimed. This exemption amount is adjusted annually for inflation.

In addition, low-income workers with children are able to claim a refundable earned income tax credit (EITC) of up to 17.6 percent (18.4 percent for taxpayers with more than one qualifying child) of the first $7,520 of earned income for 1992. The maximum amount of credit for 1992 is $1,324 ($1,384 for taxpayers with more than one qualifying child). This maximum credit is reduced by 12.57 percent (13.14 percent for taxpayers with more than one qualifying child) of earned income (or adjusted gross income, if greater) in excess of $11,840. The EITC is totally phased out for workers with earned income (or adjusted gross income, if greater) over $22,370. The maximum amount of earned income on which the EITC may be claimed and the income threshold for the phaseout of the EITC are indexed for inflation. Earned income consists of wages, salaries, other employee compensation, and net self-employment income.

The credit rates for the EITC change over time under present law, as shown in the following table.

Year	One qualifying child—		Two or more qualifying children	
	Credit rate	Phaseout rate	Credit rate	Phaseout rate
1993	18.5	13.21	19.5	13.93
1994 and after	23.0	16.43	25.0	17.86

Reasons for Change

The committee believes that middle-income taxpayers with children have borne increasingly larger tax burdens over the past two decades. An appropriate means to address this inequity is an income tax reduction in the form of a tax credit for middle-income

families with children. The credit amount should be adjusted for inflation so that the value for the credit in terms of purchasing power does not decline over time. The credit should be targeted toward middle-income taxpayers and not be available to taxpayers with higher incomes.

Explanation of Provision

The bill provides a $300 income tax credit for each qualifying child of the taxpayer. A "qualifying child" would be defined as a child under age 16 who resided with the taxpayer for more than 6 months during the taxable year. The tax credit offsets regular tax liability and is not refundable (though through the offset of tax liability, the tax credit could act to increase the amount of refund from the earned income tax credit that a taxpayer might receive). The credit amount is indexed annually for inflation. In addition, the credit is phased out ratably for higher-income taxpayers with adjusted gross income between $50,000 and $70,000.

Effective Date

The provision is effective for taxable years beginning after December 31, 1991.

2. Simplification and Expansion of Earned Income Tax Credit (sec. 1002 of the bill and sec. 32 of the Code)

Present Law

Eligible low-income workers are able to claim a refundable earned income tax credit (EITC) of up to 17.6 percent (18.4 percent for taxpayers with more than one qualifying child) of the first $7,520 of earned income for 1992. The maximum amount of credit for 1992 is $1,324 ($1,384 for taxpayers with more than one qualifying child). This maximum credit is reduced by 12.57 percent (13.14 percent for taxpayers with more than one qualifying child) of earned income (or adjusted gross income, if greater) in excess of $11,840. The EITC is totally phased out for workers with earned income (or adjusted gross income, if greater) over $22,370. The maximum amount of earned income on which the EITC may be claimed and the income threshold for the phaseout of the EITC are indexed for inflation. Earned income consists of wages, salaries, other employee compensation, and net self-employment income.

The credit rates for the EITC change over time under present law, as shown in the following table.

Year	One qualifying child—		Two or more qualifying childern—	
	Credit rate	Phaseout rate	Credit rate	Phaseout rate
1992	17.6	12.57	18.4	13.14
1993	18.5	13.21	19.5	13.93
1994 and after	23.0	16.43	25.0	17.86

A supplemental young child credit is available to taxpayers with qualifying children under the age of one year. This young child credit rate is 5 percent and the phase-out rate is 3.57 percent. It is computed on the same income base as the ordinary EITC. The maximum supplemental young child credit for 1992 is $376. If a taxpayer claims the supplemental young child credit, the child that qualifies the taxpayer for such credit is not a qualifying individual for purposes of the dependent care tax credit (sec. 21).

A supplemental health insurance credit is available to taxpayers who provide health insurance coverage for their qualifying children. This health insurance credit rate is 6 percent and the phase-out rate is 4.285 percent. It is computed on the same income base as the ordinary EITC, but the credit claimed cannot exceed the out-of-pocket cost of the health insurance coverage. In addition, the taxpayer is denied an itemized deduction for medical expenses of qualifying insurance coverage up to the amount of credit claimed. The maximum supplemental health insurance credit for 1992 is $451.

Reasons for Change

Providing a higher basic EITC credit rate to taxpayers with two or more qualifying children recognizes the equity of providing larger tax benefits to those with a lesser ability to pay taxes. A larger gap between the two basic credit rates than currently exists is appropriate in light of the larger financial resources necessary to maintain larger families.

The committee recognizes the complexity faced by taxpayers in claiming the present law EITC. Repeal of the rules regarding interactions between the supplemental health insurance credit and deductions for medical expenses should lessen the compliance burden for taxpayers claiming the EITC.

Explanation of Provision

The bill increases the basic EITC rate for taxpayers with two or more qualifying children as shown in the following table.

Year	One qualifying child—		Two or more qualifying children—	
	Credit rate	Phaseout rate	Credit rate	Phaseout rate
1992	17.6	12.57	20.15	14.39
1993	18.5	13.21	21.25	15.17
1994 and after	23.0	16.43	26.75	19.10

The bill permits taxpayers to include all health insurance expenses as medical expenses, subject to the 7.5 percent of adjusted gross income floor on deductible medical expenses, regardless of whether these expenses had been used to claim the health insurance component of the EITC. The bill also permits a self-employed taxpayer to claim the allowable deduction for health insurance

costs and to use the full amount of these expenses that are related to coverage of dependent children to claim the health insurance component of the EITC.

The bill also repeals the supplemental young child credit.

Effective Date

The provision is effective for taxable years beginning after December 31, 1991.

3. Extension of Targeted Jobs Tax Credit (sec. 1003 of the bill and sec. 51 of the Code)

Present Law

Tax credit

The targeted jobs tax credit is available on an elective basis for hiring individuals from several targeted groups. The targeted groups consist of individuals who are either recipients of payments under means-tested transfer programs, economically disadvantaged, or disabled.

The credit generally is equal to 40 percent of up to $6,000 of qualified first-year wages paid to a member of a targeted group. Thus, the maximum credit generally is $2,400 per individual. With respect to economically disadvantaged summer youth employees, however, the credit is equal to 40 percent of up to $3,000 of wages, for a maximum credit of $1,200.

The credit is scheduled to expire for wages paid to individuals who begin work for an employer after June 30, 1992.

Authorization of appropriations

Present law authorizes appropriations for administration and publicity expenses relating to the credit through June 30, 1992. These monies are to be used by the Internal Revenue Service and the Department of Labor to inform employers of the credit program.

Reasons for Change

The committee believes that the targeted jobs tax credit provides a useful incentive for hiring disadvantaged individuals.

Explanation of Provision

The bill extends the targeted jobs tax credit and the authorization for appropriations for 18 months, through December 31, 1993.

Effective Date

The provision is effective on the date of enactment.

TITLE II—PROMOTION OF LONG-TERM ECONOMIC GROWTH

Subtitle A—Increased Savings: Individual Retirement Arrangements (IRAs) (secs. 2001–2022 of the bill; secs. 72, 219, 401(k), and 403(b) of the Code; and new sec. 408A of the Code)

Present Law

Under present law, certain individuals are allowed to deduct contributions (up to the lesser of $2,000 or 100 percent of the individual's compensation or earned income) to an individual retirement arrangement (IRA). The amounts held in an IRA, including earnings on contributions, generally are not included in taxable income until withdrawn.

The $2,000 deduction limit is phased out over certain adjusted gross income (AGI) levels ($25,000 for individuals, $40,000 for joint filers) if the individual or the individual's spouse is an active participant in an employer-sponsored retirement plan. An individual may make nondeductible IRA contributions (up to the $2,000 or 100 percent of compensation limit) to the extent the individual is not permitted to make deductible IRA contributions.

Reasons For Change

The committee is concerned about the national saving rate, and believes that individuals should be encouraged to save. The committee believes that the ability to make deductible contributions to an IRA is a significant savings incentive. Under present law, however, this incentive is not available to all taxpayers. Further, the present-law income thresholds for IRA deductions are not indexed for inflation, so that fewer Americans will be eligible to make a deductible IRA contribution each year, and the amount of the maximum contribution is declining in real terms over time.

The committee believes it is appropriate to encourage individual saving by making an IRA deduction available to all taxpayers. Expanding the IRA deduction will provide all Americans with a meaningful incentive to save for their retirement years. Appropriate limits for taxpayers with other elective tax-favored savings vehicles will ensure that tax benefits are distributed among individuals more evenly.

The committee is also concerned that Americans are not saving enough to ensure that their children will be able to afford a college education. College costs have risen dramatically over the past two decades. The ability to obtain a college education is an important factor in ensuring that the United States remains competitive with other nations. Home ownership among young individuals has also decreased. In addition, medical costs have continued to increase at a rate faster than inflation. Accordingly, the committee believes that there should be appropriate incentives to save for education, home ownership, and large medical expenses, and that taxpayers should be able to use without penalty amounts saved in an IRA for such purposes.

The committee also believes that some individuals would be more likely to save if funds set aside in a tax-favored account could be

withdrawn without tax after a reasonable holding period. The committee believes that an account to which contributions are nondeductible but withdrawals from which are tax free will provide taxpayers with an alternative savings vehicle that some taxpayers may find more suitable for their savings needs.

Explanation of Provision

The bill restores the deductibility of IRA contributions for all taxpayers under the rules in effect prior to the Tax Reform Act of 1986 and provides for the indexing of the limits on contributions to IRAs, in increments of $500.

In addition, the bill permits nondeductible contributions to new special IRAs. Withdrawals from a special IRA are not includible in income if attributable to contributions that have been held by the special IRA for at least 5 years. The limits on contributions to deductible IRAs and special IRAs are coordinated. Furthermore, the limit on contributions to deductible IRAs and special IRAs is coordinated with the limit on elective deferrals to a qualified cash or deferred arrangement (sec. 401(k) plan), tax-sheltered annuity (sec. 403(b) annuity), simplified employee pension (SEP), or a section 501(c)(18) plan. Thus, for example, in no case can the sum of contributions (deductible and nondeductible) to an IRA, contributions to a special IRA, and elective contributions to a 401(k) plan exceed the limit on elective deferrals ($8,728 in 1992).

The bill permits transfers from deductible IRAs to special IRAs without imposition of the 10-percent tax on early withdrawals. The amount transferred to a special IRA generally is includible in income in the year withdrawn. However, in the case of a transfer before January 1, 1994, the transferred amount is includible in income ratably over a 4-taxable year period.

The bill allows withdrawals from an IRA and from amounts attributable to elective deferrals under (1) a section 401(k) plan, (2) a tax-sheltered annuity (sec. 403(b) annuity), or (3) a section 501(c)(18) plan without imposition of the 10-percent additional income tax on early withdrawals to the extent the amount withdrawn is used to pay qualified acquisition, construction, or reconstruction costs with respect to a principal residence of a first-time homebuyer who is the taxpayer, the taxpayer's spouse, or the taxpayer's child or grandchild. A first-time homebuyer is any individual (and if married, such individual's spouse) who had no present interest in a principal residence during the 2-year period prior to the purchase of a home.

The waiver of the 10-percent additional tax on early withdrawals also applies to the extent distributions do not exceed qualified higher education expenses. Qualified higher educational expenses means tuition, fees, books, supplies, and equipment required for the enrollment of or attendance of the taxpayer, the taxpayer's spouse, or the taxpayer's child or grandchild at a college, university, or post-secondary vocational school. The amount of qualified higher educational expenses for any taxable year is reduced by any amount excludable from gross income under the provision in the Code pertaining to U.S. education savings bonds.

The bill extends to IRAs the present-law exception to the 10-percent additional income tax for distributions from qualified retirement plans used to pay deductible medical expenses. For purposes of the medical expense exception (with regard to both IRAs and qualified retirement plans), a child, grandchild, or ancestor of the taxpayer is treated as a dependent of the taxpayer in determining whether medical expenses are deductible.

Finally, the bill provides that the present-law rule permitting penalty-free IRA withdrawals after an individual reaches 59½ would not apply in the case of amounts attributable to contributions made during the previous 5 years. Thus, contributions to a deductible IRA generally must remain in the account for at least 5 years to avoid withdrawal penalties. This restriction only applies to contributions (and earnings allocated thereto) that are made after December 31, 1992. Moreover, for purposes of applying the rule, distributions are treated as having been made first from the earliest contributions (and earnings) remaining in the account, and then from other contributions in the order in which made.

Effective Date

The bill generally applies to taxable years beginning after December 31, 1992. However, the provision permitting penalty-free withdrawals for qualified purposes is effective for taxable years beginning after December 31, 1991. In addition, the provision permitting transfers from deductible IRAs to special IRAs is effective for taxable years beginning after December 31, 1991. Thus, special IRAs can be established and maintained in taxable years beginning before January 1, 1993, only with funds transferred from a deductible IRA.

Subtitle B—Improved Educational Opportunities

Part I. Income Dependent Education Assistance: Self-Reliance Loans (secs. 2101 and 2102 of the bill; new sec. 59E of the Code; and Part D of Title IV of the Higher Education Act (20 U.S.C. 1087 et seq.))

Present Law

The Department of Education subsidizes student loans under the Guaranteed Student Loan (GSL) and Parent Loans to Undergraduate Students (PLUS) programs. These loan programs generally are available for certain postsecondary educational expenses, regardless of a student's financial need. The subsidies provided under the GSL and PLUS programs generally take three forms. First, the Department of Education guarantees repayment of qualified student loans made by banks. Second, the Department pays special allowance payments as an interest subsidy on qualifying student loans so that student borrowers are required to pay less interest on the loans. Third, with so-called "Stafford" loans, the Department of

Education pays an additional interest subsidy on qualified loans while the student is attending school.[1]

In addition, through the National Direct Student Loan (NDSL) program, the Federal government has made available revolving, direct-loan funds at certain participating educational institutions.[2] Such loans (commonly referred to as "Perkins loans") are available only to low-income students with significant demonstrated financial need. The schools participating in the NDSL program are responsible for collecting amounts due from student borrowers.

Federal agencies are authorized to notify the IRS that a person owes a past-due, legally enforceable debt (such as a delinquent student loan) to that agency. The IRS then is required to reduce the amount of any Federal tax refund due such person by the amount of the debt and pay that amount to the agency. The refund offset program applies with respect to debts of individuals and corporations (sec. 6402(d)).

Reasons for Change

The committee believes that the Income-Dependent Education Assistance program offers a more flexible means of financing education expenses. Because the repayment schedule is based on the income of the borrower, the program will accommodate changes in the borrower's ability to make repayments.

Explanation of Provision

In general

The bill creates a program ("Income-Dependent Education Assistance") of direct loans ("Self-Reliance Loans") for higher education expenses. The Secretary of Education will make payments to participating institutions on the basis of estimated borrowing needs of the students at such institution. Eligible students who borrow funds under the program will have an account established with the Secretary of Education to record interest on and repayment of the Self-Reliance Loans. Such borrowers will make income-dependent repayment installments through the income tax system by means of a specially computed addition to tax that generally represents principal and interest on the loan.

Eligible students

Eligible students are United States citizens at least 17 years old, but not yet 51 years old, who are enrolled at a participating institution (which are selected by the Secretary of Education). Eligible students are able to receive Self-Reliance Loans without regard to financial need. Notwithstanding any other provision of law, an eligible student may not receive a Self-Reliance Loan in any fiscal

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[1] In the case of Supplemental Loans for Students ("SLS" loans) there is no in-school interest subsidy provided by the Federal government. SLS loans are available only to independent students.

Stafford loans generally are limited to $3,500 for freshmen and sophomores, $5,500 for juniors and seniors, with a total undergraduate cap of $23,000. SLS loans generally are limited to $4,000 for freshmen and sophomores, $5,000 for juniors and seniors, with a total undergraduate cap of $23,000.

[2] Currently, a total lending pool of about $850 million is available at over 3300 participating schools.

year unless such student's eligibility for assistance under section 428 and subpart 1 of part A of the Higher Education Act has been assessed.

Limits on amounts borrowed

In general

The maximum amount of Self-Reliance Loans that may be borrowed by a student in his or her lifetime is $30,000, with no more than $25,000 of that amount for undergraduate education. A student may receive Self-Reliance Loans in the amount of no more than $5,000 per fiscal year in the case of an undergraduate student and no more than $15,000 per fiscal year in the case of a graduate student.

Coordination with other Federal loan programs

The combined maximum amount of loans a student may borrow under the Income-Dependent Education Assistance program, Part B (Stafford and Perkins loans), and Part E (Supplemental Loans for Students) of the Higher Education Act of 1965 may not exceed $52,000 for a dependent undergraduate, $62,000 for an independent undergraduate [3] who borrows at least $10,000 in Self-Reliance Loans, and $115,000 for a graduate student.

Limit by cost of attendance

In any fiscal year, a student may not receive Self-Reliance Loans in an amount greater than such student's cost of attendance [4] at a postsecondary school [5] less any other Federal educational financial assistance received by such student.

Interest rate on loans

The interest rate on a Self-Reliance Loan is established at the time of issuance and is equal to the average market yield on the 10-year and 30-year Treasury bonds. The Secretary of Education will establish the interest rate on Self-Reliance Loans at the same time (and with the same frequency) as is done for the Supplemental Loans for Students program.[6]

Repayment procedure

In general

Repayment on an individual's Self-Reliance Loan obligations is collected through the individual income tax. For a taxpayer in repayment status, the taxpayer's income tax liability generally is increased by the applicable Self-Reliance Loan repayment rate multi-

[3] As determined in section 428A of the Higher Education Act of 1965.

[4] As defined in section 472 of the Higher Education Act of 1965 (generally, tuition, fees, room and board, and related expenses).

[5] As defined in section 481(a) of the Higher Education Act of 1965.

[6] If, during a continuous period of study, the student incurs multiple Self-Reliance loan obligations bearing different interest rates, the Secretary of Education will provide for a consolidation of the loan obligations into one loan bearing an interest rate that is the weighted average of the interest rates on the multiple loan obligations.

plied by the taxpayer's adjusted gross income (AGI).[7] The repayment installments are treated as a tax imposed by section 1 of the Code except for purposes of determining the amount of any tax credit or the amount of minimum tax.

The applicable repayment rate for a loan obligation is fixed at the time the taxpayer first enters repayment status and depends upon the taxpayer's amount of outstanding Self-Reliance Loan indebtedness.[8] Students with "high" indebtedness (as determined by the Secretary of Education) will have a repayment rate of 7 percent. Students with "moderate" indebtedness will choose between a repayment rate of 5 percent or 7 percent. Students with "low" indebtedness will choose among a repayment rate of 3 percent, 5 percent, or 7 percent. The Secretary of Education will make the determination of "low" and "moderate" indebtedness ranges so that the average borrower in each indebtedness status will be projected to repay the Self-Reliance Loan over a similar number of years as the average borrower with "high" indebtedness status.

With respect to any Self-Reliance Loan, the borrower enters repayment status in the first taxable year following the taxable year in which the borrower ceases (after the loan was incurred) to be at least a half-time student. The borrower remains in repayment status until the loan obligation is repaid or, if earlier, the end of the 25th taxable year after entering repayment status.

A borrower may prepay all or part of a Self-Reliance Loan without penalty.

Repayment tax payments received on or before the due date (without regard to any extension) for filing of the income tax return for a given taxable year are credited to the taxpayer's Self-Reliance Loan account as if received on the last day of the previous taxable year. Repayment tax payments received after the due date (without regard to any extension) for filing of the income tax return for a given taxable year are credited to the taxpayer's Self-Reliance Loan account as if received on the last day of the following taxable year.

Exception for borrowers not required to file a tax return

No repayment of a Self-Reliance Loan is required in any year in which the borrower is not required to file an income tax return.

Discharge of liability of the borrower

In general.—The Secretary of Education will discharge the liability to repay a Self-Reliance Loan in the event of the death or total permanent disability of a borrower. If a loan were discharged because of expiration of the 25-year repayment status period, the bor-

[7] In the case of a married individual whose spouse has not received a Self-Reliance Loan and who files a joint return, the income tax liability on the joint return is increased by the individual's repayment rate multiplied by the AGI on the joint return. In the case of a married individual whose spouse has not received a Self-Reliance Loan and who files a separate return, such individual's income tax liability is increased by the individual's repayment rate multiplied by the sum of the AGI of that individual and the AGI of the individual's spouse (from the spouse's separate return).

[8] If the taxpayer in repayment status later takes out another Self-Reliance loan, the repayment rate may be changed to reflect the new, larger amount of outstanding Self-Reliance Loan indebtedness.

rower (or his or her estate) is not considered to have discharge of indebtedness income.

Bankruptcy.—A Self-Reliance Loan will not be dischargeable in bankruptcy. The Secretary of Treasury, however, may postpone payment on past-due amounts owed by bankrupt individuals.

Delinquent taxpayers

Borrowers who are delinquent in repaying their Self-Reliance Loan and who subsequently make interest payments to the Secretary of the Treasury on their underpayment are entitled to have interest that is properly allocable to such loans credited by the Secretary of Education to their Self-Reliance Loan repayment.

Administration of the loan program

The Secretary of the Treasury will enter into an agreement with the Secretary of Education to process information on repayments and credit such repayments to the Department of Education.

The Secretary of the Treasury will make appropriate provisions to require borrowers to make Self-Reliance Loan repayments through payroll withholding and estimated tax payments to the extent practicable and will determine the liability of borrowers for incorrect withholding according to rules on estimated tax payments.

The Secretary of Education will develop a central data system to administer the Income-Dependent Education Assistance program. Such data system will provide borrowers with information on their Self-Reliance Loan balance and on prepayment options, on at least an annual basis.

Not later than January 1 of each year, the Secretary of Education will certify to the Secretary of the Treasury a list of borrowers in repayment status for that year and such borrowers' repayment rates. The Secretary of the Treasury will report to the Secretary of Education the amount of loan repayment installments made by the borrower.

Not later than January 31 of each calendar year, the Secretary of Education will certify to each borrower the amount of interest and principal paid on such loans for the second preceding calendar year.[9]

Any borrower who receives the certifications described above relating to principal, interest, or balances and who believes such certification contains an error of statement or omission or believes that such certification asserts a debt not owed will be required to notify the Secretary of Education within 60 days of receipt. The Secretary of Education will, within 30 days of receipt of such objection, affirm, adjust, or withdraw such certification and send notice to the borrower and the Secretary of the Treasury. Such decisions will be reviewable by the appropriate district court as a final agency decision.

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[9] Thus, under the provision in section 2121 of the bill that allows a credit or deduction for student loan interest, interest paid on Self-Reliance Loans will be treated as paid in the taxable year beginning in the calendar year following the calendar year in which such interest was paid.

Demonstration program

In general

The Secretary of Education will select institutions of higher education for participation in the Self-Reliance Loan program from those institutions submitting applications that are eligible to participate in part B loan programs. Not later than May 1, 1993, the Secretary will select not more than 500 institutions to participate in the program. The participating institutions will be chosen so as to represent a cross-section by educational sector, length of academic program, default experience, annual loan volume, highest degree offered, enrollment size, and geographic location. The Secretary will also select participating institutions in such a manner that the volume of student borrowing under the demonstration program would not exceed the following amounts: $450,000,000 in fiscal year 1994; $550,000,000 in fiscal year 1995; $650,000,000 in fiscal year 1996; and $900,000,000 in fiscal year 1997.

Each institution wishing to offer an Income-Dependent Education Assistance program is required to submit an application to the Secretary of Education and, if accepted, enter into an agreement with the Secretary of Education for receipt of funds. Each participating school must agree to follow procedures specified by the Secretary of Education in consultation with the Secretary of the Treasury in disbursing such loans; to accept liability stemming from mismanagement of loans or false origination of loans; to provide the Secretary of Education at least once a month with a list of Self-Reliance Loan participants and any change in their enrollment status; and to counsel borrowers on their repayment options and their obligations.

The Secretary of Education has the same authority to limit, suspend, or terminate an institution's participation in the Income-Dependent Education Assistance program as applies to an institution's participation in loan programs under Part B of the Higher Education Act of 1965, and may also impose additional regulations or criteria for participation. The demonstration program concludes at the end of fiscal year 1997.

Administrative costs

There will be available to the Secretaries of Education and the Treasury for administrative costs amounts not to exceed the following:

[In dollars]

Fiscal year	Treasury	Education
1992	0	0
1993	1,000,000	40,000,000
1994	7,500,000	20,000,000
1995	4,500,000	20,000,000
1996	3,600,000	20,000,000
1997	4,000,000	20,000,000

It is expected that if, in a given fiscal year, amounts less than the above maxima are appropriated, the unused balance will be devoted to deficit reduction.

Evaluation and reporting

Beginning one year after enactment, the Secretary of Education, in consultation with the Secretary of the Treasury, will make annual reports to Congress describing and evaluating the implementation and administration of the Income-Dependent Education Assistance program and identifying problems that require legislative action.

Not later than January 1, 1997, the Secretary of Education, in consultation with the Secretary of the Treasury, will make a report to the Senate Committee on Labor and Human Resources and the House Committee on Education and Labor analyzing the administrative capacity of the Departments of Education and of the Treasury to operate this program; the administrative burden and costs imposed on the Departments of Education and of the Treasury by this program; the accuracy of information provided by the Secretary of Education; the administrative and financial factors that would affect the ability of all schools to participate in the program; the impact of this program on repayments, delinquencies and defaults under all federal student loan programs; and any other relevant information. The report will also (1) publish the tuition and cost of attendance at each institution participating in the program and analyze changes in those costs compared to changes occurring at institutions not participating in the program, (2) examine the feasibility of including individuals over age 50 as eligible students and of adjusting repayment rates and schedules to insure such individuals' repayment before retirement, (3) examine the feasibility of integrating the Income-Dependent Education Assistance program with a national service program, and (4) make recommendations for criteria to govern institutional eligibility if the Income-Dependent Education Assistance program were continued or later expanded to all eligible institutions of higher education.

Effective Date

The provision generally is effective on the date of enactment. Amendments made to the Internal Revenue Code are effective for taxable years beginning after December 31, 1992. The first Self-Reliance Loans may be issued on or after September 1, 1993. No Self-Reliance Loans may be issued after September 30, 1997.

Part II—Workforce Training: Formation of, and Contributions to, Tax-Exempt Youth Training Organizations and Establishment of National Board for Professional and Technical Standards (secs. 2111-2116 of the bill, secs. 501 and 170 of the Code, and Titles I and II of the Wagner-Peyser Act (29 U.S.C. 49 et seq.))

Present Law

In order to qualify as a tax-exempt organization under section 501(c)(3) and be eligible to receive tax-deductible contributions, an

organization must be organized and operated exclusively for charitable, educational, or other exempt purposes specified in section 501(c)(3), and no part of the organization's net earnings may inure to the benefit of any private shareholder or individual. Section 501(c) also provides tax-exempt status for other types of organizations (e.g., social welfare organizations and business associations), provided certain requirements are satisfied.

Charitable contributions to organizations described in section 501(c)(3) are allowed as an itemized deduction, subject to certain percentage limitations (sec. 170). In addition, donations to States or political subdivisions are deductible as charitable contributions, provided that the donation is made for exclusively public purposes. Depending on the type of property contributed and the type of the donee organization, the amount of a taxpayer's charitable contribution deduction generally is allowed in an amount up to the contributed property's fair market value. However, special rules provide for an augmented charitable contribution deduction for certain contributions made by corporations of inventory property used for the care of the ill, the needy, or infants, and certain scientific research property donated to educational or scientific organizations (sec. 170(e)(3) and (4)). The deduction allowed for such donations is equal to the corporation's basis in the property plus one-half of the amount of ordinary income that would have been realized if the property had been sold (but in no event may the deduction exceed twice the basis in the contributed property).

Payments made by a taxpayer to a tax-exempt organization are deductible as ordinary and necessary business expenses under section 162, provided that the taxpayer has a reasonable expectation of financial return to his trade or business commensurate with the amount of the transfer. In such a case, a "gift or contribution" has not been made for purposes of section 170.[10]

Reasons for Change

The committee believes it is appropriate to specifically provide tax-exempt status for certain youth skills training and educational programs and to provide for an augmented deduction for contributions made to such programs.

The committee also believes it is appropriate to stimulate the adoption of a voluntary national system of occupational certification by establishing an independent national board to develop a system of industry-based, occupational proficiency standards, and to encourage the formation of youth skills training and education programs by establishing standards for such programs.

Explanation of Provision

Tax-exempt status

The bill specifically provides tax-exempt status for certain youth skills training and education organizations meeting the following requirements: (1) the organization is organized and operated solely for the purpose of administering a program that qualifies as a

[10] See Treas. Reg. sec. 1.170A-1(c)(5); Rev. Rul. 84-110, 1984-2 C.B. 35.

youth skills training and education program under subtitle B of title II of the Wagner-Peyser Act; (2) the organization is controlled by a board of directors consisting of representatives of employers contributing to such program (and certain of their employees),[11] schools and higher education institutions participating in the program, and State and local governments; and (3) the organization does not pay for, and prohibits the use of any contributions it receives for, employment training expenses or compensation for any student participating in the youth skills training and employment program.[12]

Augmented deduction

The bill also provides an augmented deduction for cash contributions made by a corporation or partnership to a tax-exempt youth skills training and education organization.[13] The allowable deduction under the provision is 150 percent of the contributed amount.

National Board for Professional and Technical Standards

The bill amends the Wagner-Peyser Act (29 U.S.C. 49 et seq.) to establish a National Board for Professional and Technical Standards ("National Board"), which will be an independent national board to develop a system of industry-based, occupational proficiency standards and certifications of mastery for occupations within each major industry (and occupations that involve more than one industry), for which no recognized training standards currently exist. The bill specifies criteria for the composition of the membership of the National Board, and requires that the National Board develop proficiency standards, assessments, and curricula for certain industrial or occupational categories. Such proficiency standards, assessments, and curricula will be made available for voluntary use by institutions of postsecondary education offering professional and technical education, labor organizations, trade and technical associations, employers and labor-management organizations providing formalized training, private training providers, and other organizations likely to benefit from such proficiency standards, assessments, and curricula.

Youth Skills Training and Education Programs

The bill also amends subtitle B of title II of the Wagner-Peyser Act to specify the criteria for qualified youth skills training and education programs. In general, a qualified youth skills training program is one that provides eleventh and twelfth grade high school students with the opportunity to voluntarily enter into a course of study that integrates academic instruction with supervised on-the-job training and instruction in the workplace in a curriculum designed to lead to a high school diploma and to qualify

[11] Representatives of employers (and certain of their employees) may not constitute more than 50 percent of the members of the board of directors.

[12] The bill specifically provides tax-exempt status under new section 501(c)(26) of the Internal Revenue Code for qualifying youth skills training and education organizations meeting the requirements of the bill. No inference is intended as to the required characteristics for any tax-exempt educational organization described in present-law section 501(c)(3).

[13] For purposes of this provision, amounts paid by a corporation or partnership to a tax-exempt youth skills training and education organization are treated as a charitable contribution under section 170.

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the student for further education or an advanced technical or professional training program. The program must be certified by a State or local educational agency as meeting the educational standards established and approved by such agency. In addition, the program must be certified by a State agency responsible for occupational training as meeting certain occupational-related requirements, including conforming to standards registered with the Department of Labor's Bureau of Apprenticeship or established by the National Board (or if such standards are not available, the provision of broad-based competencies and skills for career progression), coordination with participating schools, review and evaluation by the program of the student's progress in job performance and related academic instruction, and certain other labor requirements governing the terms and conditions of employment of students by employers participating in the program.

Department Studies

The Treasury, Labor, and Education Departments are directed to jointly study and report to Congress within three years after enactment on the effects of the provisions and any recommendations for further legislative modifications.

Effective Date

The provisions amending the Internal Revenue Code are effective for taxable years beginning after the date of enactment.

The National Board is required to develop, not later than December 31, 1993, proficiency standards, assessments, and criteria for at least 30 identified industrial or occupational categories. In addition, the National Board is required to develop a program to ensure that the proficiency standards, assessments, and curricula for all remaining identified industrial or occupational categories are completed not later than January 1, 1997.

Part III—Other Education Incentives

1. Choice of Credit or Deduction for Interest on Student Loans (sec. 2121 of the bill and new sec. 23 of the Code)

Present Law

The Tax Reform Act of 1986 repealed the deduction for personal interest. Student loan interest is generally treated as personal interest and thus is not allowable as an itemized deduction from income. There is no tax credit allowed for student loan interest paid by a taxpayer.

Reasons for Change

The committee believes that allowing a credit or deduction for interest paid on a student loan will encourage individuals to pursue post-secondary education and that increased education of America's workforce will enhance America's productivity and ability to compete in global markets.

By allowing the election of a credit or a deduction, the committee intends that individuals who do not itemize deductions may still be

able to take advantage of the benefit provided for the financing of higher education expenses.

Explanation of Provision

In general

The bill allows individuals who have paid interest on qualified education loans to choose either a deduction for such interest or a nonrefundable credit against regular tax liability generally equal to 15 percent of such interest, subject to a maximum credit of $300. Unused amounts of credit may not be carried forward or backward to other taxable years.

A qualified education loan generally is any indebtedness [14] incurred to pay for qualified higher education expenses of the taxpayer or the taxpayer's spouse or dependents (within the definition of Code section 152) with respect to higher education institutions and certain area vocational education schools (i.e., eligible educational institutions defined in Code section 135(c)(3)) and institutions conducting internship or residency programs leading to a degree or certificate from an institution of higher education, a hospital, or a health care facility conducting postgraduate training.

The qualified higher education expenses must be paid or incurred within a reasonable period of time before or after the indebtedness is incurred and must be attributable to education furnished during a period of time that the individual benefiting from the loan proceeds was at least a half-time student. Indebtedness that is used to refinance any indebtedness described in the previous sentence is also treated as a qualified education loan.

Qualified higher education expenses are defined as the student's cost of attendance.[15] At the time the expenses are incurred, the student must be the taxpayer or the taxpayer's spouse or dependent (as defined under Code section 152). Qualified higher education expenses taken into account for the purpose of this credit are reduced by (1) amounts excluded from gross income under Code section 135 (relating to the redemption of United States savings bonds to pay for higher education expenses), (2) the amount of the reduction described in sec. 135(d)(1) (relating to certain scholarships and veterans benefits), and (3) amounts withdrawn from individual retirement arrangements used to pay education expenses.

Deduction or credit claimed for interest on borrowing for expenses of taxpayer or spouse

In the case of qualified education loans used to pay the qualified higher education expenses of the taxpayer or the taxpayer's spouse, the credit or deduction is allowed only with respect to interest paid on a qualified education loan that is allocable to the first 48 months during which interest accrued on the loan.[16]

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[14] Indebtedness incurred by a student from borrowing from a related party (as defined in Code sections 267(b) and 707(b)(1)) will not be treated as a qualified education loan.

[15] For purposes of the provision, "cost of attendance" is defined in section 472 of the Higher Education Act of 1965 as in effect on the day before the date of enactment of this provision (generally, tuition, fees, room and board, and related expenses).

[16] For purposes of counting the 48 months, any qualified education loan and all refinancing (that is treated a qualified education loan) of such loan is treated as a single loan.

Deduction or credit claimed for interest on borrowing for expenses of taxpayer's dependent

In the case of qualified education loans used to pay the qualified higher education expenses of an individual other than the taxpayer or the taxpayer's spouse, no deduction or credit is allowed unless the individual is claimed as a dependent of the taxpayer for that taxable year and the individual is at least a half-time student during that taxable year.

Limitation on claiming deduction

A taxpayer may not claim a deduction for interest on any amount of education loan indebtedness for which a credit or deduction is allowed under any other provision.

Limitations on claiming credit

No credit is allowed to an individual if that individual is claimed as a dependent on another taxpayer's return for the taxable year beginning in the calendar year in which such individual's taxable year begins.

No credit is allowed for interest on any amount of education loan indebtedness for which a deduction is claimed under any other provision.

Effective Date

The provision is effective for taxable years beginning after December 31, 1991, and only for loans whose first payments are due after that date.

2. Expansion of Education Savings Bond Provisions (sec. 2122 of the bill and sec. 135 of the Code)

Present Law

Code section 135 provides that interest income earned on a qualified U.S. Series EE savings bond issued after December 31, 1989, is excludible from gross income if the proceeds of the bond upon redemption do not exceed qualified higher education expenses paid by the taxpayer during the taxable year.[17] "Qualified higher education expenses" include tuition and required fees for the enrollment or attendance of the taxpayer, the taxpayer's spouse, or a dependent of the taxpayer at an eligible educational institution.[18] A taxpayer cannot qualify for the interest exclusion by paying for the education expenses of another person (such as a grandchild or other relative) who is not a dependent of the taxpayer.

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

[18] Eligible educational institutions are defined in section 1201(a) and 481(a)(1)(C) and (D) of the Higher Education Act of 1965, as in effect on October 21, 1988, and in the Carl D. Perkins Vocational Education Act (subparagraph (C) or (D) of section 521(3)), as in effect on October 21, 1988. An eligible educational institution does not include proprietary institutions.

"Qualified higher education expenses" do not include expenses with respect to any course or other education involving sports, games, or hobbies other than as part of a degree program (sec. 135(c)(2)(B)).

The exclusion provided by section 135 is phased out for certain higher-income taxpayers. A taxpayer's AGI for the year the bond is redeemed (not the year the bond was issued) determines whether or not the phaseout applies. For taxpayers filing a joint return, the phaseout range is for AGI between $60,000 and $90,000 (adjusted for inflation). For single taxpayers and heads of households, the phaseout range is for AGI between $40,000 and $55,000 (adjusted for inflation).

To prevent taxpayers from effectively avoiding the income phaseout limitation (through the issuance of bonds directly in the child's name), section 135(c)(1)(B) provides that the interest exclusion is available only with respect to U.S. Series EE savings bonds issued to taxpayers who are at least 24 years old.

The interest rate on Series EE savings bonds varies, depending on how long the bonds are held. The interest rate on such bonds held for more than five years is based on the market rate for Treasury outstanding obligations with five years to maturity. Bonds held for less than five years earn interest on a fixed, graduated scale (generally below current rates on comparable Treasury instruments). Interest earned on Series EE bonds is paid when the bonds are redeemed.

Reasons for Change

To assist students in meeting the costs of higher education, the committee believes it is appropriate to expand the present-law education savings bond provisions.

Explanation of Provision

The bill expands the definition of "qualified higher education expenses" under section 135 to include tuition and required fees paid by a taxpayer for the enrollment or attendance of *any* individual (not simply dependents) at an eligible educational institution.

The bill also repeals the present-law AGI phaseout limitation under section 135 (and the related rule requiring that bonds be issued to a person who is at least 24 years old). Thus, interest earned on a Series EE savings bond is not subject to tax regardless of the taxpayer's AGI during the year the bond is redeemed if, during that year, the taxpayer pays for qualified higher education expenses of any individual and such expenses exceed the proceeds (principal plus interest) received upon redemption.[19]

Effective Date

The provision applies to U.S. Series EE savings bonds issued after December 31, 1989, and redeemed after December 31, 1991.

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[19] Present-law section 135(b) prorates the excludable interest when aggregate proceeds from bonds redeemed by a taxpayer during the taxable year exceed qualified education expenses paid by the taxpayer during that year. Consistent with this rule, the committee expects that the Treasury Department will prescribe procedures for allocating the income exclusion provided for by section 135 in cases where, with respect to a particular taxable year, two (or more) taxpayers redeem savings bonds and claim to have paid qualified education expenses for the same student, but the aggregate redemption proceeds received by the taxpayers exceed the student's qualified education expenses.

3. Extension of Exclusion for Employer-Provided Educational Assistance (sec. 2123 of the bill and sec. 127 of the Code)

Present Law

An employee's gross income and wages for income and employment tax purposes do not include amounts paid or incurred by the employer for educational assistance provided to the employee if such amounts are paid or incurred pursuant to an educational assistance program that meets certain requirements. This exclusion, which expires with respect to amounts paid after June 30, 1992, is limited to $5,250 of educational assistance with respect to an individual during a calendar year.

In the absence of this exclusion, an employee generally would be required to include in income and wages, for income and employment tax purposes, the value of educational assistance provided by an employer to the employee, unless the cost of such assistance qualified as a deductible job-related expense of the employee.

Reasons for Change

The exclusion from income for employer-provided educational assistance programs has two intended purposes: (1) to increase the levels of education and training in the workforce and (2) to eliminate the potential complexity of determining whether training and education benefits provided by an employer constitute job-related expenses that are deductible by the employee.

The committee believes that some of the benefits attributable to the exclusion for employer-provided educational assistance accrue to society at large by creating a better-educated workforce. The committee believes that the exclusion for employer-provided educational assistance is used by employees to improve their competitive position in the workforce. In the absence of the subsidy, the committee believes that some individuals would underinvest in education.

Although there is inadequate evidence to draw an unequivocal conclusion that the exclusion from income for employer-provided educational assistance is justified by the benefit to society from a better-educated workforce, the committee believes it is appropriate to provide for a temporary extension of the exclusion to reduce the complexity that would exist in the absence of the exclusion and to provide the opportunity for Congress to reevaluate the value of the exclusion.

Explanation of Provision

The exclusion for employer-provided educational assistance is extended through December 31, 1993.

Effective Date

The provision is effective for amounts paid after June 30, 1992.

4. Access to Tax Information by the Department of Veterans Affairs (sec. 2124 of the bill and sec. 6103 of the Code)

Present Law

The Internal Revenue Code prohibits disclosure of tax returns and return information of taxpayers, with exceptions for authorized disclosure to certain Governmental entities in certain enumerated instances (sec. 6103). Unauthorized disclosure is a felony punishable by a fine not exceeding $5,000 or imprisonment of not more than five years, or both (sec. 7213). An action for civil damages also may be brought for unauthorized disclosure (sec. 7431).

Among the disclosures permitted under the Code is disclosure to the Department of Veterans Affairs (DVA) of self-employment tax information and certain tax information supplied to the IRS and SSA by third-parties. Disclosure is permitted to assist DVA in determining eligibility for, and establishing correct benefit amounts under, certain of its needs-based pension and other programs (sec. 6103(l)(7)(D)(viii)). The income tax returns filed by the veterans themselves are not disclosed to DVA.

The DVA disclosure provision is scheduled to expire after September 30, 1992.

Reasons for Change

The committee believes that it is appropriate to extend this disclosure provision for six years, which will provide ample opportunity to assess the impact of this disclosure provision on voluntary compliance with the tax laws.

Explanation of Provision

The bill extends this authority to disclose tax information for six years.

Effective Date

The DVA disclosure provision expires after September 30, 1998.

Subtitle C—Better Access to Health Care

Part I—Improvements in Health Insurance Affordability for Small Employers

1. Extend Health Insurance Deduction for Self-employed (sec. 2201 of the bill and sec. 162 of the Code)

Present Law

Under present law, the tax treatment of health insurance expenses depends on whether the taxpayer is an employee and whether the taxpayer is covered under a health plan paid for by the employee's employer. An employer's contribution to a plan providing accident or health coverage for the employee and the employee's spouse and dependents is excludable from an employee's income. In addition, businesses can generally deduct, as an employee compensation expense, the full cost of any health insurance coverage provided for their employees. The exclusion and deduction

are generally available in the case of owners of the business who are also employees.

In the case of self-employed individuals (i.e., sole proprietors or partners in a partnership) no equivalent exclusion applies. However, present law provides a deduction for 25 percent of the amount paid for health insurance for a self-employed individual and the individual's spouse and dependents. The 25-percent deduction is also available to more than 2-percent shareholders of S corporations. The amount of expenses in excess of the deductible amount can be taken into account in determining whether the individual is entitled to a medical expense deduction (sec. 213). Thus, such amounts are deductible to the extent that, when combined with other unreimbursed medical expenses, they exceed 7.5 percent of adjusted gross income.

Other individuals who purchase their own health insurance can deduct their insurance premiums only to the extent that the premiums, when combined with other unreimbursed medical expenses, exceed 7.5 percent of adjusted gross income.

The 25-percent deduction expires for taxable years beginning after June 30, 1992. In the case of years beginning in 1992, only amounts paid before July 1, 1992, for coverage before July 1, 1992, are taken into account in determining the amount of the deduction.

Reason For Change

The 25-percent deduction for health insurance costs of self-employed individuals was added by the Tax Reform Act of 1986 to reduce the disparity between the tax treatment of owners of incorporated and unincorporated businesses (e.g., partnerships and sole proprietorships). The provision was enacted on a temporary basis, and has been extended several times since enactment. The committee believes that it is appropriate to extend the provision again on a temporary basis.

Moreover, the committee believes that it is desirable to increase the percentage of health insurance costs permitted as a deduction, to equalize the treatment between owners of incorporated and unincorporated businesses.

Explanation of Provision

The bill extends and increases the deduction for health insurance expenses of self-employed individuals. For 1992, the deduction is 25 percent. For 1993 and 1994, the deduction is 100 percent. The deduction expires for taxable years beginning after December 31, 1994.

Effective Date

The provision is effective for taxable years ending after June 30, 1992.

2. Grants to States for Small Employer Health Insurance Purchasing Programs (sec. 2202 of the bill)

Present Law

Currently there is no Federal grant program to finance group purchasing arrangements to assist small employers in purchasing health insurance. Several states have undertaken related initiatives.

Explanation of Provision

The Committee bill would establish a grant program to assist states in developing small employer health insurance group purchasing arrangements. Funds could be expended for administrative costs including marketing and outreach efforts, negotiations with insurers, and performance of administrative functions such as eligibility screening, claims administration and customer service. In awarding grants to states, the Secretary would be required to fund qualified applications employing a variety of approaches to group purchasing.

Such sums as necessary would be authorized for fiscal years 1993 through 1995 for the purpose of funding grant applications.

The Secretary of HHS would be required to conduct an evaluation and report to the Congress by January 1, 1995 on the impact of these programs on the number of uninsured and the price of insurance available to small employers.

3. Study of Use of Medicare Rates by Private Health Insurance Plans (sec. 2203 of the bill)

Present Law

In general, prices paid for health care services are arranged privately between insurers and health care providers. No Federal law directs these prices. Some states have laws regulating payments to hospitals by private insurers.

Explanation of Provision

The Committee bill directs the Secretary of Health and Human Services to study and report to the Congress by January 1, 1993 on the feasibility and desirability of developing prices based on Medicare payment methodologies for use by private health insurance. In developing the study, the Secretary would take into account the findings and views of the Prospective Payment Assessment Commission and the Physician Payment Review Commission.

The study would include an evaluation of 1) the appropriateness of using Medicare payment rules to determine payments for services provided to the non-Medicare population, with particular emphasis on services furnished to children; 2) the potential impact of such prices on health insurance premiums, access to health care services by Medicare beneficiaries and others and national health care spending and 3) the advantages and disadvantages of alternative mechanisms for enforcing the use of such rates when private insurers opt to use them.

Part II—Improvements in Health Insurance for Small Employers

1. Standards and Requirements of Small Employer Health Insurance; excise tax on premiums received on health insurance Policies which do not meet certain requirements; GAO study and report on rating requirements and benefit packages for small group health insurance (secs. 2211, 2221, and 2231 of the bill)

Present Law

There is no Federal law regulating the terms of sale of private health insurance sold to small employers. The National Association of Insurance Commissioners (NAIC) has adopted model legislation for state laws governing premium rates and renewability of coverage for health insurance sold to small employers, and guaranteeing availability of health insurance sold to small employers. Fourteen states have enacted legislation similar to the NAIC model on rating and renewability of coverage. Another four states have enacted additional legislation to guarantee the availability of health insurance sold to small employers.

Explanation of Provision

The Committee bill would establish minimum Federal requirements for State laws regarding the sale of health insurance to small employers. The requirements would apply to insurance sold to employers with between 2 and 50 employees working at least 30 hours a week.

Development of Standards.—The Secretary of Health and Human Services would request the National Association of Insurance Commissioners (NAIC) to develop standards for State implementation of the statutory requirements by September 30, 1992. If the NAIC fails to act in time, or if the Secretary finds that the NAIC standards do not meet the statutory requirements, the Secretary will develop standards by December 31, 1992.

State Adoption and Enforcement.—States would be required to establish a regulatory program for adoption and enforcement of the standards, subject to approval and oversight by the Secretary of Health and Human Services. The General Accounting Office would conduct periodic reviews to evaluate State compliance.

States could enact more stringent standards. The Secretary of HHS would be authorized to provide waivers for rating band requirements in the case of a state with equally stringent but not identical standards in effect prior to January 1, 1992.

The standards would apply to all entities subject to state insurance laws and regulation, including multiple employer welfare arrangements. In the case of a multiple employer welfare arrangement that is fully insured, the standards would apply to the insurer of the arrangement. Self-funded multiple employer welfare arrangements would be subject to state regulation in the same way as under current law. Nothing in the Federal requirements is intended to interfere with a state's ability to regulate licensure or financial solvency of insurers.

It is the intent of the Committee that any individual or group health insurance policy that provides coverage to employees of a small business with between 2 and 50 employees be subject to the requirements if the employer is contributing to the premium.

Standards would provide for guaranteed eligibility, guaranteed renewability, limits on pre-existing condition exclusions, restrictions on rating practices, requirements for benefit package offerings, and guaranteed availability of coverage.

Guaranteed Eligibility.—Eligible employees or their dependents could not be excluded from coverage under a small group health insurance plan.

Guaranteed Renewability.—Insurance sold to small employers could not be canceled due to claims experience or health conditions.

Pre-existing Condition Exclusions.—Newly covered employees and dependents with previous health insurance coverage would generally be protected against pre-existing condition exclusions. In the case of an individual without coverage for a particular service within the 90 day period prior to beginning employment, insurers could exclude coverage for that service for a one-time period of up to 6 months for any pre-existing condition. A pre-existing condition would be defined as one that was diagnosed or treated within 3 months of the beginning of coverage. Individuals with previous health insurance coverage would be given credit for each month of coverage toward the pre-existing condition exclusion period. Pre-existing condition exclusions could not be applied to services furnished to newborns.

Rating requirements.—Minimum Federal requirements for rating of small employer premiums would limit variation in premiums for health insurance sold to small employers on account of health status, claims experience, duration since issue, industry and occupation.

Rating bands would be established such that the highest premium charged to the lowest premium charged to a small employer with similar demographic characteristics (age, sex and family size) for the same or similar benefits could not exceed 1.5 for the first three years the law is in effect, and 1.35 in subsequent years.

Under limited circumstances, insurers could sort small employers into separate blocks of business, and the rating bands would apply independently to each block of business. Variation in premiums charged between all blocks of business could not exceed 20 percent. Insurers would be allowed to create no more than six blocks of business to segregate plans purchased from another insurer, plans provided through an association of small employers, and plans marketed through direct mail or another marketing approach.

These rating bands would not apply to differences in premiums due to age and sex, or geography. Adjustments to premiums based on these factors would have to be applied consistently across small employers. In addition, demographic rating factors would have to be consistent with guidelines developed by the National Association of Insurance Commissioners. The Committee expects that insurers will continue to apply demographic rating factors within existing ranges. It is the understanding of the Committee that taking into

account only adjustments for age and sex under current practice the typical range in premiums for groups with a mix of both males and females does not exceed 3.5 to 1, although the range in premiums for male-only groups is generally higher.

Insurers would disclose to the employer information on rating practices, the impact of rating factors on the employer's premiums, and the potential for future rate changes.

Annual Rate Increases.—Premiums for a small employer could increase by no more than 5 percent above the underlying trend in health care costs, as measured by the increase in the lowest rate charged by the insurer for the block of business.

Benefit packages.—All insurers offering coverage to small employers must make available at least a standard and a basic benefit package to all small employers in all blocks of business. State laws requiring the coverage of specified items and services would not apply to either benefit package. State laws involving the coverage of newborn children, adopted children or other individuals would continue to govern. Neither does the Committee intend to preclude state requirements with respect to continuation and conversion benefits.

The standard benefit package would provide for the following benefits:

inpatient and outpatient hospital services, except that mental health services could be limited annually to at least 45 days of inpatient treatment and 20 outpatient visits.

physician services and diagnostic tests

preventive services limited to prenatal care, well baby care for children under 1 year, well child care, Pap smears, mammograms and colorectal screening services.

Physician services would be defined to include services lawfully provided by a physician under state medical practice acts, and includes services provided by a dentist, licensed advance-practice nurse, physician assistant, optometrist, podiatrist, or chiropractor acting within the scope of their practices as determined under state law. Outpatient psychotherapy and counseling could be provided by a physician, clinical psychologist, clinical social worker or other licensed providers operating within the scope of state law. Mental health services would include treatment of alcohol and drug dependency.

Out-of-pocket costs would be limited in several ways. The annual deductible could not exceed $400 for an individual and $700 for a family in 1993. These limits would be indexed to the consumer price index. Coinsurance could not exceed 20 percent, except in the case of outpatient mental health services for which a 50 percent coinsurance rate would apply. An overall annual cap on deductibles and coinsurance would be established at $3,000 for individuals and families in 1993, indexed to the consumer price index thereafter.

The basic benefit package would provide for inpatient and outpatient hospital care, including emergency services; inpatient and outpatient physician services, preventive services which may include prenatal and well-baby care, well child care, mammograms, Pap smears and colorectal screening. Nothing in the Federal requirements prohibits the inclusion of mental health services in the

basic benefit package. Deductibles and coinsurance could be imposed. A limit on out-of-pocket spending would be required.

Within the scope of these Federal requirements, a State could choose to define a specific basic benefit package that all insurers must offer, or a State could allow insurers to offer alternative basic benefit packages. The intent of the basic benefit package requirement is to encourage the development of affordable health benefit packages for small employers.

Guaranteed Availability of Coverage.—Insurance coverage would be made available to every small employer within a state. States could choose among alternative approaches to guarantee availability of coverage. The National Association of Insurance Commissioners (or the Secretary) would develop standards to implement at least the four alternatives, including 1) mandating that all insurers issue insurance to any small employer, and be required to participate in a reinsurance pool designed to spread risk among insurers, and 2) mandating that all insurers issue insurance to any small employer and allowing voluntary participation in a reinsurance pool, 3) requiring participation in a system for allocating high-risk groups among insurers, and 4) allowing insurers to choose between issuing insurance to any small employer and participating in an allocation system. In addition, the Secretary may approve other programs guaranteeing the availability of insurance to small employers. For example, a state could require insurers to issue insurance to any small employer without establishing a reinsurance pool. Under each approach, states would be required to adopt standards to assure fair marketing of insurance sold to small employers.

The Committee intends that States be given broad flexibility in meeting the requirement for guaranteed availability. In developing the standards for alternative approaches, the Committee expects that the National Association of Insurance Commissioners, or the Secretary, provide for flexibility with respect to details of the guaranteed availability mechanisms. For example, States should have flexibility in determining contributions toward reinsurance pool.

Enforcement of standards.—Insurers violating standards would be subject to a Federal excise tax equal to 25 percent of premiums received on all policies sold to small employers. Insurers in states having a regulatory program approved by the Secretary would be exempt from the tax, as would insurers in other States that are individually certified by the Secretary as meeting the Federal standards.

Effective date.—The requirements take effect for health insurance plans offered, issued, or renewed to a small employer on or after January 1, 1994, except in states with a legislature that does not meet during 1993. In these states, the requirements would be effective on first day of the first calendar quarter after the close of the first regular legislative session occurring after January 1, 1994.

General Accounting Office Study.—The General Accounting Office would report to the Congress on (1) the impact of the standards for small group insurance on the availability and price of insurance offered to small employers, differences in available benefit packages, and the number of small employers choosing standard or basic benefit packages; (2) differences in state laws and regulations affecting the price of health insurance plans sold to individuals;

and (3) the impact of the standards on the number of small employers offering insurance to employees through a self-funded group health plan.

The GAO would also make recommendations with respect to adjusting the minimum rating requirements to eliminate experience rating based on health status and claims experience and to eliminate variation in premiums associated with age and sex.

Part III—Improvements in the Portability of Private Health Insurance

1. Excise Tax Imposed on Failure to Provide for Preexisting Condition (sec. 2241 of the bill)

Present Law

Group health plans often exclude coverage for a period of time for services related to a preexisting medical condition of a newly covered employee or his or her dependents, regardless of previous health insurance coverage. As a result individuals changing jobs may face gaps in insurance coverage for themselves or family members with chronic health conditions, even when both jobs provide similar health benefits.

Explanation of Provision

All group health insurance and self-insured employer group health plans would be prohibited from denying or limiting coverage on the basis of medical history or health status, except that a limited preexisting condition exclusion could apply to individuals with respect to services for which they did not previously have health insurance coverage.

Newly covered employees and dependents with previous health insurance coverage would generally be protected against preexisting condition exclusions. In the case of an individual without coverage for a particular service within the 90 day period prior to beginning employment, insurers could exclude coverage for that service for a one-time period of up to 6 months for any preexisting condition. Preexisting conditions would be defined as those that were diagnosed or treated during the three months prior to enrollment.

Individuals would be given credit for previous health insurance coverage. A period of preexisting condition exclusion would be reduced by one month for each month of previous coverage with respect to particular services. Credit would be given for previous coverage ending up to three months prior to the start of coverage under the new health plan.

Insurers or self-insured employer group health plans offering health plans not in compliance with these requirements would be required to retroactively cover any illegally excluded services and pay a tax penalty of $100 a day for each violation.

Part IV—Health Care Cost Containment

1. Establishment of Health Care Cost Commission (sec. 2251 of the bill)

Present Law

No provision.

Explanation of Provision

The Committee bill would establish a Health Care Cost Commission to advise the Congress and the President on strategies for reducing health care costs.

The Commission would consist of 11 members appointed by the President and confirmed by the Senate. The term of the Chairman would be 4 years and coincident with the term of the President. Other members would serve for three year terms, except that the terms of initial appointees would be staggered so that the terms of no more than 4 members would expire each year.

The President would be required to appoint members within six months of enactment of this provision, and would be required to assure representation of consumers of health services, large and small employers, State and local governments, labor organizations, health care providers, health care insurers, and experts on the development of medical technology.

The Commission would report by March 30th each year on trends in health care spending, the cost of private health insurance, sources of increases in health care costs and comparative trends in other countries. The report would also include the Commission's assessment of public and private strategies for reducing growth in health spending and its recommendations for cost containment efforts.

As part of its first annual report, the Commission would, in consultation with the Secretary of Health and Human Services, recommend a national model uniform claims form and uniform standards for the collection of medical and billing records for use by insurers and providers. The Commission would recommend a strategy and schedule for implementing by January 1, 1996, national use of these forms and standards, taking into account the need for patient confidentiality and special implementation issues, including those of providers in rural areas. The Commission would consider the use of electronic cards or other technology that allows expedited access to medical records and insurance information.

The Commission would also make recommendations to the Secretary of Health and Human Services with respect to the development and ongoing review of standards for managed care plans and utilization review programs.

2. Federal Certification of Managed Care Plans and Utilization Review Programs (sec. 2252 of the bill)

Present Law

Under present law, a health maintenance organization meeting certain standards may apply to the Health Care Financing Admin-

istration for certification as a federally qualified health maintenance organization.

Explanation of Provision

The Secretary of Health and Human Services would be directed to establish, a voluntary certification program for managed care plans and utilization review programs.

Standards for certification of qualified managed care plans would include standards related to the qualification and selection of participating providers, the distribution of providers necessary to assure that plan enrollees have access to needed health services, the provision of benefits for emergency services and the establishment of an ongoing quality assurance program. In order to be certified as a qualified managed care plan, a managed care plan would also have to meet standards identical to those established for designation of qualified utilization review programs.

Standards for certification of qualified utilization review programs include standards related to the qualification of individuals performing utilization review, the utilization review criteria and procedures for evaluating the necessity and appropriateness of health services, the timeliness of utilization review determinations and procedures for operating an appeals process and standards related to the expenses associated with requests from providers for information needed to conduct utilization review. The Secretary would be required to periodically review these criteria, taking into account recommendations of the Health Care Cost Commission. It is the expectation of the Committee that consumers and providers of health care would participate in development of the standards through the public comment opportunities provided in the regulatory process.

The Secretary could consider a plan or utilization review program accredited if it meets the requirements of a State licensure program or national accreditation body that the Secretary determines are at least as stringent as the Federal standards.

Certain state laws would not apply with respect to qualified managed care plans and qualified utilization review programs. These include laws that prohibit a qualified managed care plan from including financial incentives for enrollees to use the services of participating providers, laws that prohibit a qualified managed care plan from requiring that services be authorized by a participating primary care physician selected by the enrollee, and laws that prohibit the use of utilization review procedures by a qualified utilization review program or a qualified managed care plan. The Committee does not intend to prohibit a State from imposing requirements on managed care plans or utilization review programs under the Medicaid program.

In addition, it is not the intention of the Committee to preclude requirements that managed care plans and utilization review programs make public information with respect to the process through which utilization review criteria are developed and applied.

3. Additional Funding for Outcomes Research (sec. 2253 of the bill)

Present Law

The Omnibus Budget Reconciliation Act of 1989 authorized funding in the Department of Health and Human Services, through the Agency for Health Care Policy and Research, for research on the outcomes, effectiveness, and appropriateness of health care services and procedures. The law requires evaluations of alternative services and procedures and the development of guidelines for clinical treatments or conditions that account for a significant portion of expenditures under the Medicare program, vary significantly in the type of treatment provided and otherwise meet the priorities of the Medicare program. The law also requires the Secretary to develop standards for uniform collection of data and to provide for the dissemination of research findings and guidelines for the education of health care providers and others. Authorization for appropriations are set at $110 million for fiscal year 1992, two thirds of which is appropriated from the Medicare trust funds; $148 million for 1993, 70 percent of which is appropriated from the Medicare trust funds; and $185 million for 1994, 70 percent of which is appropriated from the Medicare trust funds.

Explanation of Provision

The Committee bill increases authorization of appropriations to $175 million in fiscal year 1992, $225 million in fiscal year 1993, $275 million in fiscal year 1994, and $300 million in fiscal year 1995. The amount contributed from the Medicare trust funds in fiscal years 1993 and 1994 would be reduced to 50 percent of the total appropriation.

Part V—Medicare prevention benefits

1. Coverage of Certain Immunizations (sec. 2261 of the bill)

Present law

Medicare generally covers only those health care services that are reasonable and necessary "for the diagnosis and treatment of illness or injury." Thus, Medicare will not pay for services, such as immunizations, that avert (rather than treat) an illness, unless the patient has been directly exposed to the illness. Although there are exceptions to this rule, most of them are the result of legislation extending Medicare coverage to a particular item or service, such as the hepatitis B and pneumococcal vaccines.

A Medicare demonstration project under which participants receive annual influenza vaccinations expires September 30, 1992. Under the project, there are State-wide sites in Tennessee, Virginia, Indiana, and Louisiana, as well as smaller sites in Arizona, Massachusetts, Michigan, New York, North Carolina, Ohio, Oklahoma, Pennsylvania, and Texas.

Explanation of Provision

The Committee bill would provide for coverage of annual influenza vaccinations and for tetanus-diphtheria boosters every 10 years. Effective for influenza vaccinations furnished on or after October 1, 1992, and for tetanus-diphtheria boosters furnished on or after January 1, 1993.

2. Coverage of Well-Child Care (sec. 2262 of the bill)

Present law

As has been explained in the preceding item, the Medicare program generally does not cover preventive services.

Explanation of Provision

The Committee bill would provide for coverage of pediatric well-child care, including appropriate immunizations, for children entitled to Medicare who have not attained 7 years of age. This would benefit the approximately 300 children who are entitled to Medicare because they have end-stage renal disease. Effective for services furnished on or after January 1, 1993.

3. Demonstration Projects for Coverage of Other Preventive Services (sec. 2263 of the bill)

Present law

Section 9314 of the Consolidated Omnibus Budget Reconciliation Act of 1985 (COBRA) required the Secretary to establish at least five demonstration projects to measure the costs and benefits of providing preventive services to Medicare beneficiaries. These demonstrations, which began in May of 1989, are to continue for four years. The sites are located in North Carolina, Washington State, California (two), Maryland, and Pennsylvania.

Explanation of Provision

The Committee bill would provide for the establishment of an ongoing series of demonstrations to evaluate the appropriateness of covering additional preventive services under Medicare. A different service would be provided at each site, so that the effect of that service on life expectancy and Medicare costs could be isolated. The Secretary would be required to evaluate specific services but could extend the demonstrations to include other services as well. Services that the Secretary would be required to evaluate include: glaucoma screening; cholesterol screening and cholesterol reducing drug therapies; screening and treatment for osteoporosis, including tests for bone-mass measurement and hormone replacement therapy; screening services for pregnant women, including ultrasound and clamydial testing and maternal serum alfa-protein; one-time comprehensive assessment for individuals beginning at age 65 or 75; and prostate-specific antigen (PSA) testing for prostate cancer. Although the Secretary would be required to use the sites at which the COBRA demonstrations are currently being conducted, he could designate other sites as well.

4. OTA Study of Process for Review of Medicine Coverage of Preventive Services (sec. 2264 of the bill)

Present law

There is an established process by which Medicare decides whether to cover new medical procedures and technologies.

Explanation of Provision

The Committee bill would require an Office of Technology Assessment study of the process by which Medicare should decide whether to cover new preventive services in the event that the current statutory exclusion of preventive services from Medicare coverage is repealed. The OTA study would be subject to the approval of the Technology Assessment Board.

5. Financing of new benefits (sec. 2265 of the bill)

Present Law

Part B of Medicare is a voluntary program in which individuals who are aged, disabled, or have end-stage renal disease may enroll. It is financed partly by premiums paid by enrollees and partly by general revenues of the Federal Government.

The monthly premium paid by enrollees is ordinarily based on a portion of projected program costs. The revised premium takes effect on January 1 of each year, which coincides with the date for the annual cost-of-living-adjustment (COLA) for Social Security cash benefits.

The part B premium generally is the lower of (1) an amount sufficient to cover one-half of the projected costs of the program for aged enrollees, or (2) the previous year's premium increased by the same percentage by which the COLA increases Social Security cash benefits.

From 1984 through 1990, the Secretary was required to set the part B premium at 25 percent of program costs. Based upon projections of 25 percent of program costs for the 1991-1995 period, the Omnibus Budget Reconciliation Act of 1990 specified the exact amounts of the part B premiums for these years in the statute. They are: $29.90 for 1991; $31.80 for 1992; $36.60 for 1993; $41.10 for 1994; and $46.10 for 1995.

Unless superseded by future legislation, the general rules described above will be used to calculate the part B premium for 1996 and thereafter.

Explanation of Provision

The new preventive benefits would be financed in the same manner as other part B services currently are paid for, with beneficiaries paying 25 percent of the increased program costs attributable to the benefits. CBO estimates that this would increase monthly part B premiums 10 cents above current law levels for each of the years 1993 through 1997.

Part VI—Ozone-Depleting Chemicals: Increase Base Tax Rate on Ozone-Depleting Chemicals (sec. 2271 of the bill and secs. 4681 and 4682 of the Code)

Present Law

An excise tax is imposed on certain ozone-depleting chemicals. The amount of tax generally is determined by multiplying the base tax rate applicable for the calendar year by an ozone-depleting factor assigned to the chemical. Certain chemicals are subject to a reduced rate of tax for years prior to 1994.

Between 1992 and 1995 there are two base tax rates applicable, depending upon whether the chemicals were initially listed in the Omnibus Reconciliation Act of 1989 or whether they were newly listed in the Omnibus Reconciliation Act of 1990. The base tax rate applicable to initially listed chemicals is $1.67 per pound for 1992, $2.65 per pound for 1993 and 1994, and an additional 45 cents per pound per year for each year thereafter. The base tax rate applicable to newly listed chemicals is $1.37 per pound for 1992, $1.67 per pound for 1993, $3.00 per pound for 1994, $3.10 per pound for 1995, and an additional 45 cents per pound per year for each year thereafter.

The initially listed chemicals are CFC-11, CFC-12, CFC-113, CFC-114, CFC-115, Halon-1211, Halon-1301, Halon-2402. The newly listed chemicals are carbon tetrachloride, methyl chloroform, CFC-13, CFC-111, CFC-112, CFC-211, CFC-212, CFC-213, CFC-214, CFC-215, CFC-216, CFC-217.

Reasons for Change

On February 11, 1992, President Bush announced that the in response to recent scientific findings, the United States will unilaterally accelerate the phaseout of substances that deplete the Earth's ozone layer. The President announced that the production of major CFCs, halons, methyl chloroform, and carbon tetrachloride generally will be eliminated by December 31, 1995. The President noted that the tax on ozone depleting chemicals has helped the United States achieve a more rapid reduction in use of such chemicals than that called for under the Montreal protocol.

In light of the President's action and recognition of the importance of the tax on ozone depleting chemicals as an economic incentive, the committee believes it is important to enhance the conservation effort and speed the search for safe substitutes by increasing the base rate of tax on ozone depleting chemicals. The committee believes an increase in the base rate of tax will help market forces to aid the work of finding substitutes and fostering reduced use of ozone-depleting chemicals.

Explanation of Provision

The bill increases and applies the same base tax rate to both initially listed chemicals and newly listed chemicals. The new base tax rate is $1.85 per pound for 1992, $2.75 per pound in 1993, $3.65 per pound in 1994, and $4.55 per pound in 1995. For years after

1995, the base tax amount will increase (as under present law) by 45 cents per pound per year.

In addition, the bill reduces the applicable percentage used in the computation of the tax applied to chemicals used in rigid foam insulation in 1992 and 1993. The provision reduces the applicable percentage from 15 percent to 13.5 percent for 1992, and reduces the applicable percentage from 10 percent to 9.6 percent for 1993. The effect of this provision is to continue present-law rates on these chemicals for 1992 and 1993.

Effective Date

The provision is effective for taxable chemicals sold or used on or after July 1, 1992. Floor stocks taxes are imposed on taxed chemicals held on the effective dates of changes in the base tax rate.

Part VII—Health Care of Coal Miners: Health benefits for retired coal miners (sec. 2281 of the bill and new secs. 9701-9724 of the Code)

Present Law

The United Mine Workers of America (UMWA) health and retirement funds were established in 1974 pursuant to an agreement between the UMWA and the Bituminous Coal Operator's Association (BCOA) to provide pension and health benefits to retired coal miners. The funds have been maintained for this purpose through a series of collective bargaining agreements. The funds created in 1974 were a restructuring of the original benefit fund, which was established in 1946.

The funds consists of four different plans, each of which is funded through a separate trust. The 1950 Pension Plan provides retirement benefits to miners who retired on or before December 31, 1975, and their beneficiaries. The 1950 Benefit Plan provides health benefits for retired mine workers who receive pensions from the 1950 Pension Plan and their dependents. The 1974 Benefit Plan provides health benefits to miners who retired after December 31, 1975. It also provides benefits to miners whose last employers are not longer in business or, in some cases, no longer signatory to the applicable bargaining agreement. These miners are generally referred to as "orphan" retirees.

Reasons for Change

The committee believes it is appropriate to provide a statutory means of financing the benefits of retired coal miners.

Explanation of Provision

The bill creates a Coal Industry Retiree Health Benefit Corporation (the Corporation), a government corporation, to provide retiree health benefits for certain retired mine workers (and their spouses and dependents)—generally retirees whose last employer is out of business or not currently paying for retiree health benefits. The Corporation's health plan is financed by a cents/hour tax on certain coal production, a per-ton tax on imported coal, and a per-par-

ticipant tax on certain former signatories to bargaining agreements who were the last employer of someone covered under the Corporation plan. The bill also (1) creates a new fund (the United Mine Workers of America (UMWA) 1991 Benefit Fund) to provide retiree health benefits to retirees of current signatories to the UMWA agreements, and (2) authorizes the tax-free transfer of excess assets from UMWA pension trusts to the Corporation and the 1991 Benefit Fund.

Effective Date

Generally effective on the date of enactment.

Subtitle D—Capital Gain Provisions

1. Progressive capital gain rates for individuals (secs. 2301-2303 of the bill and secs. 1, 1222, and 1250 of the Code)

Present Law

Tax rate on net capital gain

Under present law, ordinary income of an individual is taxed at a maximum marginal rate of 31 percent. Net capital gain of an individual is taxed at the same rates applicable to ordinary income, subject to a maximum marginal rate of 28 percent. Net capital gain is the excess of net long-term capital gain for the taxable year over net short-term capital loss for the year. Gain or loss from the sale or exchange of a capital asset is treated as long term if the asset is held for more than one year.

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

The Tax Reform Act of 1986 repealed a provision allowing a noncorporate taxpayer a deduction for 60 percent of its net capital gain for the taxable year.

Depreciation recapture

In general, gain on the sale or other disposition of section 1245 property (depreciable personal property) is taxed as ordinary income to the extent of all previous depreciation or amortization allowances with respect to the property. Gain on the sale or other disposition of section 1250 property (depreciable real property) is taxed as ordinary income to the extent of the excess of accelerated depreciation allowances over the depreciation that would have been available under the straight-line method.

Reasons for Change

The committee believes that capital gains relief should be provided on a progressive basis. In response, the provision provides a tax cut on net capital gain to 95 percent of the taxpayers who realize net capital gain.

The committee further believes that a reduction in taxes on capital gains designed as a progressive marginal tax rate system is the best way to target benefit to those taxpayers for whom a net capital gain realization is a once in a lifetime event. In 1990, the committee heard testimony that of taxpayers realizing net capital gains in only one of the five years between 1979 and 1983, more than 91 percent had adjusted gross incomes (including gain) of $100,000 or less. All these taxpayers would benefit by the provision.

In addition, the committee is concerned that churning of investment portfolios by taxable investors may contribute to short-term planning horizons by business managers. The committee believes it is appropriate to lengthen the holding period defining long term capital gain in order to induce longer holding periods among investors.

Explanation of Provisions

Progressive rates

Under the bill, the present law maximum 28 percent marginal rate is repealed and replaced with a new progressive rate system. The progressive rates apply to a noncorporate taxpayer's qualified capital gain.[20]

In general, the bill imposes a capital gains marginal tax rate of 5, 19, 23, or 28 percent, depending on the individual's taxable income. The applicable capital gains tax rate is determined by first taking into account taxable income computed without regard to qualified capital gain. Qualified capital gain then is added to such amount. The portion of qualified capital gain otherwise taxed at a 15-percent rate is taxed at a rate of 5 percent; the portion otherwise taxed at a 28-percent rate is taxed at a rate of 19 percent; the portion otherwise taxed at a 31-percent rate is taxed at a rate of 23 percent; and the portion otherwise taxed at the 36-percent rate [21] is taxed at a rate of 28 percent.

The regular tax rates and the progressive capital gains rates for 1992 for married individuals filing a joint return are set forth below as an illustration of the new rates:

Regular tax schedule

Taxable income	*Tax liability*
0 - $35,800	15%
35,800 - 86,500	$5,370 plus 28% of the excess over 35,800
86,500 - 175,000	$19,566 plus 31% of the excess over 86,500
175,000 and over	$47,001 plus 36% of the excess over 175,000

[20] Qualified capital gain is the net capital gain determined without regard to any gain taken into account in computing the 50-percent exclusion of gain from the sale of certain small business stock (as added by section 2311 of the bill).

[21] Another provision of the bill increases the maximum marginal rate on ordinary income to 36 percent.

Progressive capital gain tax schedule

0 - $35,800	5%
35,800 - 86,500	$1,790 plus 19% of the excess over 35,800
86,500 - 175,000	$11,423 plus 23% of the excess over 86,500
175,000 and over	$31,778 plus 28% of the excess over 175,000

The following examples illustrate the progressive capital gain rates (using the rate schedules set forth above). Gain from the sale or other disposition of property is the excess of the amount realized (generally, the sales price) over the taxpayer's adjusted basis (generally, the cost) in the property.

Example 1.—A has $35,000 of ordinary income, $5,000 of qualified capital gain, and deductions, adjustments and personal exemptions of $15,000. Under present law, the $5,000 of net capital gain is taxed at 15 percent, for a tax of $750.

Under the bill, the $5,000 of qualified capital gain is taxed at five percent, for a tax of $250.

Example 2.—B has $40,000 of ordinary income, $150,000 of qualified capital gain, and deductions, adjustments and personal exemptions of $20,000. Under present law, the first $15,800 of net capital gain is taxed at 15 percent, and the remaining $134,200 is taxed at 28 percent, for a total tax on net capital gain of $39,946.

Under the bill, the first $15,800 of qualified capital gain is taxed at five percent, the next $50,700 is taxed at 19 percent, and the remaining $83,500 is taxed at 23 percent, for a total tax on qualified capital gain of $29,628.

Example 3.—C has $225,000 of ordinary income, $150,000 of qualified capital gain, and deductions, adjustments and personal exemptions of $50,000. Under present law, the $150,000 of gain is taxed at 28 percent, for a tax of $42,000.

Under the bill, the $150,000 of qualified capital gain is taxed at 28 percent, for a tax of $42,000, the same as under present law.

Example 4.—D has $150,000 of ordinary income, $50,000 of qualified capital gain, and deductions, adjustments and personal exemptions of $40,000. Under present law, the $50,000 of net capital gain is taxed at 28 percent, for a tax of $14,000.

Under the bill, the $50,000 of qualified capital gain is taxed at 23 percent, for a tax of $11,500.

Holding period

The bill lengthens the holding period defining long term capital gain or loss from "more than one year" to "more than two years."

Treatment of collectibles

Gain or loss from the sale or exchange of collectibles (as defined in section 408(m)) is treated as short-term gain or loss without regard to the actual holding period, for all purposes of the Code other than in determining the amount of the charitable deduction. Thus, gain from the sale or exchange of collectibles is not eligible for the progressive capital gain rates. Any gain from the sale or ex-

change of an interest in a partnership, S corporation or trust which is attributable to unrealized appreciation in the value of collectibles is treated as gain from the sale of a collectible.

Minimum tax

The entire amount of qualified capital gain is included in alternative minimum taxable income.

Depreciation recapture

Gain on the disposition of section 1250 property (depreciable real property) is taxed as ordinary income to the extent of all previous depreciation allowances with respect to the property, subject to a maximum marginal rate of 31 percent. Thus, depreciation previously allowed with respect to such property under any method, straight-line or accelerated, is taken into account as ordinary income in the same manner as depreciation and amortization are recaptured under section 1245 (personal property), subject, however, to the 31-percent maximum marginal rate. The bill does not change the installment sale treatment of recapture income in the case of section 1250 property (under sec. 453(i)).

Effective Date

The capital gains rate provision applies to taxable years ending after January 31, 1992. For a taxable year beginning on or before that date, the new rates apply to the lesser of (i) the net capital gain for the taxable year, or (ii) the net capital gain determined by taking into account only gain or loss properly taken into account (including installment payments received) for the portion of the year after January 31, 1992. The excess, if any, of the amount described in (i) over the amount described in (ii), is taxed at a maximum rate of 28 percent as under present law. In determining when gain is taken into account in the case of a pass-through entity (i.e., a regulated investment company, a REIT, an S corporation, a partnership, an estate or trust, or a common trust fund), the date taken into account by the entity is the appropriate date. Thus, for example, if a fiscal year partnership sells a qualified capital asset on November 1, 1991, the gain from which partners take into account for the calendar year 1992, the gain will not qualify for the progressive capital gain rates.

The provisions relating to collectibles and depreciation recapture apply to dispositions after January 31, 1992.

The holding period provision applies to taxable years beginning after December 31, 1992.

2. Exclusion for capital gains on certain small business stock (sec. 2311 of the bill and new sec. 1202 of the Code)

Present Law

Under present law, ordinary income of an individual is taxed at a maximum marginal rate of 31 percent. Net capital gain of an individual is taxed at the same rates applicable to ordinary income, subject to a maximum marginal rate of 28 percent. For corpora-

tions, the maximum rate on net capital gain is the same as the maximum rate on ordinary income, i.e., 34 percent.

Net capital gain is the excess of net long-term capital gain for the taxable year over net short-term capital loss for that year. Gain or loss from the sale or exchange of a capital asset is treated as long term if the asset is held for more than one year.

The Tax Reform Act of 1986 repealed a provision allowing a non-corporate taxpayer a deduction for 60 percent of its net capital gain for the taxable year. Also under prior law, corporations were subject to an alternative tax of 28 percent on net capital gain.

Reasons for Change

The committee believes that new ventures offer the economy the greatest potential for improving future standards of living. However, new ventures and small businesses generally are riskier and, therefore, find it more costly to raise funds in the capital markets than do existing businesses. The cost of raising funds for investment in this critical sector of the economy may be reduced by providing targeted relief to investors who risk their funds in new ventures and small businesses. It is hoped that an increased flow of cheaper investment capital will result in economic growth and greater employment opportunities.

Explanation of Provision

In general

The bill generally provides taxpayers with a capital gains exclusion with respect to dispositions of qualified small business stock.[22] Taxpayers who hold qualified small business stock for more than five years can exclude 50 percent of their gain from the sale or exchange of such stock.[23]

Qualified small business stock

In order to qualify as small business stock, the following requirements must be met.

Eligible corporation

The stock generally is any stock (such as common and preferred stock) in a domestic C or S corporation. Such a corporation does not include a corporation predominantly engaged in a disqualified business. Such a business means any farming business (other than the business of raising or harvesting trees), any business of operating a hotel, motel, restaurant or similar property, or any banking, insurance, financing or similar business. In addition, an eligible corpora-

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[22] A corporate shareholder cannot claim the exclusion if it owned at any time more than 50 percent of the voting power or value of the stock of the corporation issuing the small business stock.

[23] For purposes of determining the amount of gain eligible for the exclusion, no reduction is made for any capital loss, whether from disposition of small business stock or other asset. Also, any gain excluded under this provision is not taken into account in computing long-term capital gain as defined in section 1222(3) since the excluded portion of the gain is not taken into account in computing gross income. In addition, any excluded gain is not taken into account in applying the capital loss rules of sections 1211 and 1212.

Any gain eligible for the exclusion is not also eligible for the new progressive capital gains rate system.

tion does not include a corporation with more than 10 percent of its assets in portfolio stock investments [24] or real property not used in an active business,[25] a corporation the principal activity of which is the performance of personal services, a DISC, a 936 company, a regulated investment company, a real estate investment trust, a REMIC, or any cooperative.

A corporation must constitute an eligible corporation as of the date of issuance and during substantially all of the period that the taxpayer holds the stock.

Active business

The corporation must be engaged in the active conduct of a trade or business and substantially all of its assets must be used in the active conduct of a trade or business, as of the date of issuance and during substantially all of the period that the taxpayer holds the stock. If in connection with any future trade or business, a corporation is engaged in certain start-up activities, research and experimental expenditures or in-house research expenses, the corporation is treated as satisfying the active business requirement with respect to such activities.

Any assets held for investment that are to be used to finance future research and experimentation or working capital needs of the corporation are treated as used in the active conduct of a trade or business. In addition, certain rights to computer software are treated as an asset used in the conduct of a trade or business.

Gross assets

As of the date of issuance, the excess of (i) the amount of cash and the aggregate adjusted bases of other property held by the corporation, over (ii) the aggregate amount of indebtedness of the corporation which does not have an original maturity of more than one year (such as short-term payables), cannot exceed $100 million. For these purposes, amounts received in the issuance are taken into account.

If a corporation satisfies the gross assets test as of the date of issuance but subsequently exceeds the $100 million threshold, stock that otherwise constitutes qualified small business stock would not lose such characterization solely as a result of such subsequent event. If a corporation (or a predecessor corporation) exceeds the $100 million threshold at any time on or after February 1, 1992, such corporation can never issue stock that would qualify for the exclusion.[26]

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[24] The committee understands that under certain circumstances a small business investment company operating under the Small Business Investment Act of 1958 may not qualify as an eligible corporation, either due to the restriction regarding portfolio stock investments, or due to the restriction regarding engaging in a financing or similar business.

[25] The ownership of, dealing in, or renting of real property is not treated as the active conduct of a trade or business.

[26] The Secretary of the Treasury is authorized to prescribe regulations to carry out the purposes of the provision, including preventing the evasion of the gross assets test. Thus, for example, the committee intends that a corporation that exceeds the threshold cannot split itself into smaller companies in an attempt to qualify new stock issued by such companies for the exclusion. The committee also intends that if a corporation acquires substantially all the assets of a trade or business from another corporation that exceeds the threshold, stock in the acquiring corporation would not qualify for the exclusion.

Original issue

The stock must be originally issued on or after February 1, 1992, and acquired by the taxpayer at such original issuance (directly or through an underwriter) in exchange for money, other property (not including stock) or as compensation for services (other than services performed as an underwriter of such stock).

In order to prevent the evasion of the requirement that the stock be newly issued, the exclusion does not apply if the issuing corporation purchases any of its stock either one year before or one year after the new issuance, unless the corporation has a business purpose for the redemption. For these purposes, purchases made by any corporation that is a member of the same affiliated group as the issuing corporation of any stock in any corporation that is a member of such group is treated as a purchase by the issuing corporation of its stock.

Subsidiaries of issuing corporation

In the case of a corporation that owns more than 50 percent of the voting power or value of the stock of a subsidiary, the parent corporation is deemed to own its ratable share of the subsidiary's assets, to conduct its ratable share of the subsidiary's activities and to be liable for a ratable share of the subsidiary's indebtedness, for purposes of the "eligible corporation," "active business" and "gross assets" tests described above.

Options, nonvested stock and convertible instruments

Stock acquired by the taxpayer through the exercise of options or warrants, or through the conversion of convertible debt, is treated as acquired at original issue. However, the determination whether the gross assets test is met is made at the time of exercise or conversion. In addition, the holding period of such stock is treated as beginning on the date of exercise or conversion.

In the case of convertible preferred stock, the gross assets determination is made at the time the convertible stock is issued, and the holding period of the convertible stock is added to that of the common stock acquired upon conversion.

Stock received in connection with the performance of services is treated as issued by the corporation and acquired by the taxpayer when included in the taxpayer's gross income in accordance with the rules of section 83.

Certain tax-free and other transfers

If qualified small business stock is transferred by gift, at death, from a partnership to a partner or from a subsidiary corporation to its parent in complete liquidation, the transferee is treated as having acquired the stock in the same manner as the transferor, and as having held the stock during any continuous period immediately preceding the transfer during which it was held by the transferor.[27] Transferees in other cases are not eligible for the exclu-

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[27] If a partnership distributes qualified small business stock to a partner, the partner is entitled to such treatment only if the partner held the partnership interest on the date the partnership acquired the stock and at all times thereafter, and only with respect to so much of the

Continued

sion. Thus, for example, if qualified small business stock is transferred to a partnership or corporation and such entity disposes of the stock, any gain from the disposition will not be eligible for the exclusion.

In the case of certain incorporations and reorganizations where qualified small business stock is transferred for other stock, the transferor treats the stock received as qualified small business stock. The holding period of the original stock is added to that of the stock received. However, the amount of gain eligible for the exclusion is limited to the gain accrued as of the date of the incorporation or reorganization. In addition, in the case of certain other reorganization transactions (such as those described in sections 368(a)(1)(E) and (F)), the stock issued in exchange for qualified small business stock will be treated as qualified small business stock.

Special basis rules

If property (other than money or stock) is transferred to a corporation in exchange for its stock, the basis of the stock received is treated as equal to the fair market value of the property exchanged. Thus, only gains that accrue subsequent to the transfer are eligible for the exclusion.

For purposes of determining the amount of gain eligible for the exclusion, the adjusted basis of stock in an S corporation shall not be less than its adjusted basis determined without regard to the basis adjustments of section 1367.

Pass-through entities

Gain from the disposition of qualified small business stock by a partnership, S corporation, regulated investment company or common trust fund that is taken into account by a partner, shareholder or participant is eligible for the exclusion, provided that (i) all eligibility requirements with respect to qualified small business stock are met, (ii) the stock was held by the entity for more than five years, and (iii) the partner, shareholder or participant held its interest in the entity beginning on the date the entity acquired the stock and at all times thereafter before the disposition of the stock. The amount of gain eligible for the exclusion cannot exceed the amount that would be eligible if the determination were made by reference to the interest the taxpayer held in the entity on the date the qualified small business stock was acquired.

Investment interest

The amount treated as investment income for purposes of the investment interest limitation does not include any gain excluded under the provision.

Minimum tax

The qualified small business capital gain exclusion is treated as a preference for purposes of the alternative minimum tax.

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stock that he would have received by reference to his interest in the partnership on the date the partnership acquired the stock. A similar rule applies in the case of a section 332 liquidation of a subsidiary holding qualified small business stock.

Effective Date

The provision applies to stock issued on or after February 1, 1992.

Subtitle E—Investment in Real Estate

1. Tax Credit for First-Time Homebuyers (sec. 2401 of the bill and new sec. 23 and sec. 1016 of the Code)

Present Law

There is no tax credit for the purchase of a principal residence under present law.

Reasons for Change

The committee believes that a temporary tax credit for first-time homebuyers would accelerate the time at which first-time homebuyers purchase a home. By accelerating and increasing expenditures on home purchases, the committee also believes such a credit would assist in the recovery of the homebuilding industry.

Explanation of Provision

Under the bill, individuals who purchase a new principal residence are eligible to receive a tax credit equal to 10 percent of the purchase price of the residence, up to a maximum credit of $5,000. The credit applies to a new principal residence if the original use of the residence commences with the taxpayer and if the taxpayer (1) acquires such residence on or after February 1, 1992, and before January 1, 1994, or (2) enters into a binding contract to acquire the residence on or after February 1, 1992, and before January 1, 1994, and purchases the residence within 90 days of entering into that binding contract. Only one tax credit may be claimed per residence.

First-time homebuyers are defined as individuals who did not have a present interest in a residence in the 3 years preceding the purchase of a home. If an individual is deferring tax on gain from the sale of a previous principal residence and is permitted an extended rollover period, he or she is not considered a first-time homebuyer until after the end of the extended rollover period.

The first-time homebuyer credit is nonrefundable, and thus is available only to the extent the taxpayer had income tax liability to offset. However, any unused portion of the credit may be carried forward for up to 5 years and applied against future income tax liability.

The credit is recaptured if the residence on which the credit was claimed is sold or otherwise disposed of within 3 years of the date the residence was purchased. The recapture rule does not apply, however, to dispositions by reason of the taxpayer's death or divorce. If the taxpayer sells the residence within 3 years but purchases a new home within the rollover period, the credit is recaptured to the extent the taxpayer would have claimed a smaller credit on the new residence had it been purchased during the period when the credit was available.

Effective Date

The provision is effective for purchases on or after February 1, 1992.

2. Modification of the Passive Loss Rule for Active Real Estate Persons (sec. 2411 of the bill and sec. 469 of the Code)

Present Law

The passive loss rules limit deductions and credits from passive trade or business activities. Deductions attributable to passive activities, to the extent they exceed income from passive activities, generally may not be deducted against other income, such as wages, portfolio income, or business income that is not derived from a passive activity. Credits from passive activities may not reduce the taxpayer's tax liability, to the extent such credits exceed regular tax liability from passive activities. Deductions and credits that are suspended under these rules are carried forward and treated as deductions and credits from passive activities in the next year. The suspended losses from a passive activity are allowed in full when a taxpayer disposes of his entire interest in the passive activity to an unrelated person.

The passive loss rules apply to individuals, estates and trusts, closely held C corporations, and personal service corporations.

Passive activities are defined to include trade or business activities in which the taxpayer does not materially participate. To materially participate in an activity, a taxpayer must be involved in the operations of the activity on a regular, continuous, and substantial basis. Except as provided in regulations, a taxpayer is treated as not materially participating in an activity held through a limited partnership interest.[28]

Rental activities (including rental real estate activities) are also treated as passive activities, regardless of the level of the taxpayer's participation. In general, rental activities cannot be treated as part of a larger activity that includes nonrental activities. A special rule permits the deduction of up to $25,000 of losses from rental real estate activities (even though they are considered passive), if the taxpayer actively participates in them. This $25,000 amount is allowed for taxpayers with adjusted gross incomes of $100,000 or less, and is phased out for taxpayers with adjusted gross incomes between $100,000 and $150,000. Active participation is a lesser standard of involvement than material participation. A taxpayer is treated as actively participating if, for example, he participates, in a significant and bona fide sense, in the making of management decisions or arranging for others to provide services (such as repairs). The active participation standard is not satisfied, however, if the taxpayer's interest is less than 10 percent (by value) of all interests in the activity. A taxpayer generally is deemed not

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[28] Treas. Reg. section 1.469-5T(e) provides exceptions to this general rule for limited partnership interests in certain circumstances, including the circumstance where an individual taxpayer is both a general and a limited partner, or where the taxpayer meets certain of the material participation tests (including the 500 hour test) applicable to persons other than limited partners.

to satisfy the active participation standard with respect to property he holds through a limited partnership interest.

If the taxpayer has suspended losses from a former passive activity (an activity that is not a passive activity for the current taxable year but was a passive activity for the taxable year in which the loss arose), the losses are offset against the income from such activity for the taxable year, and any excess after the offset continues to be treated as a loss from a passive activity.

Reasons for Change

The committee wishes to alleviate the unfairness that may occur when a person with nonpassive income from the performance of certain types of real estate services is not permitted to offset such income with losses from rental real estate activities. At the same time, the committee does not want to take action that would aggravate the current oversupply of rental real estate. Moreover, the committee intends not to permit taxpayers to eliminate tax liability with rental real estate losses, nor to recreate the opportunities for real estate tax shelter investment of the type and magnitude that resulted in the enactment of the passive loss rules as part of the 1986 Tax Reform Act.

Explanation of Provision

The provision modifies the passive loss rules to treat a taxpayer's performance of certain qualified real estate services and rental of certain qualified real property as a single activity. If the taxpayer materially participates in this activity, net losses from the rental of the qualified real property generally are allowed to the extent of a portion of the taxpayer's income.

In particular, losses from rental activities with respect to qualified real property are allowed to the extent of the sum of (1) income from such activities and (2) net income [29] from other passive activities. Losses in excess of this sum are allowed in an amount equal to 80 percent of the lesser of (1) the taxpayer's net income from activities consisting of the performance of qualified real estate services, or (2) the taxpayer's taxable income (determined without regard to any item of income, gain, loss or deduction from rental activities with respect to qualified real property). Credits from rental activities with respect to qualified real property are allowed subject to a similar rule.

Qualified real estate services means services in the construction, substantial renovation, and management of real property or in the lease-up and sale of qualified real property in which the taxpayer owns more than a de minimis interest.[30] Services as an employee are not taken into account unless the taxpayer owns more than a de minimis interest in the employer.

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[29] This net income is to be determined after taking into account suspended losses, if any, from such other passive activities.

[30] For example, an ownership interest is considered de minimis under the provision if it was acquired principally for the purpose of qualifying the taxpayer's activities as qualified real estate services, or if the taxpayer's interest is disproportionately small in relation to the value of the taxpayer's services with respect to the property. Ownership interests acquired through stock options, employee stock ownership plans, or other similar compensation arrangements, for example, are also considered de minimis.

Qualified real property means real property if during the taxable year the taxpayer actively participates in rental activities with respect to the property. Active participation has the same meaning as under present law, except that the taxpayer is required to have an interest in the property that is not de minimis, rather than to meet the 10 percent test of present law. Thus, as under present law, for determining active participation (as well as for determining material participation), except as provided in regulations,[31] no interest as a limited partner in a limited partnership shall be treated as an interest with respect to which the taxpayer actively (or materially) participates. Similarly, in determining whether a taxpayer actively (or materially) participates, the participation of the taxpayer's spouse is taken into account, and active participation is not required with respect to rehabilitation and low income housing credits.

The determination of whether an item is from the rental of qualified real property is made in the same manner as the determination of whether an item is from a rental real estate activity under present law. Thus, for example, gain or loss from sale or exchange of qualified real property generally is treated as from the rental of qualified real property.

Suspended passive activity losses and credits arising in a prior taxable year from the rental of property that is qualified real property in the current year are not treated as former passive activity losses and credits, but rather are treated in the same manner as losses and credits from the rental of qualified property.

The provision does not apply with respect to any real property originally placed in service (by the taxpayer or another person) after March 3, 1992. Property that is substantially renovated after that date is treated as originally placed in service after that date. Property is treated as substantially renovated after that date if, during any 24-month period beginning after that date, expenditures for renovation equal or exceed the adjusted basis of the property at the start of the 24-month period. Expenditures for renovation are any expenditures that are added to the basis of the property. Thus, generally, if the renovation expenditures double the basis of the property within any 24-month period beginning after March 3, 1992, then the property is thereupon treated as having been placed in service after March 3, 1992.

The provision applies to taxpayers subject to the passive loss rule, other than closely held C corporations.

Effective Date

The provision is effective with respect to taxable years beginning after December 31, 1991.

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[31] It is anticipated that any Treasury regulations setting forth circumstances in which a taxpayer may be treated as actively participating in a rental real property activity through a limited partnership interest (provided he otherwise actively participates) will include among such circumstances those in which the taxpayer performs significant qualified real estate services with respect to the real property, and those in which the taxpayer is a general partner in the partnership at all times he holds a limited partnership interest in the partnership.

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3. Changes Relating to Real Estate Investments by Pension Funds and Others (secs. 2421-2426 of the bill and secs. 514, 512, and 501 of the Code)

a. Relax debt-finance restrictions

Present Law

A qualified pension trust or an organization that is otherwise exempt from Federal income tax generally is taxed on any income from a trade or business that is unrelated to the organization's exempt purposes (Unrelated Business Taxable Income or "UBTI") (sec. 511). Certain types of income, including rents, royalties, dividends, and interest, are excluded from UBTI, except when such income is derived from "debt-financed property." Income from debt-financed property generally is treated as UBTI in proportion to the amount of debt financing (sec. 514(a)).

An exception to the rule treating income from debt-financed property as UBTI is available to pension trusts, educational institutions, and certain other exempt organizations (collectively referred to as "qualified organizations") that make debt-financed investments in real property (sec. 514(c)(9)(A)). Under this exception, income from investments in real property is not treated as income from debt-financed property. Mortgages are not considered real property for purposes of the exception.

The debt-financed exception, however, is available for investments in debt-financed property only if the following six restrictions of section 514(c)(9)(B) are satisfied: (1) the price of the real property is a fixed amount determined as of the date of the acquisition (the "fixed price" restriction); (2) the amount of the indebtedness or any amount payable with respect to the indebtedness, or the time for making any payment of any such amount, is not dependent (in whole or in part) upon revenues, income, or profits derived from the property (the "participating loan" restriction); (3) the property is not leased by the qualified organization to the seller or to a person related to the seller (the "leaseback" restriction); (4) in the case of a pension trust, the seller or lessee of the property is not a disqualified person (the "disqualified person" restriction); (5) the seller or a person related to the seller (or a person related to the plan with respect to which a pension trust was formed) is not providing financing in connection with the acquisition of the property (the "seller-financing" restriction); and (6) if the investment in the property is held through a partnership, certain additional requirements are satisfied by the partnership (the "partnership" restrictions) (sec. 514(c)(9)(B)(i) through (vi)).

Reasons for Change

The committee believes that modifications to the debt-financed income rules are desirable to permit qualified organizations to make debt-financed investments in real property on commercially reasonable terms in circumstances where there is not believed to be a potential for abuse.

Explanation of Provision

Relax the leaseback and disqualified person restrictions

The bill relaxes the leaseback and disqualified person restrictions to permit a de minimis leaseback of debt-financed real property to the seller (or a person related to the seller) or to a disqualified person.[32] The de minimis exception applies only where (1) no more than 20 percent of the leasable floor space in a building is leased back to the seller (or related party) or to the disqualified person, and (2) the lease is on commercially reasonable terms.

Relax the seller-financing restriction

The bill relaxes the seller-financing restriction to permit seller financing on terms that are commercially reasonable. Regulations are authorized for the purpose of determining commercially reasonable financing terms. In addition, seller financing that is on terms that include a down payment of at least 15 percent of the sales price and an interest rate of at least 150 percent of the applicable Federal rate ("AFR") on any indebtedness is deemed to be commercially reasonable.

The present-law "fixed price" and "participating loan" restrictions are not affected by this modification. Thus, for example, income from real property acquired with financing where the timing or amount of payment is based on revenue, income, or profits from the property generally will continue to be treated as income from debt-financed property, unless some other exception applies.

Relax the fixed price and participating loan restriction for property foreclosed on by financial institutions

The bill also relaxes the fixed price and participating loan restrictions for certain sales of real property foreclosed upon by financial institutions.[33] The relaxation of these rules is limited to cases where: (1) a qualified organization acquires the property from a financial institution that acquired the real property by foreclosure (or after an actual or imminent default); (2) the property is not a capital asset of the financial institution; (3) the stated principal amount of the seller financing does not exceed the financial institution's outstanding indebtedness (including accrued but unpaid interest) with respect to the property at the time of foreclosure; and (4) the value of any participation feature at the time of sale does not exceed 25 percent of the value of the property.

Regulations are authorized for the purpose of clarifying these limitations. In particular, these regulations are expected to establish standards for determining what constitutes a participation feature and how to determine whether the value of a participation feature at the time of sale exceeds 25 percent of the value of the property. For example, a participation feature that provides the seller with less than a 25 percent interest in net proceeds, net

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[32] As under present law, a leaseback to a disqualified person remains subject to the prohibited transaction rules set forth in section 4975 of the Code.

[33] Financial institutions include institutions in conservatorship or receivership and certain affiliates of financial institutions.

income, or gain on sale of the property is expected to be valued at less than 25 percent of the value of the property.

Eliminate section 514(c)(9)(B) restrictions for investments through certain large partnerships

The bill also eliminates the six section 514(c)(9)(B) restrictions for qualified organizations that invest in real property through certain "large" partnerships.

A "large" partnership is a partnership having at least 250 partners that satisfies the following three tests: (1) interests in the partnership are registered with the Securities and Exchange Commission; (2) a significant percentage (at least 50 percent) of each class of interests is owned by taxable individuals; and (3) a principal purpose of the partnership allocations is not tax avoidance. Partnership interests that are subject to the same terms are considered to be in the same class, regardless of whether the interests are subject to different ownership restrictions (a partnership can therefore monitor the 50-percent ownership restriction by requiring that designated interests be held only by taxable persons).

Treat certain mortgages as real property

The bill treats mortgages as real property for purposes of section 514(c)(9) under the following conditions: (1) the mortgages have been acquired from a financial institution that is in conservatorship or receivership, (2) the mortgages have been acquired with a cash down payment of at least 50 percent of the sales price (i.e., the acquisition indebtedness is less than 50 percent of the price of the mortgages), (3) the mortgages are not debt-financed property except on account of acquisition indebtedness that is granted by the seller, and (4) the mortgages are acquired prior to January 1, 1994. Mortgages are eligible for treatment as real property for two-and-a-half years after they are acquired by the tax-exempt purchaser.

Effective Date

The provision is effective for debt-financed acquisitions of real estate and mortgages on or after February 1, 1992, and for partnership interests acquired on or after February 1, 1992.

b. Repeal automatic UBTI rule for publicly-traded partnerships

Present Law

In general, the character of a partner's distributive share of income is the same as if the income had been directly realized by the partner. Thus, a tax-exempt organization's share of income from a partnership (other than from a publicly-traded partnership) is treated as unrelated business income, or not, depending on the underlying character of the income (sec. 512(c)(1)).

However, a tax-exempt organization's share of gross income from a publicly-traded partnership (that is not otherwise treated as a corporation) automatically is treated as UBTI (sec. 512(c)(2)(A)). The organization's share of the partnership deductions is allowed in

computing the organization's taxable unrelated business income (sec. 512(c)(2)(B)).

Reasons for Change

The automatic UBTI rule effectively discourages pension funds and other tax-exempt organizations from investing in publicly-traded partnerships. The committee believes that these investors can provide a valuable source of capital that should be available to publicly-traded partnerships.

Explanation of Provision

The bill repeals the rule that automatically treats income from publicly-traded partnerships as UBTI. Thus, under the provision, investments in publicly-traded partnerships are treated the same as investments in other partnerships for purposes of the UBTI rules.

Effective Date

The provision is effective for partnership interests acquired on or after February 1, 1992.

c. Permit title-holding companies to receive small amounts of UBTI

Present Law

Code section 501(c)(2) provides tax-exempt status to certain corporations organized for the exclusive purpose of holding title to property and turning over any income from the property to one or more related tax-exempt organizations. Section 501(c)(25) provides tax-exempt status to certain corporations and trusts that are organized for the exclusive purposes of acquiring and holding title to real property, collecting income from such property, and remitting the income therefrom to no more than 35 shareholders or beneficiaries that are: (1) qualified pension, profit-sharing, or stock bonus plans (sec. 401(a)); (2) governmental pension plans (sec. 414(d)); (3) the United States, a State or political subdivision, or governmental agencies or instrumentalities; or (4) tax-exempt charitable, educational, religious, or other organizations described in section 501(c)(3).

Ordinarily, a tax-exempt organization will not lose its exempt status because it generates UBTI, so long as the activities producing such taxable income are not substantial in comparison to the organization's activities that further its exempt purposes. However, the IRS has taken the position that a title-holding company described in section 501(c)(2) or 501(c)(25) will lose its tax-exempt status if it generates any amount of UBTI.[34]

Reasons for Change

Typical investments of section 501(c)(2) and (c)(25) corporations include shopping centers, office buildings, and apartment buildings.

[34] IRS Notice 88-121, 1988-2 C.B. 457. See also Treas. Reg. sec. 1.501(c)(2)-1(a).

These real estate investments typically generate rental income which is not considered UBTI, but occasionally generate small amounts of UBTI (e.g., money collected from laundry machines offered to tenants, or from vending machines offered as a convenience to the patrons of a shopping center).

The committee believes that a section 501(c)(2) or (c)(25) organization should not lose its exemption merely because it receives small amounts of UBTI that are incidentally derived from the holding of real property.

Explanation of Provision

The bill permits a title-holding company that is exempt from tax under sections 501(c)(2) or 501(c)(25) to receive UBTI up to 10 percent of its gross income for the taxable year, provided that the UBTI is incidentally derived from the holding of real property. For example, income generated from parking or operating vending machines located on real property owned by a title-holding company generally would qualify for the 10-percent de minimis rule, while income derived from an activity that is not incidental to the holding of real property (e.g., manufacturing) would not qualify.[35]

In addition, the bill provides that a section 501(c)(2) or 501(c)(25) title-holding company will not lose its tax-exempt status if UBTI that is incidentally derived from the holding of real property exceeds the 10-percent limitation, provided that the title-holding company establishes to the satisfaction of the Secretary of the Treasury that the receipt of UBTI in excess of the 10-percent limitation was inadvertent and reasonable steps are being taken to correct the circumstances giving rise to such excess UBTI.

Effective Date

The provision is effective for taxable years beginning after December 31, 1991.

d. Exclude from UBTI any gains from the disposition of property acquired from financial institutions in conservatorships or receiverships

Present Law

In general, gains or losses from the sale, exchange or other disposition of property are excluded from UBTI (sec. 512(b)(5)). However, gains or losses from the sale, exchange or other disposition of property held primarily for sale to customers in the ordinary course of the trade or business are not excluded from UBTI (the "dealer UBTI rule") (sec. 512(b)(5)(B)).

Reasons for Change

The dealer UBTI rule effectively discourages pension funds and other tax-exempt organizations from investing in the properties bundled together by troubled financial institutions. The committee

[35] In cases where unrelated income is incidentally derived from the holding of real property, receipt by a title-holding company of such income (up to the 10-percent limit) will not jeopardize the title-holding company's tax-exempt status, but nonetheless, will be subject to tax as UBTI.

believes that these investors can provide a valuable source of capital that should be available to purchase these bundled properties.

Explanation of Provision

The bill creates an exception to the dealer UBTI rule by excluding gains from the sale, exchange or other disposition of real property and mortgages acquired from financial institutions that are in conservatorship or receivership. The exclusion is limited to properties designated as disposal property within six months of acquisition, and disposed of within two-and-a-half years of acquisition. The two-and-a-half-year period may be extended by the Secretary if an extension is necessary for the orderly liquidation of the property. The exclusion is not available for properties that are substantially improved or renovated after acquisition and before disposition. The exclusion generally is not available for property that is developed except if the property is developed only in a limited manner (e.g., by securing zoning permits).

Effective Date

The provision is effective for property acquired after February 1, 1992.

e. Exclude loan commitment fees and certain option premiums from UBTI

Present Law

Income from a trade or business that is unrelated to an exempt organization's purpose generally is UBTI. Passive income such as dividends, interest, royalties, and gains or losses from the sale, exchange or other disposition of property generally is excluded from UBTI (sec. 512(b)). In addition, gains on the lapse or termination of options on securities are explicitly exempted from UBTI (sec. 512(b)(5).

Present law is unclear on whether loan commitment fees and premiums from unexercised options on real estate are UBTI.

Reasons for Change

The committee believes that taxing loan commitment fees and premiums from unexercised options on real estate is inconsistent with the generally tax-free treatment accorded to exempt organizations' income from investment activities.

Explanation of Provision

The bill clarifies that loan commitment fees and premiums from unexercised options on real estate are excluded from UBTI. For purposes of this provision, loan commitment fees are non-refundable charges made by a lender to reserve a sum of money with fixed terms for a specified period of time. These charges are to compensate the lender for the risk inherent in committing to make the loan (e.g., for the lender's exposure to interest rate changes and for potential lost opportunities).

Effective Date

The provision is effective for premiums or loan commitment fees that are received after February 1, 1992.

f. Exclude certain hotel rental income from UBTI

Present Law

Rents from real property generally are excluded from UBTI unless the rents are measured by reference to the net income derived by any person from the leased property (sec. 512(b)(3)). Payments for the use or occupancy of rooms and other space where services are also rendered to the occupant, such as for the use or occupancy of rooms or other quarters in hotels, do not constitute rents from real property (Treas. Reg. sec. 1.512(b)-1(c)(5)).

Reasons for Change

The UBTI consequences of operating a hotel discourage pension funds and other tax-exempt organizations that might seek to acquire one. The committee believes that these restrictions should be relaxed to permit pension funds and other tax-exempt investors to purchase hotels that are owned by troubled financial institutions.

Explanation of Provision

The bill excludes from UBTI any hotel rental income when (1) the hotel has been acquired from a financial institution in receivership or conservatorship, (2) the hotel has been designated as disposal property within six months of acquisition, and (3) the hotel either is disposed within two-and-a-half years of acquisition or, after two-and-a-half years, any related services are rendered by an independent contractor pursuant to a contract that does not permit the exempt organization to share any of the income of the independent contractor.

Effective Date

The provision is effective for hotels acquired after February 1, 1992.

4. Increase Recovery Period for Depreciation of Nonresidential Real Property (sec. 2431 of the bill and sec. 168 of the Code)

Present Law

A taxpayer is allowed to recover, through annual depreciation allowances, the cost or other basis of nonresidential real property (other than land) that is used in a trade or business or that is held for the production of rental income. For regular tax purposes, the amount of the depreciation deduction allowed with respect to nonresidential real property for any taxable year generally is determined using the straight-line method and a recovery period of 31.5 years. For alternative minimum tax purposes, the amount of the depreciation deduction allowed with respect to nonresidential real property for any taxable year is determined using the straight-line method and a recovery period of 40 years.

Reasons for Change

The committee believes that the recovery period for nonresidential real property under present law results in depreciation allowances that are larger than the actual decline in value of the property. In order to more accurately measure the economic income derived from the use of nonresidential real property in a trade or business or an investment activity, the recovery period for the depreciation of such property should be increased.

Explanation of Provision

The bill requires the depreciation deduction allowed with respect to nonresidential real property for regular tax purposes to be determined by using a recovery period of 40 years. The bill does not change the determination of the depreciation deduction allowed with respect to nonresidential real property for alternative minimum tax purposes.

Effective Date

The provision generally applies to property placed in service after February 12, 1992. The provision does not apply to property that is placed in service by a taxpayer before January 1, 1995, if (1) the taxpayer or a qualified person entered into a binding written contract to purchase or construct the property before February 13, 1992, or (2) construction of the property was commenced by or for the taxpayer or a qualified person before February 13, 1992. For this purpose, a qualified person is defined as any person who transfers his or her rights in such a contract or in the property to the taxpayer, but only if the property is not placed in service by such person before such rights are transferred to the taxpayer.

5. Extension of Low-Income Housing Tax Credit (sec. 2432 of the bill and sec. 42 of the Code)

Present Law

In General

A tax credit is allowed in annual installments over ten years for qualifying newly constructed or substantially rehabilitated low-income rental housing. For most qualifying housing, the maximum credit is an amount having a present value of 70 percent of the eligible basis of the low-income housing units. For housing receiving other Federal subsidies (e.g., tax-exempt bond financing) and for the acquisition cost of existing housing that is substantially rehabilitated (e.g., costs other than rehabilitation expenditures), the maximum credit is an amount having a present value of 30 percent of qualified basis. Generally, that part of the building for which the credit is claimed must be rented to qualified low-income tenants at restricted rents for 15 years after the building is placed in service. In addition, a subsequent additional 15-year period of low-income use generally is required.

Eligible basis

The basis on which the credit is computed is determined as a percentage of the eligible basis of a qualified low-income building that is attributable to low-income rental housing units. This percentage is the lesser of (1) the percentage of low-income units to all residential units or (2) the percentage of the floor space of the low-income units to the floor space of all residential rental units. Generally, eligible basis is limited to the adjusted basis of the residential rental units, facilities for use by the tenants, and other facilities reasonably required by the project. There is no per-housing unit limit on the amount of eligible basis.

Ten-year anti-churning rule

The credit is not allowed on buildings, or substantial improvements to buildings, that have been previously placed in service within ten years of placement in service for credit purposes. Waivers from the ten-year rule may be granted by the Treasury Department under certain circumstances.

Minimum set-aside requirement for low-income individuals

Under the general minimum set-aside a residential rental project qualifies for the credit only if: (1) 20 percent or more of the aggregate residential rental units in the project are occupied by individuals with incomes of 50 percent or less of area median income or (2) 40 percent or more of the aggregate residential rental units in the project are occupied by individuals with incomes of 60 percent or less of area median income.[36] Also, a special set-aside may be elected for projects that satisfy a stricter requirement and that significantly restrict the rents on the low-income units relative to the other residential units in the building.

Students

A housing unit generally is not eligible for the low-income housing tax credit if the tenants are full-time students who are not married individuals filing joint returns. Exceptions to this rule allow the credit to be claimed on housing units occupied by persons who are enrolled in certain job training programs or students who are receiving AFDC payments.

State low-income housing credit authority limitation

Each State receives an annual low-income housing credit volume ceiling of $1.25 per resident. To qualify for the credit, a building owner generally must receive a credit allocation from the appropriate State credit authority. An exception is provided for property which is substantially financed with the proceeds of tax-exempt bonds subject to the State's private-activity bond volume limitation.

That portion of a State's credit authority which is unallocated in the year in which it originally arises may be carried forward and added to the State's credit authority for the subsequent calendar year. If allocations in the subsequent year exceed that year's

[36] A special set-aside requirement under which a project qualifies if 25 percent or more of the units are occupied by individuals with incomes of 60 percent or less of area median income is provided for New York City.

annual credit authority, but do not exhaust the sum of that year's annual credit authority plus any credit authority carried forward from the preceding year, any remaining carried-forward credit authority is allocated in the next subsequent year to a national pool.

Expiration

The low-income housing credit is scheduled to expire after June 30, 1992.

Reasons for Change

The committee believes it is appropriate for the Federal Government to play a significant role in the development of additional affordable housing for low-income individuals. The committee believes that the low-income housing tax credit is a useful incentive for increasing the housing stock available to these individuals.

Explanation of Provision

Expiration

The bill would extend the low-income housing tax credit for 18 months (through December 31, 1993) with several modifications.

Eligible basis

The bill makes two changes to the eligible basis rules:

First, the eligible basis of each building in a credit project is limited to an amount equal to the maximum FHA single family insurance amount (currently $124,875). This amount would be indexed for inflation. In high-cost areas this maximum basis amount would be increased to 130 percent of the otherwise allowable maximum amount.

Second, the bill provides that community service buildings in projects in qualified census tracts are included in eligible basis as functionally related and subordinate facilities if (a) the size of the facilities is commensurate with tenant needs, (b) the use of the facilities is predominantly (although not exclusively) used by the tenants and employees of the project owner, and (c) no more than 20 percent of the credit project's eligible basis is attributable to such facilities.

Ten-year anti-churning rule

The bill authorizes the Treasury Department to grant waivers from the credit's ten-year anti-churning rule for certain projects substantially assisted, financed, or operated under sec. 221(d)(4) of the National Housing Act.

Minimum set-aside requirement for low-income individuals

The bill authorizes the Treasury Department to: (1) provide a waiver of penalties for de minimis errors in the application of the minimum set-aside rules, and (2) grant a waiver from the annual recertification of tenant income, for tenants in a building, if the population of a building is composed entirely of low-income tenants.

Students

The bill provides that a unit occupied entirely by full-time students may qualify for the credit if the full-time students are a single parent and his or her minor children and none of the tenants is a dependent of a third party. The bill also codifies the present-law exception regarding married students filing joint returns (which continues to apply to all buildings placed in service since original enactment of the low-income housing credit by the Tax Reform Act of 1986.)

State low-income housing credit authority limitation

For purposes of the carryforward rule, the bill treats credits carried forward from previous years as used before current year credits.

Effective Date

Generally, the provision is effective for allocations of low-income credit volume limitation (and bond-financed buildings financed with tax-exempt bonds issued) after June 30, 1992. The provisions relating to the Treasury Department's authority to grant waivers are effective on date of enactment. The provision relating to the credit carryforward rules is effective on or after January 1, 1992.

6. Extension of Qualified Mortgage Bond and Mortgage Credit Certificate Programs (sec. 2433 of the bill and secs. 143 and 25 of the Code)

Present Law

Qualified mortgage bonds

Qualified mortgage bonds ("QMBs") are bonds the proceeds of which are used to finance the purchase, or qualifying rehabilitation or improvement, of single-family, owner-occupied residences located within the jurisdiction of the issuer of the bonds. Persons receiving QMB loans must satisfy principal residence, purchase price, borrower income, first-time homebuyer, and other requirements. Part or all of the interest subsidy provided by QMBs is recaptured if the borrower experiences substantial increases in income and disposes of the subsidized residence within nine years after its purchase.

The volume of QMBs that a State may issue is subject to an annual State private activity bond volume limitation.

Mortgage credit certificates

Qualified governmental units may elect to exchange private activity bond volume authority for authority to issue mortgage credit certificates ("MCCs"). MCCs entitle home buyers to nonrefundable income tax credits for a specified percentage of the interest paid on mortgage loans on their principal residences. Once issued, an MCC remains in effect as long as the loan remains outstanding and the residence being financed continues to be the MCC-recipient's principal residence. MCCs are subject to the same targeting requirements as QMBs. MCCs also are subject to the same recapture rules as those applicable to QMBs.

Expiration

Authority to issue QMBs and to elect to trade in private activity bond volume authority to issue MCCs is scheduled to expire after June 30, 1992.

Reasons for Change

If properly targeted and administered, the QMB and MCC programs should enable individuals who otherwise would be unable to afford homes without the longer-term Federal subsidy provided by these programs. A temporary extension of the programs would permit Congressional oversight to continue.

Explanation of Provision

The bill extends the authority to issue QMBs and to elect to trade in bond volume authority to issue MCCs for 18 months (through December 31, 1993).

Effective Date

The extension of the QMB and MCC programs is effective for bonds issued after June 30, 1992, and bond volume authority traded in after that date for authority to issue MCCs.

Subtitle F—Other Incentives

Part I—Special Depreciation Allowance for Certain Equipment Acquired in 1992 (sec. 2501 of the bill and secs. 56 and 168 of the Code)

Present Law

Depreciation deductions

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 accelerated cost recovery system ("ACRS"), as modified by the Tax Reform Act of 1986. Under ACRS, different types of property are assigned applicable recovery periods and depreciation methods. The recovery periods applicable to most tangible personal property (generally tangible property other than residential rental property and nonresidential real property) range from 3 to 20 years. The depreciation methods generally applicable to tangible personal property are the 200-percent and 150-percent declining balance methods, switching to the straight-line method for the taxable year in which the depreciation deduction would be maximized.

For purposes of the alternative minimum tax ("AMT"), tangible personal property generally is depreciated using the 150-percent declining balance method over useful lives that typically are longer than the applicable recovery periods for regular tax purposes. In addition, for purposes of the adjusted current earnings ("ACE") component of the corporate AMT, tangible personal property is de-

preciated using the straight-line method over these longer useful lives.

Expensing election

In lieu of depreciation, a taxpayer with a sufficiently small amount of annual investment may elect to deduct up to $10,000 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 $10,000 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. In addition, the amount eligible to be expensed for a taxable year may not exceed the taxable income of the taxpayer for the year that is derived from the active conduct of a trade or business (determined without regard to this provision). Any amount that is not allowed as a deduction because of the taxable income limitation may be carried forward to succeeding taxable years (subject to similar limitations).

Reasons for Change

The committee believes that allowing additional first-year depreciation will accelerate purchases of new equipment, promote capital investment, modernization, and growth, and lead to a more rapid economic recovery.

Explanation of Provision

The bill allows an additional first-year depreciation deduction equal to 10 percent of the adjusted basis of certain qualified property that is placed in service before July 1, 1993. The additional depreciation deduction is allowed for both regular tax and AMT purposes for the taxable year in which the property is placed in service. The basis of the property and the depreciation allowances in the year of purchase and later years are appropriately adjusted to reflect the additional first-year depreciation deduction. A taxpayer may elect to not claim the additional first-year depreciation for qualified property.

Property qualifies for the additional first-year depreciation deduction if (1) the property is section 1245 property to which ACRS applies (other than property that is required to be depreciated under the alternative depreciation system of ACRS) and (2) the original use of the property commences with the taxpayer on or after February 1, 1992.[37] In addition, the property must be acquired by the taxpayer (1) on or after February 1, 1992, and before January 1, 1993, but only if no binding written contract for the acquisition is in effect before February 1, 1992, or (2) pursuant to a binding written contract which was entered into on or after February 1, 1992, and before January 1, 1993. Finally, property that is

[37] A special rule applies in the case of certain leased property. In the case of any property that is originally placed in service by a person and that is sold to the taxpayer and leased back to such person by the taxpayer within three months after the date that the property was placed in service, the property is to be treated as originally placed in service by the taxpayer not earlier than the date that the property is used under the leaseback.

manufactured, constructed, or produced by the taxpayer for use by the taxpayer will qualify if the taxpayer begins the manufacture, construction, or production of the property on or after February 1, 1992, and before January 1, 1993 (and all other requirements are met).

The limitations on the amount of depreciation deductions allowed with respect to certain passenger automobiles (sec. 280F of the Code) are adjusted to reflect the additional first year depreciation deduction. Thus, the limitation on the amount of depreciation allowable for the first year that a passenger automobile to which this provision applies will be increased by 10 percent and subsequent year depreciation allowances will be decreased to reflect this first year increase.

The following examples illustrate the operation of the provision.

Example 1.—Assume that on July 1, 1992, a calendar year taxpayer acquires and places in service qualified property that costs $1 million. Under the provision, the taxpayer is allowed an additional first-year depreciation deduction of $100,000. The remaining $900,000 of adjusted basis is to be recovered in 1992 and subsequent years pursuant to the depreciation rules of present law.

Example 2.—Assume that on July 1, 1992, a calendar year taxpayer acquires and places in service qualified property that costs $30,000. In addition, assume that the property qualifies for the expensing election under section 179. Under the provision, the taxpayer is first allowed a $10,000 deduction under section 179. The taxpayer then is allowed an additional first-year depreciation deduction of $2,000 based on $20,000 ($30,000 original cost less the section 179 deduction of $10,000) of adjusted basis. Finally, the remaining adjusted basis of $18,000 ($20,000 adjusted basis less $2,000 additional first-year depreciation) is to be recovered in 1992 and subsequent years pursuant to the depreciation rules of present law.

Effective Date

The provision applies to property placed in service on or after February 1, 1992.

Part II—Modifications to Minimum Tax

1. Extension of Relief for AMT Purposes for Contributions of Appreciated Property (sec. 2502 of the bill and sec. 57(a)(6) of the Code)

Present Law

In computing taxable income, a taxpayer who itemizes deductions generally is allowed to deduct the fair-market value of property contributed to a charitable organization.[38] However, in the case of a charitable contribution of inventory or other ordinary-income property, short-term capital gain property, or certain gifts to private foundations, the amount of the deduction is limited to

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

the taxpayer's basis in the property.[39] In the case of a charitable contribution of tangible personal property, a taxpayer's deduction is limited to the adjusted basis in such property if the use by the recipient charitable organization is unrelated to the organization's tax-exempt purpose (sec. 170(e)(1)(B)(i)).

For purposes of computing alternative minimum taxable income (AMTI), the deduction for charitable contributions of capital gain property (real, personal, or intangible) is disallowed to the extent that the fair-market value of the property exceeds its adjusted basis (sec. 57(a)(6)). However, in the case of a contribution made in a taxable year beginning in 1991 or made before July 1, 1992, in a taxable year beginning in 1992, this rule does not apply to contributions of tangible personal property.

Reasons for Change

The committee believes that the temporary AMT exception for contributions of appreciated tangible personal property has induced additional charitable giving. Thus, by extending this rule through 1993 and expanding it to apply to all appreciated property gifts, taxpayers will be allowed the same charitable contribution deduction for both regular tax and alternative minimum tax purposes for contributions made during 1992 and 1993. This will provide an additional incentive for taxpayers to make contributions of appreciated property.

In addition, to reduce uncertainty and disputes arising out of charitable contributions of property, the committee believes that the Treasury Department should develop and implement a procedure under which the Secretary's position as to the value of tangible personal property can be ascertained for Federal income tax purposes prior to the donation of such property to a charity.

The committee also is concerned about the tax treatment of corporate sponsorship payments received by charitable organizations and the ramifications of recently proposed IRS examination guidelines in this area. Therefore, it is appropriate that the Treasury Department conduct a study regarding such corporate sponsorship payments and report its findings to Congress.

Explanation of Provisions

Extension of AMT relief for donated appreciated property

All charitable contributions of appreciated property (real, personal, and intangible) made during 1992 and 1993 will not be treated as a tax preference item for alternative minimum tax (AMT) purposes. Thus, during 1992 and 1993, if a taxpayer makes a gift to charity of property (other than inventory or other ordinary income property, short-term capital gain property, or certain gifts to private foundations) that is real property, intangible property, or tangible personal property the use of which is related to the donee's tax-exempt purpose, the taxpayer is allowed to claim a deduction for both regular tax and AMT purposes in the amount of the prop-

[39] Section 170(e)(3) provides an augmented deduction for certain corporate contributions of inventory property for the care of the ill, the needy, or infants.

erty's fair-market value (subject to present-law percentage limitations).[40]

Advance determination of IRS position of value of donated tangible personal property

The Secretary of the Treasury is directed to develop and implement a procedure under which the Secretary's position as to the value of tangible personal property could be ascertained for Federal income tax purposes prior to the transfer of such property to a qualifying charitable organization. The Secretary is required to submit a report not later than December 31, 1992, to the Senate Committee on Finance and the House Committee on Ways and Means, reporting on the development of such a procedure and the projected timetable for its implementation.

Study of tax treatment of corporate sponsorship payments to charitable organizations

The Secretary of the Treasury is directed to conduct a study on the tax treatment of corporate sponsorship payments received by charitable and other tax-exempt organizations in connection with athletic (and other) events and the ramifications of IRS proposed examination guidelines contained in Announcement 92-15, 1992-5 I.R.B. 51. Within one year after the date of enactment, the Secretary is required to report the results of this study to the Senate Committee on Finance and the House Committee on Ways and Means.

Effective Date

The provision governing the AMT treatment of gifts of appreciated property is effective for contributions made in 1992 and 1993.

The Secretary of the Treasury is required to report to Congress prior to December 31, 1992, on the development of an advance valuation procedure for certain donations, and within one year after the date of enactment, the results of a study of corporate sponsorship payments received by tax-exempt organizations.

2. Alternative Minimum Tax Relief for Intangible Drilling Costs of Oil and Gas Independent Producers (sec. 2503 of the bill and secs. 56 and 57 of the Code)

Present Law

In general

Under present law, corporations and individuals are subject to an alternative minimum tax (AMT) which is payable, in addition to all other tax liabilities, to the extent that it exceeds the taxpayer's regular income tax owed. The tax is imposed at a flat rate of 20 percent (24 percent in the case of individuals) on alternative minimum taxable income in excess of the exemption amount. Alternative minimum taxable income is the taxpayer's taxable income increased by tax preferences and adjusted by determining the tax

[40] Contributions of inventory or other ordinary income property, short-term capital gain property, and certain gifts to private foundations continue to be governed by present-law rules.

treatment of certain items in a manner which negates the deferral of income resulting from the regular tax treatment of those items.

For taxable years beginning after 1989, the alternative minimum taxable income of a corporation is increased by an amount equal to 75 percent of the amount by which adjusted current earnings (ACE) exceed pre-net operating loss alternative minimum taxable income. In general, adjusted current earnings means alternative minimum taxable income with additional adjustments. These adjustments generally follow the rules presently applicable to corporations in computing their earnings and profits.

Net operating losses and foreign tax credits generally cannot be used to offset, in the aggregate, more than 90 percent of the pre-foreign tax credit tentative minimum tax which would otherwise be determined.

Treatment of oil and gas intangible drilling costs

Independent oil and gas producers (i.e., taxpayers other than integrated oil companies (as defined in section 291(b)(4) of the Code)) who pay or incur intangible drilling or development costs ("IDCs") in the development of domestic oil or gas properties or certain geothermal wells, may elect either to expense or capitalize such amounts. If an election to expense IDCs is made, the taxpayer deducts the amount of the IDCs as an expense in the taxable year the cost is paid or incurred. Generally, if IDCs are capitalized rather than expensed, they can be recovered through depletion or depreciation, as appropriate. Alternatively, at the election of the taxpayer, they may be amortized over a 60-month period.

The difference between the amount of a taxpayer's IDC deductions and the amount which would have been currently deductible had IDCs been capitalized and recovered over a 10-year period constitutes an item of tax preference for the AMT to the extent that this difference exceeds 65 percent of the taxpayer's net income from oil, gas, and geothermal properties for the taxable year.

Moreover, for purposes of computing the corporate AMT ACE adjustment, IDCs in taxable years beginning after 1989 are capitalized and amortized over the 60-month period beginning with the month in which they are paid or incurred.

AMT deduction for certain energy-related items

A portion of the IDC tax preference and ACE IDC adjustment (together with a portion of the preference and ACE adjustment related to percentage depletion from marginal properties) may operate to reduce an independent oil and gas producer's alternative minimum taxable income under a provision enacted as part of the Omnibus Budget Reconciliation Act of 1990 (the so-called "special energy deduction"). The special energy deduction is initially determined by determining the taxpayer's (1) IDC preference [41] and (2) marginal production depletion preference.[42] The IDC preference is

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[41] The IDC preference is the amount by which the taxpayer's alternative minimum taxable income would be reduced if it were computed without regard to the excess IDC preference and the ACE IDC adjustment.

[42] The marginal production depletion preference is the amount by which the taxpayer's alternative minimum taxable income would be reduced if it were computed without regard to the preference for percentage depletion claimed in excess of basis and the ACE adjustment related to depletion from marginal properties.

apportioned between the portion of the preference related to IDCs on exploratory wells and the portion related to IDCs on all other wells. The portion of the preference related to exploratory IDCs is multiplied by 75 percent and the remaining portion is multiplied by 15 percent. The marginal production depletion preference is multiplied by 50 percent. These three products are then added together to arrive at the taxpayer's special energy deduction.

The special energy deduction may not reduce the taxpayer's alternative minimum taxable income by more than 40 percent. In addition, the combination of the special energy deduction, the alternative minimum tax net operating loss and the alternative minimum tax foreign tax credit cannot generally offset, in the aggregate, more than 90 percent of a taxpayer's alternative minimum tax determined without such attributes. Any special energy deduction amount limited by the 40-percent threshold may not be carried to another taxable year.

Reasons for Change

The committee believes that it is appropriate to provide relief to certain taxpayers with oil and gas operations from the alternative minimum tax preference and adjustment that specifically relate to IDCs incurred in such operations. The committee believes the effectiveness of oil and gas incentives for domestic drilling is reduced to the extent that taxpayers in the oil and gas industry are subject to the alternative minimum tax. Moreover, the committee believes that a large segment of oil and gas independent producers have significant amounts of IDC tax preference and accordingly are subject to the alternative minimum tax. Consequently, to increase the effectiveness of certain oil and gas drilling incentives, the committee desires to make these incentives applicable, to a greater extent, to the alternative minimum tax.

The committee also believes that the elimination in the AMT special energy deduction of any distinction between exploratory and other IDCs will provide significant simplification to the administration of that provision.

Explanation of Provision

In general

The bill contains several provisions relating to the alternative minimum tax treatment of IDCs incurred by independent producers of oil and gas. Included among these provisions are amendments to (1) the computation of the AMT preference for IDCs, (2) the ACE adjustment, and (3) the AMT special energy deduction. These provisions of the bill are not applicable to integrated oil companies (as defined in section 291(b)(4) of the Code).

AMT preference for IDCs

For purposes of computing the AMT preference for IDCs of an independent oil and gas producer, the bill raises the 65-percent net oil and gas income offset to 70 percent. Thus, the difference between the amount of an independent oil and gas producer's IDC deductions and the amount which would have been currently deducti-

ble had IDCs been capitalized and recovered over a 10-year period constitutes an item of tax preference to the extent that this difference exceeds 70 percent of the producer's net income from oil, gas, and geothermal properties for the taxable year.

ACE adjustment for IDCs

For purposes of computing adjusted current earnings, the bill eliminates the requirement that independent oil and gas producers make an adjustment to alternative minimum taxable income for IDCs.

AMT special energy deduction

Under the bill, the IDC component of the special energy deduction would be computed by multiplying the IDC preference by 50 percent. Thus, the bill eliminates any necessity to apportion the IDC preference between exploratory and all other IDCs. Under the bill, the IDC preference for purposes of the special energy deduction is the amount by which the taxpayer's alternative minimum taxable income would be reduced if it were computed without regard to the excess IDC preference.[43]

The bill does not affect the computation of the marginal depletion related component of the special energy deduction. As under present law, the special energy deduction is permitted to reduce a taxpayer's alternative minimum taxable income by no more than 40 percent.

Effective date

The provisions of the bill related to AMT relief for IDCs incurred by independent producers are effective for taxable years beginning after December 31, 1991.

3. Elimination of ACE Depreciation Adjustment (sec. 2504 of the bill and sec. 56 of the Code)

Present Law

Under present law, a corporation is subject to an alternative minimum tax ("AMT") which is payable, in addition to all other tax liabilities, to the extent that it exceeds the corporation's regular income tax liability. Alternative minimum taxable income ("AMTI") is the corporation's taxable income increased by the corporation's tax preferences and adjusted by determining the tax treatment of certain items in a manner which negates the deferral of income resulting from the regular tax treatment of those items. For a corporation, the amount of AMT paid in a year may be carried forward as a credit and used to reduce the corporation's regular tax liability (but not below the corporation's tentative minimum tax for the year).

One of the adjustments which is made to taxable income to arrive at AMTI relates to depreciation. Depreciation on personal property to which the modified ACRS system adopted in 1986 ap-

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[43] In contrast to present law, calculation of the IDC preference for purposes of the special energy deduction does not take into account an ACE IDC adjustment since that adjustment is repealed by the bill with respect to independent producers.

plies is calculated using the 150-percent declining balance method (switching to straight line in the year necessary to maximize the deduction) over the life described in Code section 168(g) (generally the ADR class life of the property).

For taxable years beginning after 1989, AMTI is increased by an amount equal to 75 percent of the amount by which adjusted current earnings ("ACE") exceed AMTI (as determined before this adjustment). The ACE adjustment replaced the book-income adjustment applicable to tax years 1987 through 1989. In general, ACE means AMTI with additional adjustments that generally follow the rules presently applicable to corporations in computing their earnings and profits. For purposes of ACE, depreciation is computed using the straight-line method over the class life of the property. Thus, a corporation generally must make two depreciation calculations for purposes of the AMT—once using the 150-percent declining balance method and again using the straight-line method.

Reasons for Change

There is a concern that the depreciation component of the ACE adjustment may constitute a too great a reduction to the regular tax incentive for capital investment for U.S. corporations. As a result of the depreciation adjustment required in computing ACE, many capital-intensive corporations are subject to the AMT. The effects of the adjustment may be magnified for capital-intensive corporations that are adding to their capital stock or showing depressed earnings. Because many such corporations may find themselves continually subject to the AMT, the minimum tax credit is of little value in mitigating the long-term effects of the ACE depreciation adjustment.

The ACE depreciation adjustment also is the source of substantial complexity. As a result of the adjustment, corporations must make three separate depreciation computations to determine taxable income and alternative minimum taxable income.

Explanation of Provision

Effective for property placed in service on or after February 1, 1992, the bill eliminates the depreciation component of ACE for corporate AMT purposes. Thus, in computing ACE, a corporation would use the same depreciation methods and lives that it uses in computing AMTI (generally, the 150-percent declining balance method for tangible personal property).

Effective Date

The provision is effective for property placed in service on or after February 1, 1992.

Part III—Extension of Other Expiring Provisions

1. Research and Experimentation Tax Credit (sec. 2505 of the bill and sec. 41 of the Code)

Present Law

A 20-percent tax credit is allowed to the extent that a taxpayer's qualified research expenditures for the current year exceed its base amount for that year. The credit will not apply to amounts paid or incurred after June 30, 1992.

The base amount for the current year generally is computed by multiplying the taxpayer's "fixed-base percentage" by the average amount of the taxpayer's gross receipts for the four preceding years. If a taxpayer both incurred qualified research expenditures and had gross receipts during each of at least three years from 1984 through 1988, then its "fixed-base percentage" is the ratio that its total qualified research expenditures for the 1984–1988 period bears to its total gross receipts for that period (subject to a maximum ratio of .16). All other taxpayers (such as "start-up" firms) are assigned a fixed-base percentage of .03.

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

Qualified research expenditures eligible for the credit consist of: (1) "in-house" expenses of the taxpayer for research wages and supplies used in research; (2) certain time-sharing costs for computer use in research; and (3) 65 percent of amounts paid by the taxpayer for contract research conducted on the taxpayer's behalf. Expenditures attributable to research that is conducted outside the United States do not enter into the credit computation. In addition, the credit is not available for research in the social sciences, arts, or humanities, nor is it available for research to the extent funded by any grant, contract, or otherwise by another person (or governmental entity).

In addition, the 20-percent tax credit also applies to the *excess* of (1) 100 percent of corporate cash expenditures (including grants or contributions) paid for university basic research *over* (2) the sum of (a) the greater of two fixed research floors plus (b) an amount reflecting any decrease in nonresearch giving to universities by the corporation as compared to such giving during a fixed-base period, as adjusted for inflation.

Deductions for qualified research expenditures allowed to a taxpayer under section 174 are reduced by an amount equal to 100 percent of the taxpayer's research credit determined for that year.

Reasons for Change

Technological development is an important component of economic growth. However, businesses may not find it profitable to invest in some research activities, because it is difficult to capture the full benefits from the research. (Costly technological advances made by one firm are often cheaply copied by its competitors.) A research credit can help to promote investment in research, so that research activities undertaken approach the optimal level for the

overall economy. The committee, therefore, believes that it is appropriate to extend the research tax credit.

Explanation of Provision

The bill extends the research tax credit for 18 months (i.e., for qualified research expenditures and university basic research expenditures incurred through December 31, 1993).

Effective Date

The provision applies to qualified expenditures incurred during the period July 1, 1992, through December 31, 1993.

2. Qualified Small-Issue Bonds (sec. 2506 of the bill and sec. 144 of the Code)

Present Law

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

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

Authority to issue qualified small-issue bonds is scheduled to expire after June 30, 1992.

Reasons for Change

The committee believes that it is appropriate to permit State and local governments to continue to issue qualified small-issue bonds.

Explanation of Provision

The bill extends authority to issue qualified small-issue bonds for 18 months (through December 31, 1993).

Effective Date

The provision is effective for bonds issued after June 30, 1992.

3. Business Energy Tax Credits for Solar and Geothermal Property (sec. 2507 of the bill and sec. 48 of the Code)

Present Law

Nonrefundable business energy tax credits are allowed for 10 percent of the cost of qualified solar and geothermal energy property (Code sec. 48(a)). Solar energy property that qualifies for the credit includes any equipment that uses solar energy to generate electricity, to heat or cool (or provide hot water for use in) a structure, or to provide solar process heat. Qualifying geothermal prop-

erty includes equipment that produces, distributes, or uses energy derived from a geothermal deposit, but, in the case of electricity generated by geothermal power, only up to (but not including) the electrical transmission stage.[44]

The business energy tax credits currently are scheduled to expire with respect to property placed in service after June 30, 1992.

The business energy tax credits are components of the general business credit (sec. 38(b)(1)). The business energy tax credits, when combined with all other components of the general business credit, generally may not exceed for any taxable year the excess of the taxpayer's net income tax over the greater of (1) 25 percent of net regular tax liability above $25,000 or (2) the tentative minimum tax. An unused general business credit generally may be carried back 3 years and carried forward 15 years.

Reasons for Change

The committee believes it is important to provide tax-based support for the development of alternative energy sources. The committee also believes that periodic Congressional oversight of tax credits for solar and geothermal property is desirable in view of the potential for significant technological change in this area.

Explanation of Provision

The bill extends the business credits for solar and geothermal property for 18 months, through December 31, 1993.

The committee strongly feels that energy security is an important national goal and has attempted to further this goal by including several measures related to energy conservation and the utilization of renewable energy sources and domestic fossil fuel resources. One area that the committee did not address is the concern of several members that much of the alternative fuel infrastructure necessary to meet the demands of the Clean Air Act Amendments of 1990 and the National Energy Security Act of 1992 will be located outside the United States. These members believe that this is a disturbing trend that threatens to increase, rather than alleviate, America's dependence on foreign energy sources. In addition, this overseas development may preclude much of the economic benefit that could be generated by a vital domestic industry. The committee intends to examine this trend in 1992 to determine whether further Congressional action is necessary to insure that the proper incentives and trade laws are in place to promote a strong domestic alternative fuels industry.

Effective Date

The provision is effective for qualifying solar and geothermal property placed in service after June 30, 1992.

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[44] For purposes of the credit, a geothermal deposit is defined as a domestic geothermal reservoir consisting of natural heat which is stored in rocks or in an aqueous liquid or vapor, whether or not under pressure (sec. 613(e)(2)).

4. Extension of Excise Tax on Certain Vaccines for the Vaccine Injury Compensation Trust Fund (sec. 2508 of the bill and secs. 4131 and 9510 of the Code)

Present Law

The Vaccine Injury Compensation Trust Fund ("Vaccine Trust Fund") provides a source of revenue to compensate individuals who are injured (or die) as a result of the administration of certain vaccines: diphtheria, pertussis, and tetanus ("DPT"); diphtheria and tetanus ("DT"); measles, mumps, and rubella ("MMR"); and polio. The Vaccine Trust Fund provides the funding source for the National Vaccine Injury Compensation Program ("Program"), which provides a substitute, Federal "no-fault" insurance system for the State-law tort and private liability insurance systems otherwise applicable to vaccine manufacturers.

Under the Program, all persons who were immunized with a covered vaccine after the effective date of the Program, October 1, 1988, are prohibited from commencing a civil action in State court for vaccine-related damages unless they first file a petition with the United States Claims Court, where such petitions are assigned to a special master and governed by streamlined procedural rules designed to expedite the proceedings.[45] In these cases, the Federal Government is the respondent party in the proceedings, and the claimant generally must show only that certain medical conditions (or death) followed the administration of a covered vaccine and that the first onset of symptoms occurred within a prescribed time period.[46] Compensation under the Program generally is limited to actual and projected unreimbursed medical, rehabilitative, and custodial expenses, lost earnings, pain and suffering (or, in the event of death, a recovery for the estate) up to $250,000, and reasonable attorney's fees.[47] Only if the final settlement under the Program is rejected may the claimant proceed with a civil tort action in the appropriate State court, where recovery generally will be governed by State tort law principles[48], subject to certain limitations and specifications imposed by the National Childhood Vaccine Injury Act of 1986.[49]

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[45] Persons who received vaccines before the Program's effective date of October 1, 1988 ("retrospective cases") also may be eligible for compensation under the Program if they had not yet received compensation and elected to file a petition with the United States Claims Court on or before January 31, 1991. Under the Program, awards in retrospective cases are somewhat limited compared to "prospective cases" (i.e., those where the vaccine was administered on or after October 1, 1988). Awards in retrospective cases are not paid out of the Vaccine Trust Fund but are paid out of funds specially authorized by Congress. See 42 U.S.C. sec. 300aa-15(i), (j) (appropriating $80 million for fiscal year 1989 and for each subsequent year).

[46] Compensation may not be awarded, however, if there is a preponderance of the evidence that the claimant's condition or death resulted from factors unrelated to the vaccine in question.

[47] 42 U.S.C. sec. 300aa-15.

The committee wishes to clarify its understanding that amounts received by a claimant from the Vaccine Trust Fund constitute damages received on account of personal injuries or sickness for purposes of the exclusion from gross income provided by the general rules of section 104(a)(2).

[48] In most State proceedings, significant issues arise whether injuries suffered by a child after immunization were, in fact, caused by the vaccine administered and whether the manufacturer was at fault in either the manufacture or marketing of the vaccine.

[49] Title III, P.L. 99-660. This Act preempts State tort law to a limited extent by imposing limits on recovery from vaccine manufacturers. Among the limitations are a prohibition on com-

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The Vaccine Trust Fund is funded by a manufacturer's excise tax on DPT, DT, MMR, and polio vaccines (and any other vaccines used to prevent these diseases). The excise tax per dose is $4.56 for DPT, $0.06 for DT, $4.44 for MMR, and $0.29 for polio vaccines.

The vaccine excise tax will expire after the later of: (1) December 31, 1992; or (2) the date on which the Vaccine Trust Fund revenues exceed the projected liabilities with respect to compensable injuries from vaccines administered before October 1, 1992. Amounts in the Vaccine Trust Fund are available for the payment of compensation under the Program with respect to vaccines administered after September 30, 1988, and before October 1, 1992.

Reasons for Change

Congress created the National Vaccine Injury Compensation Program as part of the National Childhood Vaccine Injury Act of 1986, in view of concerns that the combination of significantly higher prices for vaccines and uncertain compensation for injuries could result in reduced compliance with the nation's childhood immunization efforts. The Program became effective following enactment of a Federal funding source. This funding source was provided by the enactment of vaccine excise taxes in the Omnibus Budget Reconciliation Act of 1987, with the excise taxes imposed on sales of covered vaccines on or after January 1, 1988. The Program for administering claims became effective on October 1, 1988, but was not fully operational until February 1, 1989.[50]

Because data on the administration of the Program and the Vaccine Trust Fund are only beginning to be collected, it is appropriate to extend for two years (i.e., through December 31, 1994) the present-law vaccine excise taxes. In addition, the authorization for compensation to be paid from the Vaccine Trust Fund for certain damages resulting from vaccines administered after September 30, 1988, and before October 1, 1992, is extended for two years (i.e., for vaccines administered before October 1, 1994). In the interim, the Secretary of the Treasury, in consultation with the Secretary of Health and Human Services, should study the administration of the Program and Vaccine Trust Fund to determine whether additional vaccines should be included in the Program or other modifications (such as adjustments to the excise tax rates) are warranted.

Explanation of Provisions

Extension of excise tax and Program funding

The present-law excise taxes imposed on certain vaccines are extended for two years (i.e., through December 31, 1994). Authorization for compensation to be paid from the Vaccine Trust Fund for certain damages resulting from vaccines administered after Sep-

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pensation if the injury or death resulted from side effects that were unavoidable; a presumption that manufacturers are not negligent in manufacturing or marketing vaccines if they complied, in all material respects, with Federal Food and Drug Administration requirements; and limits on punitive damage awards.

[50] Several procedural aspects of the Program were amended by section 6601 of the Omnibus Budget Reconciliation Act of 1989. To date, most of the dispositions under the Program have involved so-called "retrospective cases." See Mariner, Wendy K., *Innovation and Challenge: The First Year of the National Vaccine Injury Compensation Program*, May 1991, report prepared for consideration by the Administrative Conference of the United States.

tember 30, 1988, and before October 1, 1992, also is extended for two years (i.e., for vaccines administered after September 30, 1988, and before October 1, 1994).

Study

In addition, the Secretary of the Treasury, in consultation with the Secretary of Health and Human Services, is directed to conduct a study of: (1) the estimated amount that will be paid from the Vaccine Trust Fund with respect to vaccines administered after September 30, 1988, and before October 1, 1994; (2) the rates of vaccine-related injury or death with respect to various types of vaccines; (3) new vaccines and immunization practices being developed or used for which amounts may be paid from the Vaccine Trust Fund; (4) whether additional vaccines should be included in the Program; and (5) the appropriate treatment of vaccines produced by State governmental entities. The Secretary of the Treasury must submit a report detailing his findings no later than January 1, 1994, to the House Committee on Ways and Means and the Senate Committee on Finance.

Effective Date

The provisions are effective on the date of enactment.

5. Permanent Extension of General Fund Transfer to Railroad Retirement Tier 2 Fund (sec. 2509 of the bill)

Present Law

The proceeds from the income taxation of railroad retirement Tier 2 benefits are transferred from the general fund of the Treasury to the Railroad Retirement Account. This transfer applies only to proceeds from the taxation of benefits which have been received prior to October 1, 1992. Proceeds from the taxation of benefits received after this date remain in the general fund.

Reasons for Change

It is appropriate to make permanent the transfer of funds from the general fund of the Treasury to the Railroad Retirement Account to promote the ongoing solvency of the Railroad Retirement system.

Explanation of Provision

The transfer of proceeds from the income taxation of railroad retirement Tier 2 benefits from the general fund of the Treasury to the Railroad Retirement Account is made permanent.

Effective Date

The provision is effective beginning September 30, 1992.

6. Extension of Tax Credit for Orphan Drug Clinical Testing Expenses (sec. 2510 of the bill and sec. 28 of the Code)

Present Law

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

The orphan drug tax credit is scheduled to expire after June 30, 1992.

Reasons for Change

To encourage the development of drugs to treat rare diseases, the committee believes it is appropriate to extend the orphan drug tax credit.

Explanation of Provision

The bill extends the orphan drug tax credit for 18 months (i.e., for qualified clinical testing expenses incurred through December 31, 1993).

Effective Date

The provision is effective for expenses incurred during the period July 1, 1992, through December 31, 1993.

7. Allocation and Apportionment of Research Expenses (secs. 861-864 of the Code)

Present Law

U.S. persons are taxable on their worldwide income, including their foreign income. Foreign source taxable income equals foreign source gross income less the expenses, losses and other deductions properly apportioned or allocated to that income. The Internal Revenue Code generally articulates only the broad principles of how expenses reduce U.S. and foreign source gross income, leaving the Treasury Department to provide detailed rules for the task of allocating and apportioning expenses.

Treasury regulations issued in 1977 described methods for allocating expenses between U.S. and foreign source income, including rules for the allocation of research and development (R&D) expenses. Upon issuance of these regulations, a significant dispute regarding the appropriate allocation of R&D expenses developed be-

tween taxpayers and the Treasury Department. This unresolved dispute between taxpayers and the Treasury Department precipitated Congressional involvement on this issue, and since 1981, the R&D allocation regulations have been subject to a series of eight suspensions and temporary modifications. The current temporary provision is applicable generally for the first six months of the first taxable year beginning after August 1, 1991, and among other rules, automatically allocates 64 percent of U.S. performed R&D to U.S. source income, and generally permits a greater amount of taxable income to be classified as foreign source than under the 1977 regulations. This will increase the benefits of the foreign tax credit to many taxpayers.

Reasons for Change

The committee believes that the Treasury Department should now resolve this controversy. The President's Fiscal Year 1993 Budget contains a proposal to provide an 18-month extension of these R&D allocation rules. The *General Explanations of the President's Budget Proposals Affecting Receipts* (January 1992), in a section entitled "Jobs and Investments," states that the Administration believes in providing tax incentives to increase the performance of U.S.-based research activities. Further, the Treasury explanation states that by enhancing the return on R&D expenditures, the proposal encourages the growth of overall R&D activity as well as the location of such research within the United States.

Explanation of Provision

The committee believes that the Treasury Department has broad authority under current law to revise the current R&D allocation regulations. Since the Administration has indicated its support of an allocation system that provides incentives to increase the performance of U.S.-based research activities, the committee expects, and in the strongest terms, urges the Treasury Department to revise its permanent regulations in a manner consistent with the Administration's stated objectives and proposals. The committee believes that such a revision would be consistent both with current law regulatory authority and with the stated goals of the Administration.

The committee further urges the Treasury Department, when revising its regulations, to take into consideration that taxpayers, in appropriate circumstances, are required for business purposes to conduct significant amounts of R&D at foreign sites and should not be penalized by the allocation rules.

Effective Date

The committee expects and requests the Treasury Department to issue regulations no later than June 1, 1992, to be effective after the termination of the current temporary rules.

Part IV—Excise Taxes

1. Repeal of Luxury Excise Tax on Boats, Aircraft, Jewelry, and Furs; Indexing of Luxury Excise Tax on Automobiles (sec. 2511 of the bill and secs. 4001-4012 of the Code)

Present Law

Present law imposes a ten-percent excise tax on the portion of the retail price of the following items that exceeds the thresholds specified: automobiles above $30,000; boats above $100,000; aircraft above $250,000; jewelry above $10,000; and furs above $10,000.

The tax generally applies only to the first retail sale after manufacture, production or importation of items subject to the tax. It does not apply to subsequent sales of these items. The taxes on automobiles, boats, and aircraft generally do not apply to items used in trade or business.

The tax applies to sales before January 1, 2000.

Reasons for Change

During the current recession, the boat, aircraft, jewelry, and fur industries have suffered job losses and increased unemployment. The committee believes, in the context of the current general economic hardship, it is appropriate to eliminate the burden these taxes impose in the interests of fostering economic recovery in those and related industries.

The committee recognizes that in the absence of indexation of the threshold above which the tax on automobiles applies, even modest inflation will subject more automobiles to the luxury tax than were subject to the tax when it was first enacted.

Explanation of Provision

Repeal of tax on boats, aircraft, jewelry, and fur

The bill repeals the luxury excise tax imposed on boats, airplanes, jewelry, and furs.

Indexing of tax on automobiles

The bill modifies the luxury excise tax on automobiles to provide that the $30,000 threshold is indexed annually for inflation occurring after 1990. Consequently, the applicable threshold for 1992 will be $30,000 increased by the 1991 inflation rate.

Effective Date

The repeal of the luxury excise taxes on boats, aircraft, jewelry, and furs is effective for sales on or after January 1, 1992. The indexation of the threshold applicable to automobiles is effective for sales on or after January 1, 1992.

Persons entitled to a refund may request it from the seller at which they purchased the taxed item, who then obtains the refund as provided under present-law Code section 6416.

2. Impose Excise Tax on Diesel Fuel Used in Noncommercial Boats (sec. 2512 of the bill and secs. 4092, 4041, 6421, 9503, and 9508 of the Code)

Present Law

Federal excise taxes generally are imposed on gasoline and special motor fuels used in highway transportation and by certain off-highway recreational trail vehicles and by boats (14 cents per gallon). A Federal excise tax also is imposed on diesel fuel (20 cents per gallon) used in highway transportation. Diesel fuel used in trains generally is taxed at 2.5 cents per gallon.

The revenues from these taxes, minus 2.5 cents per gallon, are deposited in the Highway Trust Fund ("HTF"), the National Recreational Trails Trust Fund, or the Aquatic Resources Trust Fund through September 30, 1999. Revenues from the remaining 2.5 cents per gallon are retained in the General Fund through September 30, 1995, after which time the 2.5-cents-per-gallon portion of the taxes (including the tax on diesel fuel used in trains) is scheduled to expire.

An additional 0.1-cent-per-gallon tax applies to these fuels to finance the Leaking Underground Storage Trust Fund ("LUST Fund"), generally through December 31, 1995.

Diesel fuel used in boats is not taxed.

Reasons for Change

The bill eliminates the discrepancy between gasoline used by pleasure boats (which is taxable) and diesel fuel used by these boats (which is not taxable).

Explanation of Provision

The bill extends the current 20.1-cents-per-gallon diesel fuel excise taxes to diesel fuel used by boats. Fuel used by boats for commercial fishing, transportation for compensation or hire, or for business use other than predominantly for entertainment, amusement, or recreation, remains exempt.

As under the President's budget proposal, the tax is collected at the same point in the distribution chain as the highway diesel fuel tax (i.e., on sale to a retailer). However, to prevent unnecessary tax-paid sales followed by refunds, retailers that sell diesel fuel exclusively to commercial (i.e., nonpleasure) boats are permitted to buy the fuel tax-free.

The revenues from the 20.1-cents-per-gallon tax on diesel fuel used by boats will be retained in the General Fund.

Effective date

The provision is effective after June 30, 1992.

Part V—Other Provisions

1. Employer-Provided Transportation Benefits (sec. 2513 of the bill and sec. 132 of the Code)

Present Law

Under Treasury regulations, monthly transit passes, tokens, etc., provided by an employer are excludable from an employee's income (for both income and payroll tax purposes) as a de minimis fringe benefit if the total value of the transit pass does not exceed $21. If the total value of such benefits exceeds $21 per month, the full value of the benefits is includible in income.

Parking at or near the employer's business premises that is paid for by the employer is excludable from the gross income of the employee (for both income and payroll tax purposes) as a working condition fringe benefit, regardless of the value of the parking.

Reasons for Change

Present law favors employer-provided parking over employer-provided transit benefits. This disparity may discourage employers from providing transit benefits as opposed to parking benefits. The committee believes that a significant increase in the amount and type of employer-provided public transit commuting benefits that may be excluded from income, together with a limit on the exclusion for employer-provided parking, will create a more meaningful incentive for employers to support commuting by public transit than the present-law exclusions. The committee believes that increased use of mass transit could provide substantial benefits to society, such as reduced traffic congestion and reduced environmental degradation.

Explanation of Provision

Under the bill, gross income (for both income and payroll tax purposes) does not include qualified transportation fringe benefits. In general, a qualified transportation fringe is (1) transportation in a commuter highway vehicle if such transportation is in connection with travel between the employee's residence and place of employment, (2) a transit pass, or (3) qualified parking. The maximum amount of qualified parking that is excludable from an employee's gross income is $160 per month (regardless of the total value of the parking). Other qualified transportation fringes are excludable from gross income to the extent that the aggregate value of the benefits does not exceed $60 per month (regardless of the total value of the benefits). The dollar limits are indexed for inflation after 1992.

A transit pass includes any pass, token, farecard, voucher, or similar item entitling a person to transportation on mass transit facilities (whether or not publicly owned). Types of transit facilities that may qualify for the exclusion include, for example, rail, bus, and ferry.

A commuter highway vehicle is a highway vehicle with the capacity to seat at least 6 adults (not including the driver) and at least 80 percent of the mileage use of which is for transporting em-

ployees between their residences and their place of employment using at least one-half of the adult seating capacity of the vehicle (not including the driver). Transportation furnished in a commuter highway vehicle operated by or for the employer is considered provided by the employer.

Qualified parking is parking provided to an employee on or near the business premises of the employer or on or near a location from which the employee commutes to work by mass transit, in a commuter highway vehicle, or by carpool.

The specific statutory exclusion for employer-provided commuting expenses and parking replaces the present-law exclusion of transit passes under the rules relating to de minimis fringe benefits and the present-law exclusion for employer-provided parking as a working condition fringe benefit.

Effective Date

The provision applies to benefits provided by the employer on or after January 1, 1992, except that the $160 per month limit on the exclusion for qualified parking benefits applies to benefits provided after the date of enactment.

2. Classification of Multi-Purpose Vehicles (sec. 2514 of the bill)

Present Law

Under present regulations, multi-purpose vehicles (MPVs) such as mini-vans and sport utility vehicles are inconsistently classified as autos or trucks. For purposes of emission and fuel economy standards, most MPVs are classified as trucks. However, for customs purposes, MPVs with more than two doors are generally classified under the Harmonized Tariff System (HTS) as "vehicles principally designed for the transport of persons" (HTS heading 8703), subject to a 2.5 percent duty. Two-door MPVs are generally classified as "vehicles for the transport of goods" (HTS heading 8704), subject to a 25 percent duty. The current tariff classification resulted from a controversial Treasury Department ruling in 1989 reversing an earlier Customs Service ruling which classified all MPVs under HTS heading 8704 and subjected them to the 25 percent duty.

Reasons for Change

The committee believes that it is appropriate to make this modification.

Explanation of Provision

The bill incorporates into the HTS language from the regulations of the Environmental Protection Agency and the Department of Transportation such that MPVs classified as trucks for emission and fuel economy standards would also be classified as trucks for tariff purposes. The effect would be to raise the duty on certain MPVs from 2.5 percent to 25 percent.

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Effective Date

The proposal is effective 15 days after the bill's enactment.

TITLE III—PAYMENT OF FAIR SHARE BY HIGH-INCOME TAXPAYERS

Subtitle A—Treatment of Wealthy Individuals

1. Individual Income Tax Rates (36-Percent Bracket) (sec. 3001 of the bill and secs. 1, 541, 32, 41, 63, 68, 135, 151 and 513 of the Code)

Present Law

For 1992, the individual income tax rate schedules are as follows—

If taxable income is	Then income tax equals
Single individuals	
$0–$21,450	15 percent of taxable income.
$21,450–$51,900	$3,217.50 plus 28% of the amount over $21,450.
Over $51,900	$11,743.50 plus 31% of the amount over $51,900.
Heads of households	
$0–$28,750	15 percent of taxable income.
$28,750–$74,150	$4,312.50 plus 28% of the amount over $28,750.
Over $74,150	$17,024.50 plus 31% of the amount over $74,150.
Married individuals filing joint returns	
$0–$35,800	15 percent of taxable income.
$35,800–$86,500	$5,370 plus 28% of the amount over $35,800.
Over $86,500	$19,566 plus 31% of the amount over $86,500.
Married individuals filing separate returns	
$0–$17,900	15 percent of taxable income.
$17,900–$43,250	$2,685 plus 28% of the amount over $17,900.
Over $43,250	$9,783 plus 31% of the amount over $43,250.
Estates and trusts	
$0–$3,600	15 percent of taxable income.
$3,600–$10,900	$540 plus 28% of the amount over $3,600.
Over $10,900	$2,584 plus 31% of the amount over $10,900.

The individual income tax bracket thresholds are indexed for inflation.

Reasons for Change

To improve tax equity and to make the Federal individual income tax system more progressive, a higher marginal income tax rate should be imposed on taxpayers with a greater ability to pay taxes.

Explanation of Provision

The bill creates a 36-percent bracket for taxable incomes above: $150,000 (unmarried individuals filing single returns); $162,500 (unmarried individuals filing as heads of households); $175,000 (married individuals filing joint returns); $87,500 (married individuals filing separate returns); and $3,500 (estates and trusts). The thresholds for the 36-percent bracket are adjusted for inflation in the same manner as under present law. The individual income tax rate schedules for 1992 are as follows—

If taxable income is	Then income tax equals
Single individuals	
$0–$21,450	15 percent of taxable income.
$21,450–$51,900	$3,217.50 plus 28% of the amount over $21,450.
$51,900–$150,000	$11,743.50 plus 31% of the amount over $51,900.
Over $150,000	$42,154.50 plus 36% of the amount over $150,000.
Heads of households	
$0–$28,750	15 percent of taxable income.
$28,750–$74,150	$4,312.50 plus 28% of the amount over $28,750.
$74,150–$162,500	$17,024.50 plus 31% of the amount over $74,150.
Over $162,500	$44,413 plus 36% of the amount over $162,500.
Married individuals filing joint returns	
$0–$35,800	15 percent of taxable income.
$35,800–$86,500	$5,370 plus 28% of the amount over $35,800.
$86,500–$175,000	$19,566 plus 31% of the amount over $86,500.
Over $175,000	$47,001 plus 36% of the amount over $175,000.
Married individuals filing individuals separate returns	
$0–$17,900	15 percent of taxable income.
$17,900–$43,250	$2,685 plus 28% of the amount over $17,900.

If taxable income is	Then income tax equals
$43,250–$87,500	$9,783 plus 31% of the amount over $43,250.
Over $87,500	$23,500.50 plus 36% of the amount over $87,500.
	Estates and trusts
$0–3,500	15 percent of taxable income.
Over $3,500	$525 plus 36% of the amount over $3,500.

Effective Date

The provision is effective for taxable years beginning after December 31, 1991.

2. Surtax on Taxable Income in Excess of $1 Million (sec. 3002 of the bill and new secs. 59B, 59C, and 59D of the Code)

Present Law

Under present law, there is no surtax imposed on higher-income individuals.

Reasons for Change

The committee believes the Federal individual income tax system is less progressive than is desirable. To increase the progressivity of the income tax system, a surtax on taxpayers with the greatest ability to pay taxes is appropriate. The surtax should apply to both the regular income tax and to the alternative minimum tax imposed on individuals (but not to the income tax imposed on estates and trusts).

Explanation of Provision

The bill imposes a 10-percent surtax on individuals with taxable income over $1,000,000 ($500,000 for married taxpayers filing separate returns). The surtax equals 10 percent of otherwise computed tax liability multiplied by the ratio of taxable income in excess of $1,000,000 to total taxable income. The effect of the proposal is that the more that taxable income exceeds $1,000,000, the closer the surtax approaches a 10-percent increase in total tax liability.

A 2.4-percentage point surtax applies to individuals with alternative minimum taxable income above $1,000,000 ($500,000 for married taxpayers filing separate returns). The surtax is applied by increasing the taxpayer's tentative minimum tax by 2.4 percent of the amount by which the taxpayer's alternative minimum taxable income exceeds $1,000,000 ($500,000 for married taxpayers filing separate returns).

Effective Date

The provision is effective for taxable years beginning after December 31, 1991.

3. Extension of Itemized Deduction Limitation (sec. 3003 of the bill and sec. 68 of the Code)

Present Law

Under present law, individuals who do not elect the standard deduction may claim itemized deductions (subject to certain limitations) for certain nonbusiness expenses incurred during the taxable year. Among these deductible expenses are unreimbursed medical expenses, casualty and theft losses, charitable contributions, qualified residence interest, State and local income and property taxes, unreimbursed employee business expenses, and certain other miscellaneous expenses.

Certain itemized deductions are allowed only to the extent that the amount exceeds a specified percentage of the taxpayer's adjusted gross income (AGI). Unreimbursed medical expenses for care of the taxpayer and the taxpayer's spouse and dependents are deductible only to the extent that the total of these expenses exceeds 7.5 percent of the taxpayer's AGI. Nonbusiness casualty or theft losses are deductible only to the extent that the amount of loss arising from each casualty or theft exceeds $100 and only to the extent that the net amount of casualty and theft losses exceeds 10 percent of the taxpayer's AGI. Unreimbursed employee business expenses and certain other miscellaneous expenses are deductible only to the extent that the total of these expenses exceeds 2 percent of the taxpayer's AGI.

The total amount of otherwise allowable itemized deductions (other than medical expenses, casualty and theft losses, and investment interest) is reduced by 3 percent of the amount of the taxpayer's AGI in excess of $105,250 in 1992 (indexed for inflation). Under this provision, otherwise allowable itemized deductions may not be reduced by more than 80 percent. In computing the reduction of total itemized deductions, all present-law limitations applicable to such deductions are first applied and then the otherwise allowable total amount of deductions is reduced in accordance with this provision.

The reduction of otherwise allowable itemized deductions does not apply to taxable years beginning after December 31, 1995.

Reasons for Change

The limitation on the amount of itemized deductions that may be claimed by higher-income taxpayers is a sound means for ensuring that the individual income tax system is a sufficiently progressive method of raising revenue. In addition, the goal of personalizing the Federal income tax system to reflect an individual's ability to pay taxes is promoted by a rule that imposes some limitation on the deductibility of amounts paid by higher-income individuals, yet generally allows full deductibility of these expenses on the margin. Accordingly, this provision should be extended beyond its present law expiration date.

Explanation of Provision

The bill extends permanently the present-law itemized deduction limitation applicable to higher-income individuals.

Effective Date

The provision is effective for taxable years beginning in 1996 and thereafter.

4. Extension of Personal Exemption Phaseout (sec. 3004 of bill and sec. 151 of the Code)

Present Law

Present law permits a personal exemption deduction from gross income for an individual, the individual's spouse, and each dependent. For 1992, the amount of this deduction is $2,300 for each exemption claimed. This exemption amount is adjusted for inflation. The deduction for personal exemptions is phased out for taxpayers with adjusted gross income (AGI) above a threshold amount (indexed for inflation) which is based on filing status. For 1992, the threshold amounts are $157,900 for married taxpayers filing joint returns, $78,950 for married taxpayers filing separate returns, $131,550 for unmarried taxpayers filing as head of household, and $105,250 for unmarried taxpayers filing as single.

The total amount of exemptions which may be claimed by a taxpayer is reduced by 2 percent for each $2,500 (or portion thereof) by which the taxpayer's AGI exceeds the applicable threshold (the phaseout rate is 4 percent for married taxpayers filing separate returns). Thus, the personal exemptions claimed are phased out over a $122,500 range, beginning at the applicable threshold.

This provision does not apply to taxable years beginning after December 31, 1995.

Reasons for Change

The committee believes that the phaseout of the deduction a taxpayer may claim for personal exemptions is a sound means for ensuring that the individual income tax system is a sufficiently progressive means of raising revenue. The phaseout accomplishes this through denial of a deduction for personal exemptions to those taxpayers with the greatest ability to pay taxes. Accordingly, this provision should be extended beyond its present law expiration date.

Explanation of Provision

The bill extends permanently the present-law personal exemption phaseout.

Effective Date

The provision is effective for taxable years beginning in 1996 and thereafter.

5. Mark to Market Inventory Method for Dealers in Securities (sec. 3005 of the bill and new sec. 475 of the Code)

Present Law

A taxpayer that is a dealer in securities is required for Federal income tax purposes to maintain an inventory of securities held for sale to customers. A dealer in securities is allowed for Federal income tax purposes to determine (or value) the inventory of securities held for sale based on: (1) the cost of the securities; (2) the lower of the cost or market value of the securities; or (3) the market value of the securities.

If the inventory of securities is determined based on cost, unrealized gains and losses with respect to the securities are not taken into account for Federal income tax purposes. If the inventory of securities is determined based on the lower of cost or market value, unrealized losses (but not unrealized gains) with respect to the securities are taken into account for Federal income tax purposes. If the inventory of securities is determined based on market value, both unrealized gains and losses with respect to the securities are taken into account for Federal income tax purposes.

For financial accounting purposes, the inventory of securities generally is determined based on market value.

Reasons for Change

Inventories of securities are easily valued at year end, and, in fact, are currently valued at market by securities dealers in determining their income for financial statement purposes and in adjusting their inventory using the lower of cost or market method for Federal income tax purposes. The committee believes that the cost method and the lower of cost or market method generally understate the taxable income of securities dealers and that the market method most clearly reflects the income of securities dealers.

Explanation of Provision

Mark-to-market rules

The bill provides two general rules (the "mark-to-market rules") that apply to certain securities that are held by a dealer in securities. First, any such security that is inventory in the hands of the dealer is required to be included in inventory at market value. Second, any such security that is not inventory in the hands of the dealer and that is held as of the close of any taxable year is treated as sold for its fair market value on the last business day of the taxable year and any gain or loss is required to be taken into account in determining gross income for that taxable year.[51]

If gain or loss is taken into account with respect to a security by reason of the second mark-to-market rule, then the amount of gain or loss subsequently realized as a result of a sale, exchange, or

[51] For purposes of this provision, a security is treated as sold to a person that is not related to the dealer even if the security is a contract between the dealer and a related person. Thus, for example, sections 267 and 707(b) of the Code are not to apply to any loss that is required to be taken into account under this provision.

other disposition of the security, or as a result of the application of the mark-to-market rules, is to be appropriately adjusted to reflect such gain or loss. In addition, the bill authorizes the Treasury Department to promulgate regulations that provide for the application of the second mark-to-market rule at times other than the close of a taxable year or the last business day of a taxable year.

The mark-to-market rules described above apply only for purposes of determining the amount of gain or loss that is taken into account by a dealer in securities for any taxable year and not for any other purpose. Thus, for example, the mark-to-market rules do not apply in determining the character of any gain or loss or in determining the holding period of any security. As a further example, the mark-to-market rules do not apply in determining whether gain or loss is recognized by any other taxpayer that may be a party to a contract with a dealer in securities.

For purposes of the bill, a dealer in securities is defined as any taxpayer that either (1) regularly purchases securities from, or sells securities to, customers in the ordinary course of a trade or business, or (2) regularly offers to enter into, assume, offset, assign, or otherwise terminate positions in securities with customers in the ordinary course of a trade or business.

For purposes of the bill, a security is defined as: (1) any share of stock in a corporation; (2) any partnership or beneficial ownership interest in a widely-held or publicly traded partnership or trust; (3) any note, bond, debenture, or other evidence of indebtedness; (4) any notional principal contract, including any interest rate or currency swap, but not including any other commodity-linked notional principal contract; and (5) any evidence of an interest in, or any derivative financial instrument in, a security described in (1) through (4) above, including any option, forward contract, short position, or any similar financial instrument in such a security (but not including a contract to which section 1256(a) applies).

In addition, a security is defined to include any position if: (1) the position is not a security described in the preceding paragraph; (2) the position is a hedge [52] with respect to a security described in the preceding paragraph; and (3) before the close of the day on which the position was acquired or entered into (or such other time as the Treasury Department may specify in regulations), the position is clearly identified in the dealer's records as a hedge with respect to a security described in the preceding paragraph.[53]

Exceptions to the mark-to-market rules

Notwithstanding the definition of security, the mark-to-market rules generally do not apply to: (1) any security that is held for investment; [54] (2) any evidence of indebtedness that is originated or

[52] The bill defines a hedge as any position which reduces the dealer's risk from interest rate or price changes, or currency fluctuations.

[53] If at any time a dealer identifies a position as a hedge with respect to a security described in the preceding paragraph but the position, in fact, is not at such time a hedge with respect to a security described in the preceding paragraph, or if a dealer fails to properly identify a position as a hedge with respect to a security described in the preceding paragraph as of the time that the identification is required, then any gain, but not any loss, with respect to the position is to be taken into account under the mark-to-market rules.

[54] To the extent provided in regulations to be promulgated by the Treasury Department, the exception to the mark-to-market rules for a security that is held for investment does not apply

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acquired by a dealer in the ordinary course of a trade or business of the dealer but only if the evidence of indebtedness is not held for sale; (3) any security which is a hedge with respect to a security that is not subject to the mark-to-market rules (*i.e.*, any security that is a hedge with respect to a security held for investment or that is a hedge with respect to an evidence of indebtedness described in (2)); and (4) any security which is a hedge with respect to a position or a liability that is not a security in the hands of the taxpayer.[55]

These exceptions to the mark-to-market rules do not apply unless before the close of the day on which the security (including any evidence of indebtedness) is acquired, originated, or entered into (or such other time as the Treasury Department may specify in regulations),[56] the security is clearly identified in the dealer's records as being described in one of the exceptions listed in the preceding paragraph.[57]

In addition to clearly identifying a security as qualifying for one of the exceptions to the mark-to-market rules listed above, a dealer must continue to hold the security in a capacity that qualifies the security for one of the exceptions listed above. If at any time after the close of the day on which the security was acquired, originated, or entered into (or such other time as the Treasury Department may specify in regulations), the security is held for sale to customers in the ordinary course of the taxpayer's trade or business or the security is held as a hedge with respect to a security that is subject to the mark-to-market rules, then the exceptions to the mark-to-market rules do not apply to the security as of such time.

Further, if at any time a dealer identifies a security as qualifying for an exception to the mark-to-market rules when, in fact, the security does not, at that time, qualify for an exception to these rules, or a dealer fails to identify a security that qualifies for an exception as qualifying for an exception as of the time that the identification is required, then any gain, but not any loss, with respect to the security is to be taken into account under the mark-to-market rules.

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to any notional principal contract or any evidence of any interest in, or any derivative financial instrument in, a security that is held by a dealer in such securities.

[55] For purposes of the mark-to-market rules, debt issued by a taxpayer is not considered to be a security in the hands of such taxpayer.

[56] The committee anticipates that the Treasury regulations will permit a floor specialist to identify a security as held for investment before the close of the seventh business day following the day that the security is acquired, originated, or entered into (see section 1236(d)). In addition, the committee anticipates that the Treasury regulations will permit a dealer that originates or acquires evidences of indebtedness in the ordinary course of a trade or business to identify such evidences of indebtedness as not held for sale based on the accounting practices of the dealer but in no event later than the date that is 60 days after any such evidence of indebtedness is originated or acquired.

[57] A security is to be treated as clearly identified in a dealer's records as being described in one of the exceptions listed in the preceding paragraph if all of securities of the taxpayer that are not so described are clearly identified in the dealer's records as not being described in such exception.

For example, assume that, in the ordinary course of its trade or business, a bank originates loans that are sold if the loans satisfy certain conditions. In addition, assume that (1) the bank determines whether a loan satisfies the conditions within 30 days after the loan is made, and (2) if a loan satisfies the conditions for sale, the bank records the loan in a separate account on the date that the determination is made. For purposes of the bill, the bank is a dealer in securities with respect to the loans that it holds for sale. In addition, by identifying these loans as held for sale, the bank is considered to have identified all other loans as not held for sale. Consequently, the loans that are not held for sale are not subject to the mark-to-market rules.

Other rules

The bill also provides that the uniform cost capitalization rules of section 263A of the Code and the rules of section 263(g) of the Code that require the capitalization of certain interest and carrying charges in the case of straddles do not apply to any security to which the mark-to-market rules apply. Finally, the bill authorizes the Treasury Department to promulgate such regulations as may be appropriate to carry out the provisions of the bill, including rules to prevent the use of year-end transfers, related persons, or other arrangements to avoid the provisions of the bill.

Effective Date

The provision applies to taxable years ending on or after December 31, 1993. A taxpayer that is required to change its method of accounting to comply with the requirements of the provision is treated as having initiated the change in method of accounting and as having received the consent of the Treasury Department to make such change. The net amount of any section 481(a) adjustment that is required by the change in method of accounting generally is to be taken into account by the taxpayer ratably over a 10-taxable year period beginning with the first taxable year ending on or after December 31, 1993.

The committee anticipates that the provisions of section 8 of Rev. Proc. 92-20, 1992-12 I.R.B., which provides rules for the acceleration of section 481(a) adjustments, will apply to any section 481(a) adjustment that is required by reason of the enactment of this provision. In addition, the committee anticipates that net operating losses will be allowed to offset the section 481(a) adjustment, tax credit carryforwards will be allowed to offset any tax attributable to the section 481(a) adjustment, and, for purposes of determining liability for estimated taxes, the section 481(a) adjustment will be taken into account ratably throughout the taxable year in question.

6. Limit Deduction for Executive Compensation (sec. 3006 of the bill and sec. 162 of the Code)

Present Law

Under present law, a deduction is allowed in computing Federal income tax liability for ordinary and necessary expenses paid or incurred during the taxable year in carrying on a trade or business, including a reasonable allowance for salaries or other compensation for personal services actually rendered.

Reasons for Change

The committee believes that compensation received by corporate executives in excess of $1 million is per se unreasonable, and should not be deductible as an ordinary and necessary expense in carrying on a trade or business.

Explanation of Provision

For purposes of the regular income tax and the alternative minimum tax, the otherwise allowable deduction for compensation paid or accrued with respect to a covered employee is limited to no more than $1 million per year. A covered employee means any employee of the taxpayer who is an officer of the taxpayer, other than an employee-owner of a personal service corporation.

For purposes of the provision, an officer generally is an administrative executive who is in regular and continued service, regardless of the employee's job title. An employee who has the title of an officer but does not have the authority of an officer is not considered an officer. Similarly, an employee who does not have the title of an officer but has the authority of an officer is an officer for purposes of this rule.

An employee-owner of a personal service corporation is generally defined as under section 269A of the Code. Thus, a personal service corporation is a corporation the principal activity of which is the performance of personal services if the services are substantially performed by employee-owners. An employee-owner is any employee who owns more than 10 percent of the outstanding stock of the personal service corporation.

The term covered employee includes former employees. Thus, for example, the provision applies to compensation paid to former employees (e.g., nonqualified deferred compensation that is not paid until after termination of employment) as well as current employees.

The provision does not apply to compensation paid to employees who are not officers. Similarly, the provision does not apply to payments to partners in a partnership because they are not employees. The provision also does not apply to payments to independent contractors.

The deduction limitation generally applies to all remuneration for services, including the cash value of all remuneration (including benefits) paid in a medium other than cash. The limit does not apply to fringe benefits excludable from income under section 132, meals and lodging furnished on the business premises of the employer that are excludable under section 119, or any payment made to, or on behalf of, an employee or beneficiary (1) from or to a qualified pension, profit-sharing, or annuity plan, or (2) under a simplified employee pension (SEP) or tax-sheltered annuity (other than elective deferrals to such a plan or annuity).

The deduction limitation applies at the time the deduction would otherwise be taken.

Certain related employers are treated as a single employer for purposes of the provision. In particular, employers treated as a single employer under section 52(a) or (b) or section 414(m) or (n) are treated as a single employer. An employee who is an officer of any of the members of a group of employers treated as a single employer is treated as an officer of the single employer. Similarly, compensation from related employers is aggregated for purposes of the $1 million limit.

It is intended that the Secretary will prevent avoidance of the rules through the use of arrangements other than employee-employer arrangements.

Effective Date

The provision is effective for taxable years beginning on or after January 1, 1992.

Subtitle B—Administrative Provisions

1. Modify Individual Estimated Tax Requirements (sec. 3101 of the bill and sec. 6654 of the Code)

Present Law

Under present law, an individual taxpayer generally is subject to an addition to tax for any underpayment of estimated tax. An individual generally does not have an underpayment of estimated tax if he or she makes timely estimated tax payments at least equal to: (1) 100 percent of the tax liability of the prior year (the "100 percent of last year's liability safe harbor") or (2) 90 percent of the tax liability of the current year. Income tax withholding from wages is considered to be a payment of estimated taxes.

In addition, under a special rule, for taxable years beginning after 1991 and before 1997, a taxpayer that has an adjusted gross income (AGI) in the current year that exceeds the taxpayer's AGI in the prior year by more than $40,000 ($20,000 in the case of a separate return by a married individual) and (2) the taxpayer has an AGI in excess of $75,000 in the current year ($37,500 in the case of a separate return by a married individual) generally may not use the 100 percent of last year's liability safe harbor.

Reasons for Change

The committee believes that the special rule applicable to taxable years beginning after 1991 and before 1997 should be made permanent.

Explanation of Provision

The special rule that denies the use of the 100 percent of last year's liability safe harbor is made permanent.

In addition, the bill clarifies that for purposes of the special rule, an estate or a trust is to calculate its AGI (and modified AGI) pursuant to rules similar to those of section 67(e) of the Code.

Effective Date

The provision is effective for estimated tax payments applicable to taxable years beginning after December 31, 1991.

2. Modify Estimated Tax Payment Rules for Large Corporations (sec. 3102 of the bill and sec. 6655 of the Code)

Present Law

A corporation is subject to an addition to tax for any underpayment of estimated tax. For taxable years beginning in 1993, 1994, 1995, and 1996, a corporation does not have an underpayment of estimated tax if it makes four equal timely estimated tax payments that total at least 95 percent of the tax liability shown on the return for the current taxable year. In addition, a corporation may annualize its taxable income and make estimated tax payments based on 95 percent of the tax liability attributable to such annualized income.

For taxable years beginning in 1992, the 95 percent requirement is a 93 percent requirement; the 95 percent requirement becomes a 90 percent requirement for taxable years beginning in 1997 and thereafter.

A corporation that is not a "large corporation" generally may avoid the addition to tax if it makes four timely estimated tax payments each equal to at least 25 percent of its tax liability for the preceding taxable year (the "100 percent of last year's liability safe harbor"). A large corporation may use this rule with respect to its estimated tax payment for the first quarter of its current taxable year. A large corporation is one that had taxable income of $1 million or more for any of the three preceding taxable years.

Reasons for Change

The committee believes that the corporate estimated tax requirements applicable to taxable years beginning in 1993, 1994, 1995, and 1996 should be made permanent.

Explanation of Provision

For taxable years beginning after 1996, a corporation that does not use the 100 percent of last year's liability safe harbor for its estimated tax payments is required to base its estimated tax payments on 95 percent (rather than 90 percent) of its current year tax liability, whether such liability is determined on an actual or annualized basis.

The bill does not change the present-law availability of the 100 percent of last year's liability safe harbor for large or small corporations.

Effective Date

The bill is effective for estimated tax payments with respect to taxable years beginning after December 31, 1992.

3. Expansion of 45-Day Interest-Free Period (sec. 3103 of the bill and sec. 6611 of the Code)

Present Law

No interest is paid by the Government on a refund arising from an income tax return if the refund is issued by the 45th day after

the later of the due date for the return (determined without regard to any extensions) or the date the return is filed (Code sec. 6611(e)).

There is no parallel rule for refunds of taxes other than income taxes (i.e., employment, excise, and estate and gift taxes), for refunds of any type of tax arising from amended returns, or for claims for refunds of any type of tax.

If a taxpayer files a timely original return with respect to any type of tax and later files an amended return claiming a refund, and if the IRS determines that the taxpayer is due a refund on the basis of the amended return, the IRS will pay the refund with interest computed from the due date of the original return.

Reasons for Change

The committee believes that it is inappropriate for the payment of interest on tax refunds to be determined by the type of tax; all types of taxes should be treated similarly. In addition, taxpayers generally control the time of filing of an amended return or claim for refund. Consequently, the committee believes that it is appropriate to alter the interest rules with respect to amended returns and claims for refunds.

Explanation of Provision

No interest is to be paid by the Government on a refund arising from any type of original tax return if the refund is issued by the 45th day after the later of the due date for the return (determined without regard to any extensions) or the date the return is filed.

A parallel rule applies to amended returns and claims for refunds: if the refund is issued by the 45th day after the date the amended return or claim for refund is filed, no interest is to be paid by the Government for that 45-day period (interest would continue to be paid for the period from the due date of the return to the date the amended return or claim for refund is filed). If the IRS does not issue the refund by the 45th day after the date the amended return or claim for refund is filed, interest would be paid (as under present law) for the period from the due date of the original return to the date the IRS pays the refund.

A parallel rule also applies to IRS-initiated adjustments (whether due to computational adjustments or audit adjustments). With respect to these adjustments, the IRS is to pay interest for 45 fewer days than it otherwise would.

Effective Date

The extension of the 45-day processing rule is effective for returns required to be filed (without regard to extensions) on or after July 1, 1992.

The amended return rule is effective for amended returns and claims for refunds filed on or after July 1, 1992 (regardless of the taxable period to which they relate).

The rule relating to IRS-initiated adjustments is applicable to refunds paid on or after July 1, 1992 (regardless of the taxable period to which they relate).

TITLE IV—SIMPLIFICATION PROVISIONS

Subtitle A—Provisions Relating to Individuals

1. Rollover of gain on sale of principal residence in the case of divorce or separation (sec. 4101 of the bill and sec. 1034 of the Code)

Present Law

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

The determination whether property is used by a taxpayer as a principal residence depends upon all the facts and circumstances in each case, including the good faith of the taxpayer. No safe harbor is provided for sales of principal residences incident to divorce or marital separation.

Reasons for Change

In the case of a divorce or marital separation, the determination of principal residence for one or both spouses may be unduly complex for both the taxpayer and the Internal Revenue Service. The creation of a safe-harbor rule for certain sales pursuant to a divorce or marital separation will ease administration of the law while still preserving the policy that the rollover is available only for the sale of an individual's principal residence.

Explanation of Provision

The bill provides a safe harbor in the determination of principal residence in certain cases incident to divorce or marital separation. Specifically, the bill provides that a residence is treated as the taxpayer's principal residence at the time of sale if (1) the residence is sold pursuant to a divorce or marital separation and (2) the taxpayer used such residence as his or her principal residence at any time during the two-year period ending on the date of sale.

Effective Date

The provision applies to sales of old residences (within the meaning of section 1034) after the date of enactment.

2. Permit payment of taxes by credit card (sec. 4102 of the bill and sec. 6311 of the Code)

Present Law

Payment of taxes may be made by checks or money orders, to the extent and under the conditions provided by regulations.

Reasons for Change

Credit cards are a commonly used and reliable form of payment. Some taxpayers may find paying taxes by credit card more convenient than paying by check or money order.

Explanation of Provision

The bill permits payment of taxes by credit card, to the extent and under the conditions provided by regulations.

Effective Date

The provision is effective on the date of enactment.

3. Election by parent to claim unearned income of certain children on parent's return (sec. 4103 of the bill and secs. 1(g)(7) and 59(j)(1) of the Code)

Present Law

The net unearned income of a child under 14 years of age is taxed to the child at the parents' statutory rate. Net unearned income means unearned income less the sum of $500 and the greater of: (1) $500 of the standard deduction or $500 of itemized deductions or (2) the amount of allowable deductions directly connected with the production of the unearned income. The dollar amounts are adjusted for inflation occurring after 1987.

In certain circumstances, a parent may elect to include a child's unearned income on the parent's income tax return if the child's income is less than $5,000. A parent making this election must include the gross income of the child in excess of $1,000 in income for the taxable year. In addition, the parent must report an additional tax liability equal to the lesser of (1) $75 or (2) 15 percent of the excess of the child's income over $500. The dollar amounts for the election are not adjusted for inflation.

A person claimed as a dependent cannot claim a standard deduction exceeding the greater of $500 or such person's earned income. For alternative minimum tax purposes, the exemption of a child under 14 years of age generally cannot exceed the sum of such child's earned income plus $1,000. The $500 amount is adjusted for inflation occurring after 1987 but the $1,000 amount is not.

Reasons for Change

The election by a parent to include a child's unearned income on a return is intended to eliminate the need to file a separate return for a child without reducing the family's total tax liability. Indexation of the underlying dollar amounts simplifies return preparation by making the election available to more taxpayers.

The restriction upon the exemption allowed to a child for alternative minimum tax purposes is intended to treat the family the same as if the child's income had been included on the parent's return. Indexation of this exemption amount achieves this goal and simplifies transfers by removing a tax consideration influencing the ownership of property within the family.

Explanation of Provision

The bill adjusts for inflation occurring after 1987 the dollar amounts involved in the election to claim unearned income on the parent's return. It likewise indexes the $1,000 amount used in computing the child's alternative minimum tax.

Effective Date

The provision applies to taxable years beginning after December 31, 1991.

4. Simplified foreign tax credit limitation for individuals (sec. 4104 of the bill and sec. 904 of the Code)

Present Law

In order to compute the foreign tax credit, a taxpayer computes foreign source taxable income and foreign taxes paid in each of the applicable separate foreign tax credit limitation categories. In the case of an individual, this requires the filing of IRS Form 1116, designed to elicit sufficient information to perform the necessary calculations.

In many cases, individual taxpayers who are eligible to credit foreign taxes may have only a modest amount of foreign source gross income, all of which is income from investments (e.g., dividends from a foreign corporation subject to foreign withholding taxes or dividends from a domestic mutual fund that can pass through its foreign taxes to the shareholder (see sec. 853)). Taxable income of this type ordinarily is subject to the single foreign tax credit limitation category known as passive income. However, under certain circumstances, the Code treats investment-type income (e.g., dividends and interest) as income in several other separate limitation categories (e.g., high withholding tax interest income, general limitation income) designed to accomplish certain policy objectives or forestall certain abuses. For this reason, any taxpayer with foreign source gross income is required to provide sufficient detail on Form 1116 to ensure that foreign source taxable income from investments, as well as all other foreign source taxable income, is allocated to the correct limitation category.

Reasons for Change

The committee believes that a significant number of individuals are entitled to credit relatively small amounts of foreign tax imposed at modest effective tax rates on foreign source investment income. For taxpayers in this class, applicable foreign tax credit limitations typically exceed the amounts of taxes paid. Therefore, relieving these taxpayers from application of the full panoply of foreign tax credit rules may achieve significant reduction in the complexity of the tax law without significantly altering actual tax liabilities. At the same time, however, the committee believes that the benefits of simplified treatment should be limited to cover those cases where the taxpayer is receiving a payee statement showing the amount of the foreign source income and the foreign tax.

Explanation of Provision

The bill allows individuals with no more than $200 of creditable foreign taxes, and no foreign source income other than income that is in the passive basket, to elect a simplified foreign tax credit limitation equal to the lesser of 25 percent of the individual's foreign source gross income or the amount of the creditable foreign taxes paid or accrued by the individual during the taxable year. (The committee intends that an individual electing this simplified limitation calculation not be required to file Form 1116 in order to obtain the benefit of the credit.) A person who elects the simplified foreign tax credit limitation is not allowed a credit for any foreign tax not shown on a payee statement (as that term is defined in sec. 6724(d)(2)) furnished to him or her. Nor is the person entitled to treat any excess credits for a taxable year to which the election applied as a carryover to another taxable year. Because the limitation for a taxable year to which the election applies can be no more than the creditable foreign taxes actually paid for the taxable year, it is also the case under the bill that no excess credits from another year can be carried over to the taxable year to which the election applies.

For purposes of the simplified limitation, passive income generally is defined to include all types of income that would be foreign personal holding company income under the subpart F rules, plus income inclusions from passive foreign corporations (as defined by the bill), so long as the income is shown on a payee statement furnished to the individual. Thus, for purposes of the simplified limitation, passive income includes all dividends, interest (and income equivalent to interest), royalties, rents, and annuities; net gains from dispositions of property giving rise to such income; net gains from certain commodities transactions; and net gains from foreign currency transactions that give rise to foreign currency gains and losses as defined in section 988. The statutory exceptions to treating these types of income as passive for foreign tax credit limitation purposes, such as the exceptions for high-taxed income and high-withholding-tax interest, are not applicable in determining eligibility to use the simplified limitation.

Although an estate or trust generally computes taxable income and credits in the same manner as in the case of an individual (Code sec. 641(b); Treas. Reg. sec. 1.641(b)-1), the simplified limitation does not apply to an estate or trust.

Effective Date

The provision applies to taxable years beginning after December 31, 1991.

5. Personal transactions by individuals in foreign currency (sec. 4105 of the bill and sec. 988 of the Code)

Present Law

When a U.S. taxpayer with a dollar functional currency makes a payment in a foreign currency, gain or loss (referred to as "exchange gain or loss") arises from any change in the value of the foreign currency relative to the U.S. dollar between the time the

currency was acquired (or the obligation to pay was incurred) and the time that the payment is made. Gain or loss results because foreign currency, unlike the U.S. dollar, is treated as property for Federal income tax purposes.

Exchange gain or loss can arise in the course of a trade or business or in connection with an investment transaction. Exchange gain or loss can also arise where foreign currency was acquired for personal use. For example, the IRS has ruled that a taxpayer who converts U.S. dollars to a foreign currency for personal use—while traveling abroad—realizes exchange gain or loss on reconversion of appreciated or depreciated foreign currency (Rev. Rul. 74-7, 1974-1 C.B. 198).

Prior to the Tax Reform Act of 1986 (the "1986 Act"), most of the rules for determining the Federal income tax consequences of foreign currency transactions were embodied in a series of court cases and revenue rulings issued by the Internal Revenue Service ("IRS"). Additional rules of limited application were provided by Treasury regulations and, in a few instances, statutory provisions. Pre-1986 law was believed to be unclear regarding the character, the timing of recognition, and the source of gain or loss due to fluctuations in the exchange rate of foreign currency. The result of prior law was uncertainty of tax treatment for many legitimate transactions, as well as opportunities for tax-motivated transactions. Therefore, in 1986 Congress determined that a comprehensive set of rules should be provided for the U.S. tax treatment of transactions involving "nonfunctional currencies;" that is, currencies other than the taxpayer's "functional currency."

However, the 1986 Act provisions designed to clarify the treatment of currency transactions, primarily found in section 988, apply to transactions entered into by an individual only to the extent that expenses attributable to such transactions would be deductible under section 162 (as a trade or business expense) or section 212 (as an expense of producing income, other than expenses incurred in connection with the determination, collection, or refund of taxes). Therefore, the principles of pre-1986 law continue to apply to personal currency transactions.[58]

Reasons for Change

An individual who lives or travels abroad generally cannot use U.S. dollars to make all of the purchases incident to ordinary daily life. Instead, the local currency must often be used, yet the individual will not be treated for tax purposes as having changed his or her functional currency to the local currency. If it were necessary to treat foreign currency in this instance as property giving rise to U.S. dollar income or loss every time it was, in effect, "bartered" for goods or services, the U.S. individual living in or visiting a foreign country would have a significant administrative burden that may bear little or no relation to whether U.S.-dollar measured income has increased or decreased. An analogous issue arises for a

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[58] See, e.g., Rev. Rul. 90-79, 1990- C.B. 187 (where the taxpayer purchased a house in a foreign country, financed by a foreign currency loan, and the currency appreciates before the house is sold and the loan is repaid, the taxpayer's exchange loss on repayment of the loan is not deductible under sec. 165 and does not offset taxable gain on the sale of the house).

corporation that has a qualified business unit ("QBU") in a foreign country but nevertheless uses the U.S. dollar as its functional currency pursuant to section 986(b)(3). Complexity concerns aside, Congress could have required in that case that gain or loss be computed on each transaction carried out in the local currency. Instead, however, Congress directed the Treasury to adopt a method of translation of the QBU's results that merely approximates the results of determining exchange gain or loss on a transaction-by-transaction basis.[59] The committee believes that individuals also should be given relief from the requirement to keep track of gains on an actual transaction-by-transaction basis in certain cases.

Explanation of Provision

In a case where an individual acquires nonfunctional currency and then disposes of it in a personal transaction, and where exchange rates have changed in the intervening period, the bill provides for nonrecognition of an individual's resulting exchange gain not exceeding $200. The bill does not change the treatment of resulting exchange losses. The committee understands that under other Code provisions, such losses typically are not deductible by individuals (e.g., sec. 165(c)).

Effective Date

The provision applies to taxable years beginning after December 31, 1991.

6. Make income tax withholding rules parallel to rules for exclusion from income for combat pay (sec. 4106 of the bill and sec. 3401(a)(1) of the Code)

Present Law

Exclusion for combat pay

Gross income does not include certain combat pay of members of the Armed Forces (sec. 112). If enlisted personnel serve in a combat zone during any part of any month, military pay for that month is excluded from gross income (special rules apply if enlisted personnel are hospitalized as a result of injuries, wounds, or disease incurred in a combat zone). In the case of commissioned officers, these exclusions from income are limited to $500 per month of military pay.

Income tax withholding

There is no income tax withholding with respect to military pay for a month in which a member of the Armed Forces of the United States is entitled to the benefits of section 112 (sec. 3401(a)(2)). With respect to enlisted personnel, this income tax withholding rule parallels the exclusion from income under section 112: there is total exemption from income tax withholding and total exclusion from income. With respect to officers, however, the withholding rule is

[59] See Staff of the Joint Committee on Taxation, 100th Cong., 1st Sess., *General Explanation of the Tax Reform Act of 1986* at 1096 (1987); Treas. Reg. sec. 1.985-3.

not parallel: there is total exemption from income tax withholding, although the exclusion from income is limited to $500 per month.

Reasons for Change

In most instances, the wage withholding rules closely parallel the inclusion in income rules. Consequently, most individuals whose income is subject to withholding may rely on withholding to fulfill their tax obligations. The differences between the withholding rules and the exclusion rules with respect to combat pay could cause affected taxpayers (primarily officers) to be surprised at the size of their additional tax liability at the time of filing their tax returns as a result of underwithholding. Paying the additional tax liability with their tax returns could lead to greater financial hardship than would withholding that is parallel to the exclusion rules.

Explanation of Provision

The bill makes the income tax withholding exemption rules parallel to the rules providing an exclusion from income for combat pay.

Effective Date

The provision is effective as of January 1, 1993.

7. Expanded access to simplified income tax returns (sec. 4107 of the bill)

Present Law

There are three principal tax forms that are utilized by individual taxpayers: Form 1040EZ, Form 1040A, and Form 1040.

Reasons for Change

Many individual taxpayers find the tax forms to be complex.

Explanation of Provision

The bill provides that the Secretary of the Treasury (or his delegate) shall take such actions as may be appropriate to expand access to simplified individual income tax forms and otherwise to simplify the individual income tax returns.

The bill also requires that the Secretary submit a report to the Congress on the actions undertaken pursuant to this provision, together with any recommendations he may deem advisable.

Effective Date

The report is due no later than one year after the date of enactment.

8. Simplification of tax treatment of rural letter carriers' vehicle expenses (sec. 4108 of the bill and sec. 162 of the Code)

Present Law

A taxpayer who uses his or her automobile for business purposes may deduct the business portion of the actual operation and maintenance expenses of the vehicle, plus depreciation (subject to the limitations of sec. 280F). If the taxpayer is an employee and these expenses are not reimbursed, the deduction is subject to the two-percent floor. Alternatively, the taxpayer may elect to utilize a standard mileage rate in computing the deduction allowable for business use of an automobile that has not been fully depreciated. Under this election, the taxpayer's deduction equals the applicable rate multiplied by the number of miles driven for business purposes and is taken in lieu of deductions for depreciation and actual operation and maintenance expenses.

An employee of the U.S. Postal Service may compute his or her deduction for business use of an automobile in performing services involving the collection and delivery of mail on a rural route by using, for all business use mileage, 150 percent of the standard mileage rate.

Reasons for Change

The filing of tax returns by rural letter carriers can be complex. Under present law, those who are reimbursed at more than the 150 percent rate must report their reimbursement as income and deduct their expenses as miscellaneous itemized deductions (subject to the two-percent floor). Permitting the income and expenses to wash, so that neither will have to be reported on the rural letter carrier's tax return, will simplify these tax returns.

Explanation of Provision

The bill repeals the special rate of 150 percent of the standard mileage rate. In its place, the bill provides that the rate of reimbursement provided by the Postal Service to rural letter carriers is considered to be equivalent to their expenses. The rate of reimbursement that is considered to be equivalent to their expenses is the rate of reimbursement contained in the 1991 collective bargaining agreement, which may in the future be increased by no more than the rate of inflation.

Effective Date

The provision is effective for taxable years beginning after December 31, 1991.

9. Exemption from luxury excise tax for certain equipment installed on passenger vehicles for use by disabled individuals (sec. 4109 of the bill and sec. 4004(b)(3) of the Code)

Present Law

The Code imposes a 10-percent excise tax on the portion of the retail price of a passenger vehicle that exceeds $30,000. The tax

also applies to separate purchases of component parts and accessories occurring within six months of the date the vehicle is placed in service.

Reasons for Change

It is appropriate to reduce the compliance burdens on handicapped persons.

Explanation of Provision

The bill provides that the luxury excise tax does not apply to a part or accessory installed on a passenger vehicle to enable or assist an individual with a disability to operate the vehicle, or to enter or exit the vehicle, in order to compensate for the effect of the disability.

Persons entitled to a refund may request it from the seller at which they purchased the taxed item, who then obtains the refund as provided under present-law Code section 6416.

Effective Date

The provision is effective for purchases after December 31, 1990.

Subtitle B—Pension Simplification

Part I—Simplified Distribution Rules (secs. 4201-4204 of the bill and secs. 72, 101, 401, 402, 403, and 4980A of the Code)

Present Law

In general

Under present law, a distribution of benefits from a tax-favored retirement arrangement generally is includible in gross income in the year it is paid or distributed under the rules relating to the taxation of annuities. A tax-favored retirement arrangement includes (1) a qualified pension plan (sec. 401(a)), (2) a qualified annuity plan (sec. 403(a)) and (3) a tax-sheltered annuity (sec. 403(b)). Special rules apply in the case of lump-sum distributions from a qualified plan, distributions that are rolled over to an individual retirement arrangement (IRA), and employer-provided death benefits.

Rollovers

Under present law, a total or partial distribution of the balance to the credit of an employee under a qualified plan, a qualified annuity plan, or a tax-sheltered annuity may, under certain conditions, be rolled over tax free to an IRA or another qualified plan or annuity (secs. 402(a), 403(a), and 403(b)). A rollover of a partial distribution is permitted if (1) the distribution equals at least 50 percent of the balance to the credit of the employee, (2) the distribution is not one of a series of periodic payments, (3) the distribution is made on account of death, disability, or separation from service, and (4) the employee elects rollover treatment. A partial distribution may only be rolled over to an IRA and not to another qualified plan.

The maximum amount of a distribution that can be rolled over is the amount of the distribution that would otherwise be taxable. That is, after-tax employee contributions cannot be rolled over. In addition, minimum required distributions (sec. 401(a)(9)) may not be rolled over. The rollover must be made within 60 days after the distribution is received.

Lump-sum distributions

Under present law, lump-sum distributions from qualified plans and annuities are eligible for special 5-year forward income averaging (sec. 402(e)). In general, a lump-sum distribution is a distribution within one taxable year of the balance to the credit of an employee that becomes payable to the recipient (1) on account of the death of the employee, (2) after the employee attains age 59½, (3) on account of the employee's separation from service, or (4) in the case of self-employed individuals, on account of disability. In addition, a distribution is treated as a lump-sum distribution only if the employee has been a participant in the plan for at least 5 years before the year of the distribution. Lump-sum treatment is not available for distributions from tax-sheltered annuity contracts (sec. 403(b)).

A taxpayer is permitted to make an election with respect to a lump-sum distribution received on or after the employee attains age 59½ to use 5-year forward income averaging under the tax rates in effect for the taxable year in which the distribution is made. However, only one such election on or after age 59½ may be made with respect to any employee.

Special transition rules adopted in the Tax Reform Act of 1986 are available with respect to an employee who attained age 50 before January 1, 1986. Under these rules, an individual, trust, or estate may elect to use 5-year forward averaging (using present-law tax rates) or 10-year forward income averaging (using the tax rates in effect prior to the Tax Reform Act of 1986) with regard to a single lump-sum distribution, without regard to whether the employee has attained age 59½. In addition, an individual, trust, or estate receiving a lump-sum distribution with respect to such employee may elect to retain the capital gains character of the pre-1974 portion of the lump-sum distribution (using a tax rate of 20 percent).

Net unrealized appreciation

Under present law, a taxpayer is not required to include in gross income amounts received in the form of a lump-sum distribution to the extent that the amounts are attributable to net unrealized appreciation in employer securities. Such unrealized appreciation is includible in gross income when the securities are sold or exchanged.

The special treatment of net unrealized appreciation applies only if a valid lump-sum distribution election is made, without regard to the requirement that the employee be a plan participant for at least 5 years.

In addition, gross income does not include net unrealized appreciation on employer securities attributable to employee contributions, regardless of whether the securities are received in a lump-

sum distribution. Such appreciation is includible in income when the securities are sold or exchanged.

Tax on excess distributions

Under present law, a 15 percent excise tax is imposed on excess distributions from qualified plans (sec. 4980A). Excess distributions are aggregate distributions from qualified retirement plans made with respect to an individual during any calendar year to the extent the distributions exceed the greater of (1) $150,000, or (2) $112,500 (indexed). A special higher ceiling applies for purposes of determining excess distributions for any calendar year in which an individual receives a lump-sum distribution. The higher ceiling is 5 times the otherwise applicable ceiling for the calendar year ($750,000 in 1992).

Employer-provided death benefits

Under present law, the beneficiary or estate of a deceased employee generally can exclude up to $5,000 in benefits paid by or on behalf of an employer by reason of the employee's death (sec. 101(b)).

Recovery of basis

Qualified plan distributions other than lump-sum distributions generally are includible in gross income in the year they are paid or distributed under the rules relating to taxation of annuities (sec. 402). Amounts received as an annuity generally are includible in income in the year received, except to the extent they represent the return of the recipient's investment in the contract (i.e., basis) (sec. 72). Under present law, a pro-rata basis recovery rule generally applies, so that the portion of any annuity payment that represents nontaxable return of basis is determined by applying an exclusion ratio equal to the employee's total investment in the contract divided by the total expected payments over the term of the annuity.

The total expected payments depends on the form of the payment, e.g., a single-life annuity, an annuity with payments guaranteed for a specified number of years, or a joint and survivor annuity. For example, if benefits are paid in the form of an annuity during the life of the employee, the expected payments are calculated by multiplying the annual payment amount by the employee's life expectancy on the annuity starting date. If benefits are paid in the form of a joint and survivor annuity, then the total expected return depends on the life expectancies of both the primary annuitant and the person who is to receive the survivor annuity. The IRS has issued tables of life expectancies that are used to calculate expected returns.

Under a simplified alternative method provided by the Internal Revenue Service (IRS) (Notice 88-118) for payments from or under qualified retirement arrangements, the taxable portion of qualifying annuity payments is determined under a simplified exclusion ratio method. Under the simplified method, the portion of each annuity payment that represents nontaxable return of basis is equal to the employee's total investment in the contract (including the $5,000 death benefit exclusion under section 101(b), to the extent

applicable), divided by the number of anticipated payments listed in a table published by the IRS. The number of anticipated payments listed in the table is based on the employee's age on the annuity starting date. The simplified method is available if (1) the annuity payments depend on the life expectancy of the recipient (or the joint lives of the recipient and his or her beneficiary), and (2) the recipient is less than age 75 on the annuity starting date or there are fewer than 5 years of guaranteed payments under the annuity.

Under both the pro rata and simplified alternative methods, in no event will the total amount excluded from income as nontaxable return of basis be greater than the recipient's total investment in the contract.

Uniform minimum distribution rules

Present law provides uniform minimum distribution rules generally applicable to all types of tax-favored retirement vehicles, including qualified plans and annuities, individual retirement arrangements (IRAs), and tax-sheltered annuities (sec. 403(b)).

Under present law, a qualified plan is required to provide that the entire interest of each participant will be distributed beginning no later than the participant's required beginning date (sec. 401(a)(9)). The required beginning date is generally April 1 of the calendar year following the calendar year in which the plan participant or IRA owner attains age 70½. In the case of a governmental plan or a church plan, the required beginning date is the later of (1) such April 1, or (2) the April 1 of the year following the year in which the participant retires.

Under present law, the sanction for failure to make a minimum required distribution to a participant (or other payee) under a qualified retirement plan is a 50-percent nondeductible excise tax on the excess in any taxable year of the amount required to have been distributed under the minimum distribution rules, over the amount that actually was distributed (sec. 4974). The tax is imposed on the individual required to take the distribution. However, a plan will not satisfy the applicable qualification requirements unless it expressly provides that, in all events, distributions under the plan are to satisfy the minimum distribution requirements.

Reasons for Change

In almost all cases, the responsibility for determining the tax liability associated with a distribution from a qualified plan, tax-sheltered annuity, or IRA rests with the individual receiving the distribution. Under present law, this task can be burdensome. Among other things, the taxpayer must consider (1) whether special tax rules apply that reduce the tax that otherwise would be paid, (2) whether the distribution is eligible to be rolled over to another qualified plan, tax-sheltered annuity, or IRA, (3) the amount of the taxpayer's basis in the plan, annuity, or IRA and the rate at which such basis is to be recovered, and (4) whether or not a portion of the distribution is excludable from income as a death benefit. Simplifying these rules could significantly reduce the complex-

ity of these calculations for as many as 16 million individual taxpayers.

The number of special rules for taxing pension distributions makes it difficult for taxpayers to determine which method is best for them and also increases the likelihood of error. In addition, the specifics of each of the rules create complexity. For example, the present-law rules for determining the rate at which a participant's basis in a qualified plan is recovered often entail calculations that the average participant has difficulty performing. These rules require a fairly precise estimate of the period over which benefits are expected to be paid. The IRS publication on taxation of pension distributions (Publication 939) contains over 60 pages of actuarial tables used to determine total expected payments.

Results similar to those under present law can be obtained without the complexity added by the special tax rules of present law. For example, the complexity of the restrictions on rollovers under present law (e.g., the 60-day rule) lead to numerous inadvertent failures to satisfy the rollover requirements. Liberalization of the rollover rules will increase the flexibility of taxpayers in determining the timing of the income inclusion of pension distributions and eliminate the need for special rules such as 5-year averaging.

The single largest source of lost pension benefits is preretirement cashouts of pension savings in lump-sum distributions. The bill facilitates the preservation of retirement benefits for retirement purposes by requiring employers to transfer eligible rollover distributions directly into an IRA.

The committee believes it is inappropriate to require all participants to commence distributions by age 70½ without regard to whether the participant is still employed by the employer.

Explanation of Provisions

In general

The bill expands the circumstances under which a distribution may be rolled over tax free, eliminates 5-year averaging for lump-sum distributions from qualified plans, and repeals the $5,000 death benefit exclusion. The bill also provides that certain distributions are required to be transferred directly into another tax-deferred retirement arrangement. In addition, the bill simplifies the basis recovery rules applicable to distributions from qualified plans. Finally, the bill repeals the rule that generally requires all participants to commence distributions by age 70½.

Rollovers

Under the bill, any portion of any distribution to the employee or the surviving spouse of the employee (other than a minimum required distribution (sec. 401(a)(9)) may be rolled over tax free to an IRA or another qualified plan or annuity, unless the distribution is part of a series of substantially equal payments made (1) over the life (or life expectancy) of the participant or the joint lives (or joint life expectancies) of the participant and his or her beneficiary, or (2) over a specified period of 10 years or more. The present-law prohibition on rolling over employee contributions is retained due to recordkeeping concerns.

Special rules for lump-sum distributions

The bill repeals the special 5-year forward averaging rule. The original intent of the income averaging rules for pension distributions was to prevent a bunching of taxable income because a taxpayer received all of the benefits in a qualified plan in a single taxable year. Liberalization of the rollover rules increases taxpayers' ability to determine the time of the income inclusion of pension distributions, and eliminates the need for special rules to prevent bunching of income. The bill preserves the transition rules adopted in the Tax Reform Act of 1986. The bill also retains the present-law treatment of net unrealized appreciation on employer securities and generally retains the definition of lump-sum distribution solely for such purpose.

Tax on excess distributions

Under the bill, for purposes of determining the excise tax on excess distributions from qualified plans, an individual can elect in any calendar year to apply a special higher ceiling of 5 times the otherwise applicable ceiling for the calendar year ($750,000 in 1992). An individual can make such an election only once. The election is not available if the special higher ceiling applied to an individual in a taxable year prior to the effective date of the provision.

Employer-provided death benefits

The bill repeals the exclusion from gross income of up to $5,000 in employer-provided death benefits.

Transfers to IRAs or other eligible transferee plans

The bill provides that any applicable distribution that would otherwise be distributed to an employee or the surviving spouse of the employee is instead to be transferred directly to an eligible transferee plan. In general, an applicable distribution is any distribution in excess of $500 other than (1) distributions in the form of substantially equal periodic payments (as defined under sec. 72(t)), (2) a distribution made after the employee attains age 55, (3) a distribution attributable to the employee being disabled (as defined in sec. 72(m)(7)), (4) distributions of deductible dividends on employer securities (sec. 404(k)), (5) distributions to an alternate payee, (6) hardship distributions from a profit-sharing or stock bonus plan, or (7) distributions of employee contributions.

The transfer requirement applies only to amounts that, but for the transfer requirement, would otherwise be distributed to the recipient. Thus, for example, the transfer requirement does not apply to amounts that are deemed to be distributed under the rules relating to participant loans (sec. 72(p)). In addition, the transfer requirement applies after other rules relating to distributions. For example, if the plan is subject to the joint and survivor rules (secs. 401(a)(11) and 417) those rules would have to be complied with before the transfer is made.

The distribution may be transferred to an IRA or to a qualified defined contribution plan that provides for the acceptance of the transfer. The transfer is to be made to the IRA or qualified plan designated by the distributee within a reasonable period of time

before the transfer in accordance with regulations. The plan is to provide a method by which the plan trustee is to designate the transferee plan in the event the distributee does not make a designation or transfer to the designated plan is impracticable.

Amounts transferred are includible in income when distributed from the transferee plan in accordance with the rules applicable to the transferee plan. However, if the distributee withdraws all or a portion of the amount transferred by the due date (including extensions) for filing the distributee's tax return for the year the transfer was made, the distribution is treated as if it had been made from the transferor plan. Thus, for example, if a distribution is transferred to an IRA and the employee makes a withdrawal of transferred amounts (plus income) from the IRA, the exemptions to the early distribution tax applicable to qualified plans (rather than the rules applicable to IRA withdrawals) apply. This rule is designed to prevent individuals who do not want the distribution to remain in a tax-favored arrangement from being disadvantaged by the transfer.

The plan trustee is required to notify employees of the requirements of the transfer rules and of the amount of any transfer. Once the transfer is made to the transferee plan in accordance with applicable Code provisions, the employer is relieved of all responsibility for the amounts transferred.

A plan is not treated as violating the prohibition on reduction of accrued benefits (sec. 411(d)(6)) solely by reason of the transfer. For purposes of determining years of service and the buy-back rules (sec. 411(a)(7)), a transfer is treated as a distribution.

Similar rules apply to distributions from qualified annuities (sec. 403(a)) and tax-sheltered annuities (sec. 403(b)).

Recovery of basis

Under the bill, the portion of an annuity distribution from a qualified retirement plan, qualified annuity, or tax-sheltered annuity that represents nontaxable return of basis generally is determined under a method similar to the present-law simplified alternative method provided by the Internal Revenue Service. Under the simplified method provided in the bill, the portion of each annuity payment that represents nontaxable return of basis generally is equal to the employee's total investment in the contract as of the annuity starting date, divided by the number of anticipated payments determined by reference to the age of the participant listed in the table set forth in the bill. The number of anticipated payments listed in the table is based on the employee's age on the annuity starting date. If the number of payments is fixed under the terms of the annuity, that number is to be used instead of the number of anticipated payments listed in the table.

The simplified method does not apply if the primary annuitant has attained age 75 on the annuity starting date unless there are fewer than 5 years of guaranteed payments under the annuity. If in connection with commencement of annuity payments, the recipient receives a lump-sum payment that is not part of the annuity stream, such payment is taxable under the rules relating to annuities (sec. 72) as if received before the annuity starting date, and the investment in the contract used to calculate the simplified ex-

clusion ratio for the annuity payments is reduced by the amount of the payment. As under present law, in no event will the total amount excluded from income as nontaxable return of basis be greater than the recipient's total investment in the contract.

Required distributions from qualified plans

The bill repeals the rule that requires all participants in qualified plans to commence distributions by age 70-1/2 without regard to whether the participant is still employed by the employer and, therefore, generally replaces it with the rule in effect prior to the Tax Reform Act. Thus, under the bill, distributions are required to begin by April 1 of the calendar year following the later of (1) the calendar year in which the employee attains age 70 or (2) the calendar year in which the employee retires. In the case of a 5-percent owner of the employer, distributions are required to begin no later than the April 1 of the calendar year following the year in which the 5-percent owner attains age 70. Distributions from an IRA are required to begin no later than April 1 of the calendar year following the year in which the IRA owner attains age 70.

In addition, in the case of an employee (other than a 5-percent owner) who retires in a calendar year after attaining age 70, the bill requires the employee's accrued benefit to be actuarially increased to take into account the period after age 70 in which the employee was not receiving benefits under the plan. Thus, under the bill, the employee's accrued benefit is required to reflect the value of benefits that the employee would have received if the employee had retired at age 70 and had begun receiving benefits at that time.

The actuarial adjustment rule and the rule requiring 5-percent owners to begin distributions after attainment of age 70 does not apply, under the bill, in the case of a governmental plan or church plan.

Effective Date

The provisions generally apply to years beginning after December 31, 1992. However, the provision relating to rollovers is effective with respect to distributions after the date of enactment. The provision relating to trustee-to-trustee transfers applies to distributions in plan years beginning after December 31, 1993.

Part II—Increased Access to Pension Plans

1. Modifications to simplified employee pensions (sec. 4211 of the bill and sec. 408(k)(6) of the Code)

Present Law

Under present law, certain employers (other than tax-exempt and governmental employers) can establish a simplified employee pension (SEP) for the benefit of their employees under which the employees can elect to have contributions made to the SEP or to receive the contributions in cash (sec. 408(k)(6)). If an employee elects to have contributions made on the employee's behalf to the SEP, the contribution is not treated as having been distributed or made available to the employee. In addition, the contribution is not

treated as an employee contribution merely because the SEP provides the employee with such an election. Therefore, an employee is not required to include in income currently the amounts the employee elects to have contributed to the SEP. Elective deferrals under a SEP are to be treated in the same manner as elective deferrals under a qualified cash or deferred arrangement and, thus, are subject to the $8,728 (for 1992) cap on elective deferrals.

The election to have amounts contributed to a SEP or received in cash is available only if at least 50 percent of the employees of the employer elect to have amounts contributed to the SEP. In addition, such election is available for a taxable year only if the employer maintaining the SEP had 25 or fewer eligible employees at all times during the prior taxable year.

Under present law, elective deferrals under SEPs are subject to nondiscrimination standards. The amount eligible to be deferred as a percentage of each highly compensated employee's compensation (i.e., the deferral percentage) is limited by the average deferral percentage (based solely on elective deferrals) for all nonhighly compensated employees who are eligible to participate. The deferral percentage for each highly compensated employee (taking into account only the first $222,220 (indexed) of compensation) cannot exceed 125 percent of the average deferral percentage for all other eligible employees. Nonelective SEP contributions may not be combined with the elective SEP deferrals for purposes of this test. An employer may not make any other SEP contributions conditioned on elective SEP deferrals. If the 125-percent test is not satisfied, rules similar to the rules applicable to excess contributions to a cash or deferred arrangement are applied.

If any employee is eligible to make elective SEP deferrals, all employees satisfying the participation requirements must be eligible to make elective SEP deferrals. An employee satisfies the participation requirements if the employee (1) has attained age 21, (2) has performed services for the employer during at least 3 of the immediately preceding 5 years, and (3) received at least $363 (indexed) in compensation from the employer for the year. An employee can participate even though he or she is also a participant in one or more other qualified retirement plans sponsored by the employer. However, SEP contributions are added to the employer's contribution to the other plans on the participant's behalf in applying the limits on contributions and benefits (sec. 415).

Reasons for Change

The tax incentives for pension plans under present law have not significantly improved pension coverage for employees of small businesses. One of the reasons small employers fail to establish pension plans for their employees is because of the administrative costs and burdens attributable to such plans.

The committee believes that further simplification and broadening of the SEP rules will encourage more small employers to establish plans for their employees. In particular, the committee believes that making salary deferral SEPs available to a larger number of employers and providing a design-based qualification

test for such SEPs will encourage small employers to establish plans for their employees.

Explanation of Provision

The bill conforms the eligibility requirements for SEP participation to the rules applicable to pension plans generally by providing that contributions to a SEP must be made with respect to each employee who has at least one year of service with the employer.

The bill modifies the rules relating to salary reduction SEPs by providing that such SEPs may be established by employers with 100 or fewer employees. The bill also repeals the requirement that at least half of eligible employees actually participate in a salary reduction SEP.

The bill also provides that an employer is deemed to satisfy the nondiscrimination requirements applicable to salary reduction SEPs if the plan satisfies the safe harbor nondiscrimination rules applicable to qualified cash or deferred arrangements and employees are notified of the availability and features of the SEP.

Effective Date

The provision applies to years beginning after December 31, 1992.

2. Repeal of limitation on ability of nongovernmental tax-exempt employers to maintain cash or deferred arrangements (sec. 4212 of the bill and secs. 401(k) and 408(k)(6) of the Code)

Present Law

Under present law, if a tax-qualified profit-sharing or stock bonus plan meets certain requirements, then an employee is not required to include in income any employer contributions to the plan merely because the employee could have elected to receive the amount contributed in cash (sec. 401(k)). Plans containing this feature are referred to as cash or deferred arrangements. Tax-exempt organizations are generally prohibited from establishing qualified cash or deferred arrangements. Because of this limitation, many of such employers are precluded from maintaining broad-based, funded, elective deferral arrangements for their employees.

Reasons for Change

The committee believes that nongovernmental tax-exempt entities should be permitted to maintain qualified cash or deferred arrangements for their employees on the same basis as other employers.

Explanation of Provision

The bill allows nongovernmental tax-exempt organizations to maintain cash or deferred arrangements. As under present law, the limitation on the amount that may be deferred by an individual participating in both a cash or deferred arrangement and another elective deferral arrangement applies.

Effective Date

The provision applies to nongovernmental tax-exempt organizations with respect to years beginning after December 31, 1992. The provision does not affect the ability of certain State and local government employers to maintain qualified cash or deferred arrangements that were adopted before May 6, 1986.

3. Duties of master and prototype plan sponsors (sec. 4213 of the bill)

Present Law

The Internal Revenue Service (IRS) master and prototype program is an administrative program under which trade and professional associations, banks, insurance companies, brokerage houses, and other financial institutions can obtain IRS approval of model retirement plan language and then make these preapproved plans available for adoption by their customers, investors, or association members. Rules regarding who can sponsor master and prototype programs, the prescribed format of the model plans, and other matters relating to the program are contained in revenue procedures and other administrative pronouncements of the IRS.

The IRS also maintains related administrative programs that authorize advance approval of model plans prepared by law firms and others, i.e., the regional prototype plan program and volume submitter program.

Reasons for Change

As the laws relating to retirement plans have become more complex, employers have experienced an increase in the frequency and cost of amending plans and of the burdens of administering the plans. Master and prototype plans reduce these costs and burdens, particularly for small- to medium-sized employers, and improve IRS administration of the retirement plan rules. Today, the majority of employer-provided qualified retirement plans, including qualified cash or deferred arrangements (sec. 401(k) plans), simplified employee pensions (SEPs) and individual retirement arrangements (IRAs) are approved master and prototype plans. The Treasury and the IRS believe that the further expansion of the master and prototype program is desirable, but that statutory authority authorizing the IRS to define specifically the duties of master and prototype sponsors should be obtained before the program becomes more widely utilized.

Explanation of Provision

The bill authorizes the IRS to define the duties of organizations that sponsor master and prototype, regional prototype, and other preapproved plans, including mass submitters. These duties would become a condition of sponsoring preapproved plans. The bill is not intended to be interpreted as diminishing the IRS's administrative authority with respect to the master and prototype, regional prototype, or similar programs, including the authority to define who is eligible to sponsor prototype plans, or to create other rules relating

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to these programs. Rather, it is intended to create a system of sponsor accountability, subject to IRS monitori. g, that will give adopters of master and prototype and other prea.jproved plans a level of protection, comparable to that in the regional prototype plan program, against failure of master and prototype and other plan sponsors to fulfill certain obligations.

The bill thus authorizes the IRS to prescribe duties of sponsors of prototype and other preapproved plans that include, but are not limited to, maintaining annually current lists of adopting employers and providing certain annual notices to adopting employers and to the IRS. While reflecting the IRS's own requirements in its regional prototype plan procedure, the bill does not require the IRS to mandate a master and prototype accountability system that is identical to the regional prototype plan procedure. The bill also authorizes the IRS to prescribe such other reasonable duties as are consistent with the objective of protecting adopting employers from a sponsor's failure to amend a plan in a timely manner or to communicate amendments or other notices required by the IRS's procedures.

The bill authorizes the IRS to define the duties of preapproved plan sponsors that relate to providing administrative services to the plans of adopting employers. This authorization is not intended to obligate sponsors to undertake the complete day-to-day administration of the plans they sponsor (although it does not preclude the IRS from mandating the performance of specific functions), but rather to protect employers against loss of qualification merely because they are unaware of the need to arrange for such services, or the unavailability of professional assistance from parties familiar with the sponsor's plan.

It is thus intended that, at a minimum, sponsors should (1) advise adopting employers that failure to arrange for administrative services to the plan may significa: ly increase the risk of disqualification and resulting sanctions, and (2) furnish employers with the name of firms that are familiar with the plan and can provide professional administrative service. This is not intended to preclude the sponsor from providing that service itself.

The bill should not be construed as creating fiduciary relationships or responsibilities under Title I of the Employee Retirement Income Security Act of 1974 (ERISA) that would not exist in the absence of the provision.

To the extent deemed reasonably necessary to carry out the purposes of this provision of the bill, the Secretary is authorized to issue regulations that permit the relaxation of the anti-cutback rules contained in ERISA (sec. 204(g)) and the Code (sec. 411(d)(6)) when employers replace an individually designed plan with an IRS model plan, provided that the rights of participants to accrued benefits under the individually designed plan are not significantly impaired. This discretion will facilitate the shift by employers from individually designed plans to IRS model plans.

Effective Date

The provision is effective on January 1, 1993.

Part III—Nondiscrimination Provisions

1. Definition of highly compensated employee and family aggregation rules (sec. 4221 of the bill and secs. 401(a)(17) and 414(q) of the Code)

Present Law

In general

For purposes of the rules applying to qualified retirement plans under the Code, an employee, including a self-employed individual, is treated as highly compensated with respect to a year if, at any time during the year or the preceding year, the employee: (1) was a 5-percent owner of the employer; (2) received more than $93,518 in annual compensation from the employer; (3) received more than $62,345 in annual compensation from the employer and was one of the top-paid 20 percent of employees during the same year; or (4) was an officer of the employer who received compensation greater than $56,111. These dollar amounts are adjusted annually for inflation at the same time and in the same manner as the adjustments to the dollar limit on benefits under a defined benefit pension plan (sec. 415(d)). If, for any year, no officer has compensation in excess of $56,111 (indexed), then the highest paid officer of the employer for such year is treated as a highly compensated employee.

An employee is not treated as in the top-paid 20 percent, as an officer, or as receiving $93,518 or $62,345 solely because of the employee's status during the current year, unless such employee also is among the 100 employees who have received the highest compensation during the year.

Election to use simplified method

Employers are permitted to elect to determine their highly compensated employees under a simplified method. Under this method, an electing employer may treat employees who received more than $62,345 in annual compensation from the employer as highly compensated employees in lieu of applying the $93,518 threshold and without regard to whether such employees are in the top-paid group of the employer. This election is available only if at all times during the year the employer maintained business activities and employees in at least 2 geographically separate areas.

Treatment of family members

A special rule applies with respect to the treatment of family members of certain highly compensated employees. Under the special rule, if an employee is a family member of either a 5-percent owner or 1 of the top 10 highly compensated employees by compensation, then any compensation paid to such family member and any contribution or benefit under the plan on behalf of such family member is aggregated with the compensation paid and contributions or benefits on behalf of the 5-percent owner or the highly compensated employee in the top 10 employees by compensation. Therefore, such family member and employee are treated as a single highly compensated employee. An individual is considered a family member if, with respect to an employee, the individual is a

spouse, lineal ascendant or descendant, or spouse of a lineal ascendant or descendant of the employee.

Similar family aggregation rules apply with respect to the $228,860 limit on compensation that may be taken into account under a qualified plan (sec. 401(a)(17)) and for deduction purposes (sec. 404(l)). However, under such provisions, only the spouse of the employee and lineal descendants of the employee who have not attained age 19 are taken into account.

Reasons for Change

Under present law, the administrative burden on employers to comply with some of the basic rules applying to qualified retirement plans outweighs the small potential benefit of the rules. For example, the various categories of highly compensated employees require employers to perform a number of complex calculations that for many employers have largely duplicative results.

Explanation of Provisions

The bill provides that an employee is highly compensated with respect to a year if the employee (1) was a 5-percent owner of the employer at any time during the year or the preceding year, or (2) had compensation for the preceding year in excess of the dollar limit for the preceding year. The dollar limit is $50,000 (indexed). The $50,000 threshold is adjusted for cost-of-living increases in the same manner as the limitations on contributions and benefits (sec. 415(d)). Under the bill, as under present law, the dollar limit in effect for 1992 is $62,345. For example, in determining whether an employee is highly compensated in 1993, the employee's compensation for 1992 would be compared to the 1992 dollar limit, i.e., $62,345.

Under the bill, if no employee is a 5-percent owner or has compensation in excess of $50,000 (indexed), then the highest paid officer for the year is treated as a highly compensated employee. This special rule does not apply for purposes of the nondiscrimination rules applicable to elective deferrals, matching contributions, and employee contributions (secs. 401(k) and (m)), and does not apply with respect to employees of tax-exempt organizations and State and local governments (sec. 457(e)(1)).

The bill repeals the family aggregation rules.

Effective Date

The provision is effective for years beginning after December 31, 1992.

2. Election to treat base pay as compensation (sec. 4222 of the bill and sec. 414(s) of the Code)

Present Law

Present law provides a definition of compensation that is to be used for nondiscrimination testing purposes (sec. 414 (s)). Under this definition, compensation generally is defined as compensation used for purposes of the limits on contributions and benefits (sec.

415). Pursuant to statutory authority, final regulations provide alternative permissible definitions of compensation. The regulations permit certain items, such as bonuses and similar payments, to be excluded from the definition of compensation.

Reasons for Change

Many plans base benefits on base pay. Thus, the committee considers it appropriate to provide statutorily that base pay is a permissible definition of compensation.

Explanation of Provision

The bill permits an employer to elect to use base pay as a permissible definition of compensation for purposes of all provisions which specifically refer to section 414(s) of the Code. It is intended that base pay is defined generally as under Treasury regulations. Thus, subject to the applicable facts and circumstances, the employer could exclude from the definition of compensation, on a consistent basis, certain types of compensation, including (but not limited to) one or more of the following: any type of additional compensation for employees working outside their regularly scheduled tour of duty (such as overtime pay, premiums for shift differential, and call-in premiums); bonuses; or reimbursements or other expense allowances, fringe benefits (cash and noncash), moving expenses, deferred compensation, and welfare benefits. It is intended that the resulting definition may not discriminate in favor of highly compensated employees. The election applies for purposes of all applicable provisions and to all employees, and may be revoked only with the consent of the Secretary.

Effective Date

The provision is effective for years beginning after December 31, 1992.

3. Modification of additional participation requirements (sec. 4223 of the bill and sec. 401(a)(26) of the Code)

Present Law

Under present law, a plan is not a qualified plan unless it benefits no fewer than the lesser o. a) 50 employees of the employer or (b) 40 percent of all employees oı the employer (sec. 401(a)(26)). This requirements may not be satisfied by aggregating comparable plans, but my be applied separately to different lines of business of the employer. A line of business of the employer does not qualify as a separate line of business unless it has at least 50 employees.

Reasons for Change

The minimum participation rule was adopted in the Tax Reform Act of 1986 because the Congress believed that it was inappropriate to permit an employer to maintain multiple plans, each of which covered a very small number of employees. Although plans that are aggregated for nondiscrimination purposes are required to satisfy comparability requirements with respect to the amount of con-

tributions or benefits, such an arrangement may still discriminate in favor of highly compensated employees.

The committee believes that it is appropriate to better target the minimum participation rule by limiting the scope of the rule to defined benefit pension plans and reducing the minimum number of employees required to be covered under such a plan.

Finally, the committee believes that the arbitrary requirement that a line of business must have at least 50 employees requires application of the minimum participation rule on an employer-wide basis in some cases in which the employer truly has separate lines of business.

Explanation of Provision

The bill provides that the minimum participation rule (sec. 401(a)(26)) applies only to defined benefit pension plans. In addition, the bill provides that a defined benefit pension plan does not satisfy the rule unless it benefits no fewer than the lesser of (1) 25 employees or (2) the greater of (a) 40 percent of all employees of the employer or (b) 2 employees (1 employee if there is only 1 employee). The excludable employee rule applies as under present law. As an illustration of the operation of the modification of the minimum participation rule, assume that an employer has 150 nonexcludable employees. Under present law, any plan of the employer is required to cover a minimum of 50 employees. Under the bill, any defined benefit plan of the employer is required to cover a minimum of 25 employees.

In the case of an employer with only 2 employees, the minimum participation rule under the bill is satisfied only if the plan covers both employees.

The bill provides that the requirement that a line of business has at least 50 employees does not apply in determining whether a plan satisfied the minimum participation rule on a separate line of business basis.

Effective Date

The provision is generally effective for years beginning after December 31, 1991. An employer may elect to have the provision apply as if it were included in section 1112(b) of the Tax Reform Act of 1986.

4. Simplification of nondiscrimination tests applicable under sections 401(k) and (m) (sec. 4224 of the bill and secs. 401(k) and (m) of the Code)

Present Law

A profit-sharing or stock bonus plan, a pre-ERISA money purchase pension plan, or a rural cooperative plan may include a qualified cash or deferred arrangement (sec. 401(k)). Under such an arrangement, an employee may elect to have the employer make payments as contributions to a plan on behalf of the employee, or to the employee directly in cash. Contributions made at the election of the employee are called elective deferrals. The maximum annual amount of elective deferrals that can be made by an indi-

vidual is $8,728 for 1992. This dollar limit is indexed annually for inflation. A special nondiscrimination test applies to cash or deferred arrangements.

The special nondiscrimination test applicable to elective deferrals under qualified cash or deferred arrangements is satisfied if the actual deferral percentage (ADP) for eligible highly compensated employees for a plan year is equal to or less than either (1) 125 percent of the ADP of all nonhighly compensated employees eligible to defer under the arrangement, or (2) the lesser of 200 percent of the ADP of all eligible nonhighly compensated employees or such ADP plus 2 percentage points. The ADP for a group of employees is the average of the ratios (calculated separately for each employee in the group) of the contributions paid to the plan on behalf of the employee to the employee's compensation.

Employer matching contributions and after-tax employee contributions under qualified defined contribution plans are subject to a special nondiscrimination test similar to the special nondiscrimination test applicable to qualified cash or deferred arrangements.

The special nondiscrimination test is satisfied for a plan year if the actual contribution percentage (ACP) for eligible highly compensated employees does not exceed the greater of (1) 125 percent of the ACP for all other eligible employees, or (2) the lesser of 200 percent of the contribution percentage for all other eligible employees, or such percentage plus 2 percentage points. The ACP for a group of employees for a plan year is the average of the ratios (calculated separately for each employee in the group) of the sum of matching and employee contributions on behalf of each such employee to the employee's compensation for the year.

To determine the amount of excess contributions and the employees to whom they are allocated, the elective deferrals of highly compensated employees are reduced in the order of their actual deferral percentage beginning with those highly compensated employees with the highest actual deferral percentages.

Reasons for Change

The sources of complexity generally associated with the nondiscrimination requirements for qualified cash or deferred arrangements and matching contributions are the recordkeeping necessary to monitor employee elections, the calculations involved in applying the tests, and the correction mechanism, i.e., what to do if the plan fails the tests. None of these factors is new.

The committee believes that the complexity of nondiscrimination requirements, particularly after the Tax Reform Act of 1986 changes that imposed a dollar cap ($8,728 in 1992) on elective deferrals, is not justified by the marginal additional participation of rank-and-file employees that might be achieved by the operation of these requirements. It is believed that the result that the nondiscrimination rules are intended to produce can also be achieved by creating an incentive for employers to provide 100-percent matching contributions or nonelective contributions on behalf of rank-and-file employees. The committee believes that such contributions create a sufficient inducement to rank-and-file employee participation.

In addition, the committee believes that the significant simplification that a design-based safe harbor test achieves may reduce the complexity of the qualified cash or deferred arrangement requirements enough to encourage additional employers to establish such plans, thereby expanding employee access to voluntary retirement savings arrangements. The adoption of a nondiscrimination safe harbor that eliminates the testing of actual plan contributions removes a significant administrative burden that may act as a deterrent to employers who would not otherwise set up such a plan. Thus, the adoption of a simpler nondiscrimination test may encourage more employers, who do not now provide any tax-favored retirement plan for their employees, to set up such plans.

A design-based nondiscrimination test provides certainty to an employer and plan participants that does not exist under present law. Under such a test, an employer will know at the beginning of each plan year whether the plan satisfies the nondiscrimination requirements for the year.

Explanation of Provision

In general

The bill modifies the present-law nondiscrimination test applicable to elective deferrals and employer matching and after-tax employee contributions to permit the use of the average deferral percentage for nonhighly compensated employees for the preceding plan year to be used in determining the permitted average deferral percentage for highly compensated employees for the current year. In the case of the first plan year of a qualified cash or deferred arrangement, the average deferral percentage for nonhighly compensated employees for the previous year is deemed to be 3 percent or, at the election of the employer, the average deferral percentage for the first plan year.

In addition, the bill adds alternative methods of satisfying the special nondiscrimination requirements applicable to elective deferrals and employer matching contributions. Under these safe harbor rules, a cash or deferred arrangement is treated as satisfying the actual deferral percentage test if the plan of which the arrangement is a part (or any other plan of the employer maintained with respect to the employees eligible to participate in the cash or deferred arrangement) meets (1) one of two contribution requirements and (2) a notice requirement. A plan satisfies the safe harbor with respect to matching contributions if (1) the plan meets the contribution and notice requirements under the safe harbor for cash or deferred arrangements and (2) the plan satisfies a special limitation on matching contributions. These safe harbors permit a plan to satisfy the special nondiscrimination tests through plan design, rather than through the testing of actual contributions.

The bill also modifies the method of determining excess contributions under the present-law nondiscrimination test.

Safe harbor for cash or deferred arrangements

Contribution requirements.—A plan satisfies the contribution requirements under the safe harbor rule for qualified cash or deferred arrangements if the plan either (1) satisfies a matching con-

tribution requirement or (2) the employer makes a nonelective contribution to a defined contribution plan of at least 3 percent of an employee's compensation on behalf of each nonhighly compensated employee who is eligible to participate in the arrangement without regard to whether the employee makes elective contributions under the arrangement.

A plan satisfies the matching contribution requirement if, under the arrangement: (1) the employer makes a matching contribution on behalf of each nonhighly compensated employee that is not less than (a) 100 percent of the employee's elective contributions up to 3 percent of compensation and (b) 50 percent of the employee's elective contributions from 3 to 5 percent of compensation; and (2) the level of match for highly compensated employees is not greater than the match rate for nonhighly compensated employees at any level of compensation.

Alternatively, if the matching contribution requirement is not satisfied at some level of employee compensation, the requirement is deemed to be satisfied if (1) the level of employer matching contributions does not increase as employee elective contributions increase and (2) the aggregate amount of matching contributions with respect to elective contributions up to that level of compensation at least equals the amount of matching contributions that would be made if matching contributions satisfied the percentage requirements. For example, the alternative test is satisfied is an employer matches 125 percent of an employee's elective contributions up to the first 3 percent of compensation, 25 percent of elective deferrals from 3 to 4 percent of compensation, and provides no match thereafter. This is because the employer match does not increase and the aggregate amount of matching contributions is at least equal to the matching contributions required under the general safe harbor rule.

Under the safe harbor, an employee's rights to employer matching contributions or nonelective contributions used to meet the contribution requirements are required to be 100-percent vested.

An arrangement does not satisfy the contribution requirements unless the requirements are met without regard to the permitted disparity rules (sec. 401(l)) and contributions used to satisfy the contribution requirements are not taken into account for purposes of determining whether a plan of the employer satisfies the permitted disparity rules.

Employer matching and nonelective contributions used to satisfy the contribution requirements of the safe harbor rules are nonforfeitable and subject to the restrictions on withdrawals that apply to an employee's elective deferrals under a qualified cash or deferred arrangement (sec. 401(k)(2)(B) and (C)).

The matching or nonelective contribution safe harbor requirements are deemed satisfied if the employer maintains another qualified plan that meets such requirements.

Notice requirement.—The notice requirement is satisfied if each employee eligible to participate in the arrangement is given written notice within a reasonable period before any year of the employee's rights and obligations under the arrangement. This notice must be sufficiently accurate and comprehensive to apprise the employee of his or her rights and obligations and must be written in a

manner calculated to be understood by the average employee eligible to participate.

Alternative method of satisfying special nondiscrimination test for matching contributions

The bill provides a safe harbor method of satisfying the special nondiscrimination test applicable to employer matching contributions and after-tax employee contributions. Under this safe harbor, a plan is treated as meeting the special nondiscrimination test if (1) the plan meets the contribution and notice requirements applicable under the safe harbor method of satisfying the special nondiscrimination requirement for qualified cash or deferred arrangements, and (2) the plan satisfies a special limitation on matching contributions.

The limitation on matching contributions is satisfied if (1) the matching contributions on behalf of any employee may not be made with respect to employee contributions or elective deferrals in excess of 6 percent of compensation and (2) the level of an employer's matching contribution does not increase as an employee's contributions or elective deferrals increase.

Distribution of excess contributions

Under the bill, the total amount of excess contributions is determined in the same manner as under present law, but the distribution of excess contributions is required to be made on the basis of the amount of contribution by, or on behalf of, each highly compensated employee. Thus, under the bill, excess contributions are deemed attributable first to those highly compensated employees who have made the greatest dollar amount of elective deferrals under the plan.

For example, assume that an employer maintains a qualified cash or deferred arrangement under section 401(k). Assume further that the actual deferral percentage ("ADP") for the eligible non-highly compensated employees is 2 percent. In addition, assume the following facts with respect to the eligible highly compensated employees:

Employees	Compensation	Deferral	Deferral (percent)
A	$200,000	$7,000	
B	200,000	7,000	3.5
C	70,000	7,000	3.5
C	70,000	5,250	10.0
D	70,000	2,100	7.5
E	70,000	1,750	3.0
F			2.5

Under these facts, the highly compensated employees' ADP is 5 percent, which fails to satisfy the special nondiscrimination requirements.

Under present law, the highly compensated employees with the highest deferral percentages would have their deferrals reduced until the ADP of the highly compensated employees is 4 percent. Accordingly, C and D would have their deferrals reduced to $4,025 (i.e., a deferral percentage of 5.75 percent). The reduction thus is $2,975 for C and $1,225 for D, for a total reduction of $4,200.

Under the bill, the amount of the total reduction is calculated in the same manner as under present law so that the total reduction remains $4,200. However, this total reduction of $4,200 is allocated to highly compensated employees based on the employees with the largest contributions. Thus, A, B, and C would each be reduced by $1,400 from $7,000 to $5,600. The ADP test would not be performed again.

Effective Date

The provision is effective for plan years beginning after December 31, 1992.

Part IV: Miscellaneous Pension Simplification

1. Definition of leased employee (sec. 4231 of the bill and sec. 414(n) of the Code)

Present Law

An individual (a leased employee) who performs services for another person (the recipient) may be required to be treated as the recipient's employee for various employee benefit provisions if the services are performed pursuant to an agreement between the recipient and a third person (the leasing organization) who is otherwise treated as the individual's employer (sec. 414(n)). The individual is to be treated as the recipient's employee only if the individual has performed services for the recipient on a substantially full-time basis for a year, and the services are of a type historically performed by employees in the recipient's business field.

An individual who otherwise would be treated as a recipient's leased employee will not be treated as such an employee if the individual participates in a safe harbor plan maintained by the leasing organization meeting certain requirements. Each leased employee is to be treated as an employee of the recipient, regardless of the existence of a safe-harbor plan, if more than 20 percent of an employer's nonhighly compensated workforce are leased.

Reasons for Change

The committee believes that the leased employee rules are complex and have unexpected and sometimes indefensible results, especially as interpreted under regulations proposed by the Secretary. For example, under the "historically performed" standard, the employees and partners of a law firm may be the leased employees of a client of the firm if they work a sufficient number of hours for the client and if it is not unusual for employers in that business field to have in-house counsel. While arguably meeting the present-law leased employee definition, the committee believes that situations such as this are outside the intended scope of the rules.

Explanation of Provision

Under the provision, the present-law historically performed test is repealed and replaced with a new rule defining who must be considered a leased employee. This change is made because the proposed regulations under the leased employee rules (sec. 414(n)) are overly broad in defining who may be a leased employee. Under the provision, the proposed regulations are no longer valid. One of the principal purposes for adopting the significant direction or control test is to relieve the unnecessary hardship and uncertainty created for employers in these circumstances. It is intended that the Secretary interpret and apply the new control test in a manner that is targeted to prevent clear abuses.

Under the provision, an individual is not considered a leased employee unless the individual is under the control of the recipient organization. The determination of whether an individual is controlled by the employer is based on all the facts and circumstances. Among the factors that are relevant in this determination are whether the recipient organization: (1) prescribes the individual's work methods; (2) supervises the individual; (3) sets the individual's working hours; and (4) sets the individual's level of compensation. Other factors that may be considered include those that are relevant for determining whether the employer is responsible for employment taxes on the compensation paid to the individual. The Secretary may designate other relevant factors. It is not necessary that all these factors indicate that the individual is under the control of the employer in order to find that such individual is a leased employee. Nor is it necessary that the recipient organization be responsible for employment taxes in order to find that the individual is a leased employee because, if the recipient organization is liable for employment taxes, the individual is an employee of the organization who generally must be taken into account. The provision does not alter the definition of a common-law employee, nor the rules that such employees are to be taken into account unless specifically excluded.

The committee does not intend the changes made by this provision to broaden the scope of the leased employee rules. Thus, to the extent an individual is not a leased employee under present law, such employee generally will not be a leased employee under the provision. For example, in those specific situations where the Internal Revenue Service has ruled that service relationships do not involve "leased employees" under the test of present law requiring the services to be of a type historically performed, in the business field of the recipient, by employees, the recipients of those rulings may continue to rely on them.

Effective Date

The provision is effective for years beginning after December 31, 1983. In applying the leased employee rules to years beginning before the effective date, it is intended that the Secretary use a reasonable interpretation of the statute to apply the leasing rules to prevent abuse.

2. Elimination of half-year requirements (sec. 4232 of the bill and secs. 72, 401, 402, 403, 4978, 219 and 408 of the Code)

Present Law

Under present law, a number of employee plan rules refer to the age of an individual at a certain time. For example, distributions under a qualified pension plan are generally required to begin no later than April 1 following the year in which an individual attains age 70½ (sec. 401(a)(9)). Similarly, an additional income tax on early withdrawals applies to certain distributions from qualified pension plans and IRAs prior to the time the participant or IRA owner attains age 59½ (sec. 72(t)).

Reasons for Change

The committee believes that changing half-year requirements to whole year requirements would make the pension rules easier to administer.

Explanation of Provision

The bill changes the half-year requirements to birthdate requirements. Those rules under present law that refer to age 59½ are changed to refer to age 59, and those that refer to age 70½ are changed to refer to age 70.

Effective Date

The provision applies to years beginning after December 31, 1992.

3. Cost-of-living adjustments (sec. 4233 of the bill and secs. 219, 401, 403, 408, and 415(d) of the Code)

Present Law

The rules relating to qualified plans contain a number of dollar limits that are indexed annually for cost-of-living adjustments (e.g., the dollar limit on benefits under a defined benefit plan (sec. 415(b), the limit on elective deferrals under a qualified cash or deferred arrangement (sec. 402(g), and the dollar amounts used in determining highly compensated employees (sec. 414(q)). The Secretary publishes annually a list of the amounts applicable under each provision for the year.

Reasons for Change

Due to the timing of the cost-of-living adjustments, the dollar amounts for each year are not known until after the start of the calendar year.

Explanation of Provision

The bill provides that the cost-of-living adjustment with respect to any calendar year is based on the increase in the applicable index as of the close of the calendar quarter ending September 30 of the preceding calendar year. Thus, adjusted dollar limits will be

published before the beginning of the calendar year to which they apply.

In addition, the bill provides that the dollar limits determined after application of the cost-of-living adjustments are generally rounded to the nearest $1,000. Dollar limits relating to elective deferrals and elective contributions to simplified employee pensions (SEPs) are rounded to the nearest $100.

Effective Date

The provision is effective for years beginning after December 31, 1992.

4. Plans covering self-employed individuals (sec. 4234 of the bill and sec. 401(d) of the Code)

Present Law

Prior to the Tax Equity and Fiscal Responsibility Act of 1982 (TEFRA) different rules applied to retirement plans maintained by incorporated employers and unincorporated employers (such as partnerships and sole proprietors). In general, plans maintained by unincorporated employers were subject to special rules in addition to the other qualification requirements of the Code. Most, but not all, of this disparity was eliminated by TEFRA. Under present law, certain special aggregation rules apply to plans maintained by owner-employees that do not apply to other qualified plans (sec. 401(d)(1) and (2)).

Reasons for Change

The remaining special aggregation rules for plans maintained by unincorporated employers are unnecessary and should be eliminated. Applying the same set of rules to all types of plans would make the qualification standards easier to apply and administer.

Explanation of Provision

The bill eliminates the special aggregation rules that apply to plans maintained by self-employed individuals that do not apply to other qualified plans.

Effective Date

The provision is effective for years beginning after December 31, 1992.

5. Full funding limitation of multiemployer plans (sec. 4235 of the bill and sec. 412 of the Code)

Present Law

Under the Internal Revenue Code, subject to certain limitations, an employer may make deductible contributions to a defined benefit pension plan up to the full funding limitation. The full funding limitation is generally defined as the excess, if any, of (1) the lesser of (a) the accrued liability under the plan (including normal cost) or (b) 150 percent of the plan's current liability, over (2) the lesser of

(a) the fair market value of the plan's assets, or (b) the actuarial value of the plan's assets (sec. 412(c)(7)).

Plans subject to the minimum funding rules are required to make an actuarial valuation of the plan not less frequently than annually.

Reasons for Change

The committee believes that it is not necessary to apply the 150-percent of current liability full funding limit to multiemployer plans. The full funding limit is intended to limit employer deductions for liabilities that have not yet accrued. Employers who participate in multiemployer plans do not have the same incentive to make excessive contributions to the plan as is the case with single-employer plans.

Explanation of Provision

The bill amends the Internal Revenue Code to provide that the 150 percent of current liability limitation does not apply to multiemployer plans. In addition, the bill repeals the Internal Revenue Code annual valuation requirement for multiemployer plans and applies the prior-law rule that valuations generally be performed at least every 3 years.

Effective Date

The provision applies to years beginning after December 31, 1991.

6. Modification of full funding limitation (sec. 4236 of the bill and sec. 412 of the Code)

Present Law

Under present law, subject to certain limitations, an employer may make deductible contributions to a defined benefit pension plan up to the full funding limitation. The full funding limitation is generally defined as the excess, if any, of (1) the lesser of (a) the accrued liability under the plan (including normal cost) or (b) 150 percent of the plan's current liability, over (2) the lesser of (a) the fair market value of the plan's assets, or (b) the actuarial value of the plan's assets (sec. 412(c)(7)).

The Secretary may, under regulations, adjust the 150-percent figure contained in the full funding limitation to take into account the average age (and length of service, if appropriate) of the participants in the plan (weighted by the value of their benefits under the plan). In addition, the Secretary is authorized to prescribe regulations that apply, in lieu of the 150 percent of current liability limitation, a different full funding limitation based on factors other than current liability. The Secretary may exercise this authority only in a manner so that in the aggregate, the effect on Federal budget receipts is substantially identical to the effect of the 150-percent full funding limitation.

Reasons for Change

The Secretary has not yet exercised his authority with respect to the full funding limitation. The committee finds it necessary to specify a revenue-neutral way of exercising such authority.

Explanation of Provision

The bill allows certain employers to elect to apply the present-law full funding limitation without regard to the 150 percent of current liability limitation. The Secretary is required under the provision to adjust the full funding limitation in a specified manner for all plans (other than those subject to such an election) in response to employer elections under the proposal so that the provision is revenue neutral.

Effective Date

The provision is effective on the date of enactment.

7. Distributions from qualified cash or deferred arrangements maintained by rural cooperatives (sec. 4237 of the bill and sec. 401(k) of the Code)

Present Law

Under present law, a qualified cash or deferred arrangement can permit withdrawals by participants only after the earlier of (1) the participant's separation from service, death, or disability, (2) termination of the arrangement, (3) in the case of a profit-sharing or stock bonus plan, the attainment of age 59½, or (4) in the case of a profit-sharing or stock bonus plan to which section 402(a)(8) applies, upon hardship of the participant (sec. 401(k)(2)(B)). In the case of a rural cooperative qualified cash or deferred arrangement, which is part of a money purchase pension plan, withdrawals by participants cannot occur upon attainment of age 59½ or upon hardship.

Reasons for Change

It is appropriate to permit qualified cash or deferred arrangements of rural cooperatives to permit distributions to plan participants under the same circumstances as other qualified cash or deferred arrangements. Rural cooperatives could achieve the same results by modifying the structure of their plans. There is no justifiable reason to require rural cooperatives to incur the administrative costs of plan conversion when the same result can be achieved without imposing such costs.

Explanation of Provision

The bill provides that a rural cooperative plan that includes a qualified cash or deferred arrangement will not be treated as violating the qualification requirements merely because the plan permits distributions to plan participants after the attainment of age 59½.[60]

[60] Age 59½ is changed to 59 under another provision of the bill, described above.

Effective Date

The provision is effective for distributions after the date of enactment.

8. Limits on contributions and benefits under governmental plans (sec. 4238 of the bill and secs. 415 and 457 of the Code)

Present Law

Present law imposes limits on contributions and benefits under qualified plans based on the type of plan (sec. 415). The limits apply to plans maintained by private and public employers. Certain special rules apply to governmental plans.

In the case of a defined contribution plan, the annual additions to the plan with respect to each plan participant are limited to the lesser of (1) 25 percent of compensation, or (2) $30,000. The limit on the annual benefits payable by a defined benefit pension plan is generally the lesser of (1) 100 percent of compensation, or (2) $112,221 for 1992. The dollar limit is increased annually for inflation. The dollar limit is reduced actuarially if payment of benefits is to begin before the social security retirement age, and increased if benefits are to begin after that age.

Under special rules for plans maintained by State or local governments, such plans may provide benefits greater than those permitted by the limits on benefits applicable to plans maintained by private employers.

Reasons for Change

The limits on contributions and benefits create unique problems for plans maintained by public employers.

Explanation of Provision

The bill makes the following modifications to the limits on contributions and benefits as applied to governmental plans: (1) compensation includes employer contributions to certain employee plans under a salary reduction arrangement; (2) the 100 percent of compensation limitation does not apply; and (3) the defined benefit pension plan limitation does not apply to certain disability and survivor benefits. The bill also permits State and local government employers to maintain excess benefit plans (i.e., plans that provide benefits that cannot be provided under a qualified plan due to the limits on contributions and benefits) without regard to the limits on unfunded deferred compensation arrangements of State and local government employers (sec. 457). Benefits provided by such plans are subject to the same tax rules applicable to excess plans maintained by private employers (e.g., sec. 83).

Effective Date

The provision is effective for years beginning after the date of enactment. Governmental plans are treated as if in compliance with the requirements of section 415 for years beginning on or before the date of enactment.

9. Use of 501(c)(21) black lung trust assets to fund retiree health benefits (sec. 4239 of the bill and secs. 501(c)(21), 192(c), and 4951(f) of the Code)

Present Law

A qualified black lung benefit trust described in section 501(c)(21) of the Internal Revenue Code is exempt from federal income taxation. In addition, a deduction is allowed for contributions to a qualified black lung benefit trust to the extent such contributions are necessary to fund the trust.

Under present law, no assets of a qualified black lung benefit trust may be used for, or diverted to, any purpose other than (i) to satisfy liabilities, or pay insurance premiums to cover liabilities, arising under the Black Lung Acts, (ii) to pay administrative costs of operating the trust, or (iii) investment in U.S., State, or local securities and obligations, or in time demand deposits in a bank or insured credit union.

Under present law, excess trust assets may be paid into the national Black Lung Disability Trust Fund, or into the general fund of the U.S. Treasury.

Reasons for Change

Permitting excess assets in black lung trusts to be used to pay retiree accident and health benefits for miners will provide an additional source of funding to pay for promised health care benefits. This use of excess assets is appropriate provided there are safeguards to help ensure that sufficient funds will be available to pay for black lung benefit liabilities.

Explanation of Provision

The bill allows excess assets in qualified black lung benefit trusts to be used to pay accident and health benefits or premiums for insurance for such benefits (including administrative and other incidental expenses relating to such benefits) for retired coal miners and their spouses and dependents. The amount of assets available for such purpose is subject to a yearly limit as well as an aggregate limit. The yearly limit is to be the amount of assets in excess of 110 percent of the present value of the liability for black lung benefits determined as of the close of the preceding taxable year of the trust. The aggregate limit is the amount of assets in excess of 110 percent of the present value of the liability for black lung benefits determined as of the close of the taxable year of the trust ending prior to the effective date, plus earnings thereon. Each of these determinations is required to be made by an independent actuary.

The amounts used to pay retiree accident or health benefits are not includible in the income of the company, nor is a deduction allowed for such amounts.

Effective Date

The provision is effective for taxable years beginning after December 31, 1991.

10. Penalties for failure to provide reports relating to pension payments (sec. 4240 of the bill and secs. 6652(e) and 6724 of the Code)

Present Law

Any person who fails to file an information report with the Internal Revenue Service on or before the prescribed filing date is subject to penalties for each failure. The general penalty structure provides that the amount of the penalty is to vary with the length of time within which the taxpayer corrects the failure, and allows taxpayers to correct a de minimis number of errors and avoid penalties entirely (sec. 6721). A different, flat-amount penalty applies for each failure to provide information reports to the IRS or statements to payees relating to pension payments (sec. 6652(e)).

Reasons for Change

Conforming the information-reporting penalties that apply with respect to pension payments to the general information-reporting penalty structure would simplify the overall penalty structure through uniformity and provide more appropriate information-reporting penalties with respect to pension payments.

Explanation of Provision

The bill incorporates into the general penalty structure the penalties for failure to provide information reports relating to pension payments to the IRS and to recipients. Thus, information reports with respect to pension payments would be treated in a similar fashion to other information reports.

Effective Date

The provision applies to returns and statements the due date for which is after December 31, 1992.

11. Contributions on behalf of disabled employees (sec. 4241 of the bill and sec. 415 of the Code)

Present Law

Under present law, an employer may elect to continue deductible contributions to a defined contribution plan on behalf of an employee who is permanently and totally disabled. For purposes of the limit on annual additions (sec. 415(c)), the compensation of a disabled employee is deemed to be equal to the annualized compensation of the employee prior to the employee's becoming disabled. Contributions are not permitted on behalf of disabled employees who were officers, owners, or highly compensated before they became disabled.

Reasons for Change

The committee believes it is appropriate to facilitate the provision of benefits for disabled employees, if it is done on a nondiscriminatory basis.

Explanation of Provision

The bill provides that the special rule for contributions on behalf of disabled employees is applicable without an employer election and to highly compensated employees if the defined contribution plan provides for the continuation of contributions on behalf of all participants who are permanently and totally disabled.

Effective Date

The provision applies to years beginning after December 31, 1992.

12. Affiliation requirements for employers jointly maintaining a VEBA (sec. 4242 of the bill and sec. 501(c)(9) of the Code)

Present Law

A voluntary employees' beneficiary association (VEBA) that satisfies certain requirements is entitled to tax-exempt status. The Code generally describes a VEBA as an association that provides for the payment of life, sick, accident, or other benefits to the members of such association or their dependents or designated beneficiaries, if no part of the net earnings of the association inures (other than through such payments) to the benefit of nay private shareholder or individual. The requirements a VEBA must comply with in order to be tax exempt are further specified in regulations.

Under Treasury regulations, membership in a VEBA is required to be limited to individuals whose eligibility is determined by reference to objective standards that constitute an employment-related common bond. Such a common bond exists if eligibility is determined by the following standards: (1) employment by a common employer (or affiliated employers); (2) coverage under one or more collective bargaining agreements; (3) membership in a labor union (or in one or more locals of a national or international labor union); or (4) employment by one or more employers in the same line of business in the same geographic locale.

Reasons for Change

VEBAs offer an effective mechanism for affiliated employers, particularly small employers, to band together for the purpose of providing certain employee benefits at lower cost than would otherwise be possible. The committee believes that the requirement under Treasury regulations that participating employers be in the same geographic locale is an arbitrary restriction on the ability of affiliated employers to maintain VEBAs.

Explanation of Provision

The bill provides that otherwise unrelated employers are treated as affiliated and, therefore, can maintain a tax-exempt VEBA if the employers (1) are in the same line of business, (2) act jointly to perform tasks which are integral to the activities of each of the employers, (3) act jointly to such an extent that the joint maintenance of a VEBA is not a major part of the joint activities, and (4) a substantial number of the employers are tax exempt.

Under the bill, employers are considered affiliated, for example, under the following circumstances. The employers participating in the VEBA are in the same line of business and belong to an association that provides to its members a significant amount of each of the following services: (1) research and development relating to the members' primary activity; (2) education and training of members' employees; and (3) public relations. In addition. the employers are sufficiently similar (e.g., subject to similar regulatory requirements) that the association's services provide material assistance to all of the employers. The employers also demonstrate the importance of their joint activities by having meetings at least annually attended by substantially all of the employers. Finally, the employers maintain a common retirement plan.

On the other hand, it is not intended that the mere existence of a trade association is a sufficient basis for the member-employers to be considered affiliated, even if they are in the same line of business. It is also not sufficient if the trade association publishes a newsletter and provides significant public relations services, but only provides nominal amounts, if any, of other services integral to the employers' primary activity.

A group of employers are also not considered affiliated under the bill by virtue of the membership of their employees in a professional association.

Effective Date

The provision applies to years beginning before, on, or after the date of enactment. The provision is intended as a clarification of present law. However, it is not intended to create any inference as to whether any part of the Treasury regulations affecting VEBAs, other than the affiliated employer rule, is or is not present law.

13. Disaggregation of union plans (sec. 4243 of the bill and secs. 410(b), 401(a)(4), and 414(r) of the Code)

Present Law

Under present law, employees covered by a collective bargaining agreement are excluded from consideration in testing whether a qualified plan satisfies the minimum coverage and nondiscrimination tests. In addition, such employees are not counted for purposes of determining whether a line of business has at least 50 employees, the threshold number for designating a unit as a separate line of business for purposes of applying the coverage and nondiscrimination tests.

Reasons for Change

The present-law rule tests union employees separately in recognition of the collective bargaining process. The committee believes it is appropriate to permit union employes to be aggregated with other employees who are covered by the same plan.

Explanation of Provision

The bill provides that an employer can elect to include union employees who benefit under the plan on the same terms as other employees in testing whether a plan satisfies the minimum coverage and nondiscrimination tests, and in applying the 50-employee test under the line of business rules.

Effective Date

The provision applies to years beginning after December 31, 1992.

14. Uniform retirement age (sec. 4244 of the bill and sec. 401(a)(4) of the Code)

Present Law

A qualified plan generally must provide that payment of benefits under the plan must begin no later than 60 days after the end of the plan year in which the participant reaches age 65. Also, for purpose of the vesting and benefit accrual rules, normal retirement age generally can be no later than age 65. For purposes of applying the limits on contributions and benefits (sec. 415), social security retirement age is generally used as retirement age. The social security retirement age as used for such purposes is presently age 65, but is scheduled to gradually increase.

Reasons for Change

Many plans base benefits on social security retirement age so that the benefits under the plan complement social security. Under present law, plans that do so may fail applicable nondiscrimination tests. The committee believes that the social security retirement age is an appropriate age for use under plans maintained by private employers.

Explanation of Provision

The bill provides that for purposes of the general nondiscrimination rule (sec. 401(a)(4)) the social security retirement age (as defined in sec. 415) is a uniform retirement age and that subsidized early retirement benefits and joint and survivor annuities based on an employee's social security retirement age (as defined in sec. 415) are treated as being available to employees on the same terms.

Effective Date

The provision is effective for years beginning after December 31, 1992.

15. Special rules for plans covering pilots (sec. 4245 of the bill and sec. 410(b) of the Code)

Present Law

Under present law, for purposes of determining whether a qualified pension plan satisfies the minimum coverage requirements, in

the case of trust established pursuant to a collective bargaining agreement between airline pilots and one or more employers, all employees not covered by the collective bargaining agreement are disregarded (sec. 410(b)(3)(B)). This provision applies only in the case of a plan that provides contributions or benefits for employees whose principal duties are customarily performed aboard aircraft in flight. Thus, a collectively bargained plan covering only airline pilots is tested separately for purposes of the minimum coverage requirements.

Reasons for Change

Present law treats airline pilots covered by a collective bargaining agreement separately for purposes of testing whether a pension plan satisfies the minimum coverage requirements, but requires nonunion airline pilots to be considered with an employer's other employees for coverage purposes. It is understood that pilots are required to retire earlier than other workers under Federal regulations. Thus, it is believed that all pilots must accrue their benefits over a shorter period of time, regardless of whether they are members of a union.

Explanation of Provision

The bill provides that, in the case of a plan established by one or more employers to provide contributions or benefits for air pilots employed by one or more common carriers engaged in interstate or foreign commerce or air pilots employed by carriers transporting mail for or under contract with the United States government, all employees who are not air pilots are excluded from consideration in testing whether the plan satisfies the minimum coverage requirements. In addition, the bill provides that this exception does not apply in the case of a plan that provides contributions or benefits for employees who are not air pilots or for air pilots whose principal duties are not customarily performed aboard aircraft in flight.

Effective Date

The provision is effective for years beginning after December 31, 1992.

16. National Commission on Private Pension Plans (sec. 4246 of the bill)

Reasons for Provision

The committee believes that it is appropriate to review existing Federal incentives and programs that encourage and protect private retirement savings.

Explanation of Provision

The provision establishes a National Commission on Private Pension Plans to study national retirement income policy. The Commission is directed to submit a report to the Congress by Labor Day 1994, the 20th anniversary of the enactment of the Employee Re-

tirement Income Security Act of 1974, setting forth its findings and recommendations for increasing the level and security of private retirement savings.

The provision authorizes appropriations through fiscal year 1994 for such sums as may be necessary to carry out the provision.

17. Date for adoption of plan amendments (sec. 4247 of the bill)

Present Law

Under regulations, plan amendments to reflect changes generally must be made within the remedial amendment period. Such period generally ends at the time prescribed by law for filing the income tax return of the employer for the employer's taxable year in which the change in law occurs. The plan must be operated in accordance with the law at all times, and any plan amendment must apply retroactively to the period following the effective date of the change which it reflects.

Reasons for Change

The committee believes that plan sponsors should have adequate time to amend plan documents.

Explanation of Provision

The bill provides that any plan amendments required by the bill are not required to be made before the first plan year beginning on or after January 1, 1994, if the plan is operated in accordance with the applicable provision and the amendment is retroactive to the effective date of the applicable provision.

Effective Date

Date of enactment.

Subtitle C—Treatment of Large Partnerships

Part I—General Provisions

1. Simplified flow-through for large partnerships (sec. 4301 of the bill and new secs. 771-777 of the Code)

Present Law

Treatment of partnerships in general

A partnership generally is treated as a conduit for Federal income tax purposes. Each partner takes into account separately his distributive share of the partnership's items of income, gain, loss, deduction or credit. The character of an item is the same as if it had been directly realized or incurred by the partner. Limitations affecting the computation of taxable income generally apply at the partner level.

The taxable income of a partnership is computed in the same manner as that of an individual except that no deduction is permitted for personal exemptions, foreign taxes, charitable contributions, net operating losses, certain itemized deductions, or depletion. Elections affecting the computation of taxable income derived from a

partnership are made by the partnership, except for certain elections such as those relating to discharge of indebtedness income and the foreign tax credit.

Capital gains

The net capital gain of an individual is taxed generally at the same rates applicable to ordinary income, subject to a maximum marginal rate of 28 percent.[61] Net capital gain is the excess of net long-term capital gain over net short-term capital loss. Individuals with a net capital loss generally may deduct up to $3,000 of the loss each year against ordinary income. Net capital losses in excess of the $3,000 limit may be carried forward indefinitely.

A special rule applies to gains and losses on the sale, exchange or involuntary conversion of certain trade or business assets (sec. 1231). In general, net gains from such assets are treated as long-term capital gains but net losses are treated as ordinary losses.

A partner's share of a partnership's net short-term capital gain or loss and net long-term capital gain or loss from portfolio investments is separately reported to the partner. A partner's share of a partnership's net gain or loss under section 1231 generally is also separately reported.

Deductions

Miscellaneous itemized deductions (e.g., certain investment expenses) are deductible only to the extent that, in the aggregate, they exceed two percent of the individual's adjusted gross income.

In general, taxpayers are allowed a deduction for charitable contributions, subject to certain limitations. The deduction allowed an individual generally cannot exceed 50 percent of the individual's adjusted gross income for the taxable year. The deduction allowed a corporation generally cannot exceed 10 percent of the corporation's taxable income. Excess contributions are carried forward for five years.

A partner's distributive share of a partnership's miscellaneous itemized deductions and charitable contributions are separately reported to the partner.

Credits in general

Each partner is allowed his distributive share of credits against his taxable income. A refundable credit for gasoline used for exempt purposes is allowed. Nonrefundable credits for clinical testing expenses for certain drugs for rare diseases, for producing fuel from nonconventional sources, and for the general business credit are also allowed. The general business credit includes the investment credit (which in turn includes the rehabilitation credit), the targeted jobs credit, the alcohol fuels credit, the research credit, and the low-income housing credit.

The credits for clinical testing expenses and for the production of fuel from nonconventional sources are limited to the excess of regular tax over tentative minimum tax. Excess credits generally cannot be carried to another taxable year. The amount of general

[61] Another provision of the bill repeals the 28-percent maximum rate and replaces it with a progressive rate system.

business credit allowable in a taxable year is limited to the excess of a partner's net income tax over the greater of (1) the tentative minimum tax for the year or (2) 25 percent of the taxpayer's net regular tax liability in excess of $25,000. The general business credit in excess of this amount is carried back three years and forward 15 years.

The benefit of the investment credit and the low-income housing credit is recaptured if, within a specified time period, the partner transfers his partnership interest or the partnership converts or transfers the property for which the credit was allowed.

Foreign taxes

The foreign tax credit generally allows U.S. taxpayers to reduce U.S. income tax on foreign income by the amount of foreign income taxes paid or accrued with respect to that income. In lieu of electing the foreign tax credit, a taxpayer may deduct foreign taxes. The total amount of the credit may not exceed the same proportion of the taxpayer's U.S. tax which the taxpayer's foreign source taxable income bears to the taxpayer's worldwide taxable income for the taxable year.

Unrelated business taxable income

Tax-exempt organizations are subject to tax on income from unrelated businesses. Certain types of income (such as dividends, interest and certain rental income) are not treated as unrelated business taxable income. Thus, for a partner that is an exempt organization, whether partnership income is unrelated business taxable income depends on the character of the underlying income. Income from a publicly traded partnership, however, is treated as unrelated business taxable income regardless of the character of the underlying income.[62]

Special rules related to oil and gas activities

Taxpayers involved in the search for and extraction of crude oil and natural gas are subject to certain special tax rules. As a result, in the case of partnerships engaged in such activities, certain specific information is separately reported to partners.

A taxpayer who owns an economic interest in a producing deposit of natural resources (including crude oil and natural gas) is permitted to claim a deduction for depletion of the deposit as the minerals are extracted. In the case of oil and gas produced in the United States, a taxpayer generally is permitted to claim the greater of a deduction for cost depletion or percentage depletion. Cost depletion is computed by multiplying a taxpayer's adjusted basis in the depletable property by a fraction, the numerator of which is the amount of current year production from the property and the denominator of which is the property's estimated reserves as of the beginning of that year. Percentage depletion is equal to a specified percentage (generally 15 percent in the case of oil and gas) of gross income from production. Cost depletion is limited to the taxpayer's basis in the depletable property; percentage depletion is not so lim-

[62] Another provision of the bill repeals this rule.

ited. Once a taxpayer has exhausted its basis in the depletable property, it may continue to claim percentage depletion deductions (generally referred to as "excess percentage depletion").

Certain limitations apply to the deduction for oil and gas percentage depletion. First, percentage depletion is not available to oil and gas producers who also engage (directly or indirectly) in significant levels of oil and gas retailing or refining activities (so-called "integrated oil and gas companies"). Second, the deduction for percentage depletion may be claimed by a taxpayer only with respect to up to 1,000 barrels-per-day of production. Third, the percentage depletion deduction may not exceed 100 percent of the taxpayer's net income for the taxable year from the depletable oil and gas property. Fourth, a percentage depletion deduction may not be claimed to the extent that it exceeds 65-percent of the taxpayer's pre-percentage depletion taxable income.

Present law provides that in the case of a partnership that owns depletable oil and gas properties, the depletion allowance is computed separately by the partners and not by the partnership. In computing a partner's basis in his partnership interest, basis is increased by the partner's share of any partnership-related excess percentage depletion deductions and is decreased (but not below zero) by the partner's total amount of depletion deductions attributable to partnership property.

Intangible drilling and development costs (IDCs) incurred with respect to domestic oil and gas wells generally may be deducted at the election of the taxpayer. In the case of integrated oil companies, no more than 70 percent of IDCs incurred during a taxable year may be deducted. IDCs not deducted are capitalized and generally are either added to the property's basis and recovered through depletion deductions or amortized on a straight-line basis over a 60-month period.

The special treatment granted oil and gas activities through the percentage depletion rules and the election to deduct IDCs may give rise to items of tax preference or (in the case of corporate taxpayers) an adjusted current earnings ("ACE") adjustment for the alternative minimum tax. With respect to percentage depletion, any excess percentage depletion constitutes an amount of tax preference.

For IDCs, the tax preference item is based on a concept of "excess IDCs." In general, excess IDCs are the excess of IDCs deducted for the taxable year over the amount of those IDCs that would have been deducted had they been capitalized and amortized on a straight-line basis over 120 months commencing with the month production begins from the related well. The amount of tax preference is then computed as the difference between the excess IDC amount and 65 percent of the taxpayer's net income from oil and gas (computed without a deduction for excess IDCs).[63]

Taxpayers other than integrated oil companies that incur oil and gas related amounts of tax preference and ACE adjustments are permitted a "special energy deduction" in computing alternative minimum taxable income. The special energy deduction generally

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[63] Another provision of the bill raises this threshold from 65 percent to 70 percent in the case of taxpayers other than integrated oil companies.

is comprised of various specified percentages of IDC preference (and associated ACE adjustment) related to exploratory and development drilling and to a specified portion of percentage depletion preference (and associated ACE adjustment) related to marginally-producing depletable properties. The cumulative special energy deduction may not offset more than 40 percent of pre-special energy deduction alternative minimum taxable income.

Passive losses

The passive loss rules generally disallow deductions and credits from passive activities to the extent they exceed income from passive activities. Losses not allowed in a taxable year are suspended and treated as current deductions from passive activities in the next taxable year. These losses are allowed in full when a taxpayer disposes of the entire interest in the passive activity to an unrelated person in a taxable transaction. Passive activities include trade or business activities in which the taxpayer does not materially participate. (Limited partners generally do not materially participate in the activities of a partnership.) Passive activities also include rental activities (regardless of the taxpayer's material participation).[64] Portfolio income (such as interest and dividends), and expenses allocable to such income, are not treated as income or loss from a passive activity.

A partnership's operations may be treated as multiple activities for purposes of the passive loss rules. In such case, the partnership must separately report items of income and deductions from each of its activities.

Income from a publicly traded partnership is treated as portfolio income under the passive loss rules. In addition, loss from such a partnership is treated as separate from income and loss from any other publicly traded partnership, and also as separate from any income or loss from passive activities.

REMICs

A tax is imposed on partnerships holding a residual interest in a real estate mortgage investment conduit (REMIC). The amount of the tax is the amount of excess inclusions allocable to partnership interests owned by certain tax-exempt organizations ("disqualified organizations") multiplied by the highest corporate tax rate.

Contribution of property to a partnership

In general, a partner recognizes no gain or loss upon the contribution of property to a partnership. However, income, gain, loss and deduction with respect to property contributed to a partnership by a partner must be allocated among the partners so as to

[64] An individual who actively participates in a rental real estate activity and holds at least a 10 percent interest may deduct up to $25,000 of passive losses. The $25,000 amount phases out as the individual's income increases from $100,000 to $150,000.

The $25,000 allowance also applies to low-income housing and rehabilitation credits (on a deduction equivalent basis), regardless of whether the taxpayer claiming the credit actively participates in the rental real estate activity generating the credit. In addition, the income phase-out range for the $25,000 allowance for rehabilitation credits is $200,000 to $250,000 (rather than $100,000 to $150,000). For interests acquired after December 31, 1989 in partnerships holding property placed in service after that date, the $25,000 deduction-equivalent allowance is permitted for the low-income housing credit without regard to the taxpayer's income.

take into account the difference between the basis of the property to the partnership and its fair market value at the time of contribution. In addition, the contributing partner must recognize gain or loss equal to such difference if the property is distributed to another partner within five years of its contribution (sec. 704(c)). Under regulations, the amount of depreciation and gain or loss that is allocated under these rules is limited to the depreciation allowable to, or gain or loss recognized by, the partnership for tax purposes with respect to the contributed property (the "ceiling rule").

Election of optional basis adjustments

In general, the transfer of a partnership interest or a distribution of partnership property does not affect the basis of partnership assets. A partnership, however, may elect to make certain adjustments in the basis of partnership property (sec. 754). Under a section 754 election, the transfer of a partnership interest generally results in an adjustment in the partnership's basis in its property for the benefit of the transferee partner only, to reflect the difference between that partner's basis for his interest and his proportionate share of the adjusted basis of partnership property (sec. 743(b)). Also under the election, a distribution of property to a partner in certain cases results in an adjustment in the basis of other partnership property (sec. 734(b)).

Terminations

A partnership terminates if either (1) all partners cease carrying on the business, financial operation or venture of the partnership, or (2) within a 12-month period 50 percent or more of the total partnership interests are sold or exchanged (sec. 708).

Reasons for Change

The requirement that each partner take into account separately his distributive share of a partnership's items of income, gain, loss, deduction and credit can result in the reporting of a large number of items to each partner. The Schedule K-1, on which such items are reported, contains space for more than 40 items. Reporting so many separately stated items is burdensome for individual investors with relatively small, passive interests in large partnerships. In many respects such investments are indistinguishable from those made in corporate stock or mutual funds, which do not require reporting of numerous separate items.

In addition, the number of items reported under the current regime makes it difficult for the Internal Revenue Service to match items reported on the K-1 against the partner's income tax return. Matching is also difficult because items on the K-1 are often modified or limited at the partner level before appearing on the partner's tax return.

By significantly reducing the number of items that must be separately reported to partners, the provision eases the reporting burden of partners and facilitates matching by the IRS. Moreover, the committee understands that the Internal Revenue Service is considering restricting the use of substitute reporting forms by

large partnerships. Reduction of the number of items makes possible a short standardized form.

In addition, the rules governing allocations with respect to property contributed to a partnership and the rules regarding partnership terminations are ill-suited to large partnerships, whose interests are commonly transferred. By adopting a deferred sale approach for property contributions and by reducing the possibility of partnership terminations, the provision improves the administration of the tax rules governing large partnerships.

Explanation of Provisions

In general

The bill modifies the tax treatment of a large partnership (generally, a partnership with at least 250 partners, or an electing partnership with at least 100 partners) and its partners. The bill provides that each partner takes into account separately the partner's distributive share of the following items, which are determined at the partnership level: (1) taxable income or loss from passive loss limitation activities; (2) taxable income or loss from other activities (e.g., portfolio income or loss); (3) net capital gain or loss to the extent allocable to passive loss limitation activities and other activities; (4) tax-exempt interest; (5) net alternative minimum tax adjustment separately computed for passive loss limitation activities and other activities; (6) general credits; (7) low-income housing credit; (8) rehabilitation credit; (9) credit for producing fuel from a nonconventional source; and (10) creditable foreign taxes and foreign source items.[65]

Under the bill, the taxable income of a large partnership is computed in the same manner as that of an individual, except that the items described above are separately stated and certain modifications are made. These modifications include disallowing the deduction for personal exemptions, the net operating loss deduction and certain itemized deductions.[66] All limitations and other provisions affecting the computation of taxable income or any credit (except for the at risk, passive loss and section 68 itemized deduction limitations, and any other provision specified in regulations) are applied at the partnership (and not the partner) level. Thus, for example, any investment interest of the partnership is limited at the partnership level, and any carryover is made at that level.

All elections affecting the computation of taxable income or any credit generally are made by the partnership.

Capital gains

Under the bill, netting of capital gains and losses occurs at the partnership level. A partner in a large partnership takes into account separately his distributive share of the partnership's net cap-

[65] In determining the amounts required to be separately taken into account by a partner, those provisions of the large partnership rules governing computations of taxable income are applied separately with respect to that partner by taking into account that partner's distributive share of the partnership's items of income, gain, loss, deduction or credit. This rule permits partnerships to make otherwise valid special allocations of partnership items to partners.

[66] A large partnership is allowed a deduction under section 212 for expenses incurred for the production of income, subject to 70-percent disallowance, as described below. No income from a large partnership is treated as fishing or farming income.

ital gain or net capital loss.[67] Such net capital gain or loss is treated as long-term capital gain or loss.

A partner's distributive share of the partnership's net capital gain is allocated between passive loss limitation activities and other activities. The net capital gain is allocated to passive loss limitation activities to the extent of net capital gain from sales and exchanges of property used in connection with such activities, and any excess is allocated to other activities. A similar rule applies for purposes of allocating any net capital loss.

Any gains and losses of the partnership under section 1231 are netted at the partnership level. Net gain is treated as long-term capital gain and is subject to the rules described above. Net loss is treated as ordinary loss and consolidated with the partnership's other taxable income.

Deductions

The bill contains two special rules for deductions. First, miscellaneous itemized deductions are not separately reported to partners. Instead, 70 percent of the amount of such deductions is disallowed at the partnership level; [68] the remaining 30 percent is allowed at the partnership level in determining taxable income, and is not subject to the two-percent floor at the partner level.

Second, charitable contributions are not separately reported to partners under the bill. Instead, the charitable contribution deduction is allowed at the partnership level in determining taxable income, subject to the limitations that apply to corporate donors.

Credits in general

Under the bill, general credits are separately reported to partners as a single item. General credits are any credits other than the low-income housing credit, the rehabilitation credit and the credit for producing fuel from a nonconventional source. A partner's distributive share of general credits is taken into account as a current year general business credit. Thus, for example, the credit for clinical testing expenses is subject to the present law limitations on the general business credit. The refundable credit for gasoline used for exempt purposes and the refund or credit for undistributed capital gains of a regulated investment company are allowed to the partnership, and thus are not separately reported to partners.

In recognition of their special treatment under the passive loss rules, the low-income housing and rehabilitation credits are separately reported.[69] In addition, the credit for producing fuel from a nonconventional source is separately reported.

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[67] The term "net capital gain" has the same meaning as in section 1222(11). The term "net capital loss" means the excess of the losses from sales or exchanges of capital assets over the gains from sales or exchanges of capital assets. Thus, the partnership cannot offset any portion of capital losses against ordinary income.

Any excess of net short-term capital gain over net long-term capital loss is consolidated with the partnership's other taxable income and is not separately reported.

[68] The "70 percent" figure is intended to approximate the amount of such deductions that would be denied at the partner level as a result of the two-percent floor.

[69] The committee understands that the rehabilitation and low-income housing credits which are subject to the same passive loss rules (i.e., in the case of the low-income housing credit, where the partnership interest was acquired or the property was placed in service before 1990) could be reported together on the same line.

The bill imposes credit recapture at the partnership level and determines the amount of recapture by assuming that the credit fully reduced taxes. Such recapture is applied first to reduce the partnership's current year credit, if any; the partnership is liable for any excess over that amount. Under the bill, the transfer of an interest in a large partnership does not trigger recapture.

Foreign taxes

The bill retains present-law treatment of foreign taxes. The partnership reports to the partner creditable foreign taxes and the source of any income, gain, loss or deduction taken into account by the partnership. Elections, computations and limitations are made by the partner.

Tax-exempt interest

The bill retains present-law treatment of tax-exempt interest. Interest on a State or local bond is separately reported to each partner.

Unrelated business taxable income

The bill retains present-law treatment of unrelated business taxable income. Thus, a tax-exempt partner's distributive share of partnership items is taken into account separately to the extent necessary to comply with the rules governing such income.

Passive losses

Under the bill, a partner in a large partnership takes into account separately his distributive share of the partnership's taxable income or loss from passive loss limitation activities. The term "passive loss limitation activity" means any activity which involves the conduct of a trade or business (including any activity treated as a trade or business under sec. 469(c)(5) or (6)) and any rental activity. A partner's share of a large partnership's taxable income or loss from passive loss limitation activities is treated as an item of income or loss from the conduct of a trade or business which is a single passive activity, as defined in the passive loss rules. Thus, a large partnership generally is not required to separately report items from multiple activities.

A partner in a large partnership also takes into account separately his distributive share of the partnership's taxable income or loss from activities other than passive loss limitation activities. Such distributive share is treated as an item of income or expense with respect to property held for investment. Thus, portfolio income (e.g., interest and dividends) is reported separately and is reduced by portfolio deductions and allocable investment interest expense.

In the case of a partner holding an interest in a large partnership which is not a limited partnership interest, such partner's distributive share of any items are taken into account separately to the extent necessary to comply with the passive loss rules. Thus, for example, income of a large partnership is not treated as passive income with respect to the general partnership interest of a partner who materially participates in the partnership's trade or business.

Under the bill, income from a publicly traded partnership continues to be treated as portfolio income.

Alternative minimum tax

Under the bill, alternative minimum tax ("AMT") adjustments and preferences are combined at the partnership level. A large partnership would report to partners a net AMT adjustment separately computed for passive loss limitation activities and other activities. In determining a partner's alternative minimum taxable income, a partner's distributive share of any net AMT adjustment is taken into account instead of making separate AMT adjustments with respect to partnership items. The net AMT adjustment is determined by using the adjustments applicable to individuals (in the case of partners other than corporations), and by using the adjustments applicable to corporations (in the case of corporate partners). Except as provided in regulations, the net AMT adjustment is treated as a deferral preference for purposes of the section 53 minimum tax credit.

Discharge of indebtedness income

If a large partnership has income from the discharge of any indebtedness, such income is separately reported to each partner. In addition, the rules governing such income (sec. 108) are applied without regard to the large partnership rules. Thus, for example, the large partnership provisions do not affect section 108(d)(6), which provides that certain section 108 rules apply at the partner level, or section 108(b)(5), which provides for an election to reduce the basis of depreciable property.

REMICs

For purposes of the tax on partnerships holding residual interests in REMICs, all interests in a large partnership are treated as held by disqualified organizations. Thus, a large partnership holding a residual interest in a REMIC is subject to a tax equal to the excess inclusions multiplied by the highest corporate rate. The amount subject to tax is excluded from partnership income.

Deferred sale treatment for contributed property

In general

For all partners contributing property to a large partnership (including partners who are disqualified persons, as described below), the bill replaces section 704(c) with a "deferred sale" approach. Under the bill, a large partnership is treated as if it had purchased the property from the contributing partner for its then fair market value, thus taking a fair market value basis in the property. The contributing partner's gain or loss on the contribution (the "precontribution gain or loss") [70] is deferred until the occurrence of specified recognition events. In general, the character of the precontribution gain or loss is the same as if the property had been

[70] Precontribution gain is the excess of the fair market value of the contributed property at the time of contribution over the adjusted basis of such property immediately before such contribution. Precontribution loss is the excess of the adjusted basis of such property over its fair market value.

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sold to the partnership by the partner at the time of contribution. The contributing partner's basis in his partnership interest is adjusted for precontribution amounts recognized under the provision. These adjustments generally are made immediately before the recognition event.

The provision effectively repeals the ceiling rule for large partnerships, i.e., the amount of precontribution gain or loss recognized by the contributing partner under the provision is not limited to the overall gain or loss from the contributed property recognized by the partnership. In addition, the amount of depreciation allowable to the partnership is not limited to the contributing partner's basis in the property.

Recognition events

Certain events occurring at either the partnership or partner level cause recognition of precontribution gain or loss. Loss is not recognized, however, by reason of a disposition to a person related (within the meaning of sec. 267(b) or sec. 707(b)(1)) to the contributing partner.

Transactions at partnership level.—The contributing partner recognizes precontribution gain or loss as the partnership claims an amortization, depreciation, or depletion deduction with respect to the property. The amount of gain (or loss) recognized equals the increase (or decrease) in the deduction attributable to changes in basis of the property occurring by reason of its contribution. Any gain or loss so recognized is treated as ordinary.

The contributing partner also generally recognizes precontribution gain or loss if the partnership disposes of the contributed property to a person other than the contributing partner. If such property is distributed to the contributing partner, its basis in the hands of the contributing partner equals its basis immediately before the contribution, adjusted for any gain or loss previously recognized on account of the deferred sale. No adjustment is made to the basis of undistributed partnership property on account of a distribution to the contributing partner.[71]

A contributing partner's deferred gain or loss is not recognized if the partnership disposes of the property in certain nonrecognition transactions: a like-kind exchange (sec. 1031); an involuntary conversion (sec. 1033); or a contribution to a partnership (sec. 721), provided the contributing partnership owns more than 50 percent of the recipient partnership.

Transactions at partner level.—A contributing partner recognizes precontribution gain or loss to the extent that he disposes of his partnership interest other than at death.[72] Such partner also recognizes precontribution gain or loss to the extent that the cash and fair market value of property (other than the contributed property) distributed to him exceeds the adjusted basis of his partnership interest immediately before the distribution (determined without

[71] Amounts recognized by reason of these recognition events are taken into account in the partner's taxable year in which or with which ends the partnership taxable year of the deduction or disposition.

[72] The committee intends that a deceased partner's successor in interest would not recognize any remaining precontribution gain or loss.

regard to any basis adjustment under the deemed sale rules resulting from the distribution).

The committee intends that the Secretary of the Treasury have regulatory authority to apply the deferred sale rules in the case of so-called "reverse 704(c)" situations, i.e., in cases where a partnership revalues its assets. *See* Treas. Reg. sec. 1.704-1(b)(2)(iv)(*f*).

Election of optional basis adjustments

Under the bill, a large partnership may still elect to adjust the basis of partnership assets with respect to transferee partners. The computation of a large partnership's taxable income is made without regard to the section 743(b) adjustment. As under present law, the section 743(b) adjustment is made only with respect to the transferee partner. In addition, a large partnership is permitted to adjust the basis of partnership property under section 734(b) if property is distributed to a partner, as under present law.

Terminations

The bill provides that a large partnership does not terminate for tax purposes solely because 50 percent of its interests are sold or exchanged within a 12-month period.

Partnerships and partners subject to large partnership rules

Definition of large partnership

A "large partnership" is any partnership with at least 250 partners in a taxable year beginning after December 31, 1992.[73] Any partnership treated as a large partnership for a taxable year is so treated for all succeeding years, even if the number of partners falls below 250. Regulations may provide, however, that if the number of partners in any taxable year falls below 100, the partnership is not treated as a large partnership. Partnerships with at least 100 partners can elect to be treated as if they had 250 partners. The election applies to the year for which made and all subsequent years and cannot be revoked without the Secretary's consent.

Special rules for certain service partnerships

A large partnership does not include any partnership if substantially all the partners are: (1) individuals performing substantial services in connection with the partnership's activities, or personal service corporations the owner-employees of which perform such services; (2) retired partners who had performed such services; or (3) spouses of partners who had performed such services. In addition, the term "partner" does not include any individual performing substantial services in connection with the partnership's activities and holding a partnership interest, or an individual who formerly performed such services and who held a partnership interest at the time the individual performed such services.

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[73] The number of partners is determined by counting only persons directly holding partnership interests in the taxable year, including persons holding through nominees; persons holding indirectly (e.g., through another partnership) are not counted. It is not necessary for a partnership to have 250 or more partners at any one time in a taxable year for the partnership to constitute a large partnership.

Exclusion for commodity partnerships

The large partnership rules do not apply to any partnership the principal activity of which is the buying and selling of commodities (not described in section 1221(1)), or options, futures or forwards with respect to commodities.

Special rules for partnerships holding oil and gas properties

Election to use simplified reporting

In general, a large partnership that otherwise meets the qualifications for simplified reporting is not required to report information to its partners under the rules of that regime if it is substantially engaged in oil and gas related activities. Rather, such a partnership continues to report information to its partners as under present law. The bill permits such a partnership, however, to elect to utilize the simplified reporting regime, as modified for oil and gas purposes. If an election is made for any taxable year, it will also apply for all subsequent taxable years unless revoked with the consent of the Secretary.

A partnership is considered to be substantially engaged in oil and gas activities if at least 25 percent of the average value of its assets during the taxable year consists of oil or gas properties.[74] In making this determination, a partnership is treated as owning its proportionate share of assets of any partnership in which it holds an interest.

Simplified reporting treatment of large partnerships with oil and gas activities

The bill provides special rules for large partnerships with oil and gas activities that operate under the simplified reporting regime (i.e., either (1) large partnerships that are substantially engaged in oil and gas activities and which elect to use the regime, or (2) large partnerships that are not substantially engaged in oil and gas operations, but do have some oil and gas activities). These partnerships are collectively referred to herein as "oil and gas large partnerships." Generally, the bill provides that an oil and gas large partnership reports information to its partners under the general simplified large partnership reporting regime described above. To prevent the extension of percentage depletion deductions to persons excluded therefrom under present law, however, certain partners are treated as disqualified persons under the bill.

The treatment of a disqualified person's distributive share of any item of income, gain, loss, deduction, or credit attributable to any partnership oil or gas property is determined under the bill without regard to the special rules applicable to large partnerships. Thus, an oil and gas large partnership reports information related to oil and gas activities to a partner who is a disqualified person in the same manner and to the same extent that it reports such information to that partner under present law. The simplified reporting rules of the bill, however, apply with respect to reporting such a partner's share of items related to non-oil and gas activities.

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[74] For this purpose, "oil or gas properties" means the mineral interests in oil or gas which are of a character with respect to which a deduction for depletion is allowable under section 611.

The bill defines two categories of taxpayers as disqualified persons. The first category encompasses taxpayers who do not qualify for the deduction for percentage depletion under section 613A (i.e., integrated oil and gas companies). The second category includes any person whose average daily production of oil and gas (for purposes of determining the depletable oil and natural gas quantity under section 613A(c)(2)) is at least 500 barrels for its taxable year in which (or with which) the partnership's taxable year ends. In making this computation, all production of domestic crude oil and natural gas attributable to the partner is taken into account, including such partner's proportionate share of any production of the large partnership.

A taxpayer that falls within a category of disqualified person has the responsibility of notifying any large partnership in which it holds a direct or indirect interest (e.g., through a pass-through entity) of its status as such. Thus, for example, if an integrated oil company owns an interest in a partnership which in turn owns an interest in an oil and gas large partnership, the company is responsible for providing the management of the large partnership information regarding its status as a disqualified person and details regarding its indirect interest in the large partnership.

Under the bill, an oil and gas large partnership computes its deduction for oil and gas depletion under the general statutory rules (subject to certain exceptions described below) under the assumptions that it (the partnership) is the taxpayer and that it qualifies for the percentage depletion deduction. The amount of the depletion deduction, as well as other oil and gas related items, generally are reported to each partner (other than to partners who are disqualified persons) as components of that partner's distributive share of taxable income or loss from passive loss limitation activities.

The bill provides that in computing the partnership's oil and gas percentage depletion deduction, the 1,000-barrel-per-day limitation does not apply. In addition, an oil and gas large partnership is allowed to compute percentage depletion under the bill without applying the 65-percent-of-taxable-income limitation under section 613A(d)(1).

As under present law, an election to deduct IDCs under section 263(c) is made at the partnership level. Since the bill treats those taxpayers required by the Code (sec. 291) to capitalize 30 percent of IDCs as disqualified persons, an oil and gas large partnership may pass through a full deduction of IDCs to its partners who are not disqualified persons. In contrast to present law, an oil and gas large partnership also has the responsibility with respect to its partners who are not disqualified persons for making an election under section 59(e) to capitalize and amortize certain specified IDCs. Partners who are disqualified persons are permitted to make their own separate section 59(e) elections under the bill.

Consistent with the general reporting regime for large partnerships, the bill provides that a single AMT adjustment (under either corporate or non-corporate principles, as the case may be) is made and reported to the partners (other than disqualified persons) of an oil and gas large partnership as a separate item. This separately-reported item is affected by a number of oil-and-gas factors: the tax

preference for excess percentage depletion, the tax preference for excess IDCs, the adjusted current earnings adjustment, and the special energy deduction.

Since an oil and gas large partnership computes a deduction for percentage depletion under the bill, it also is required to compute the amount of tax preference for excess percentage depletion. The preference item for excess IDCs also is computed by an oil and gas large partnership. In this case, the partnership compares the amount of excess IDCs it incurs with 70 percent of its net income from oil and gas. To the extent that the excess IDC amount exceeds the partnership's 70-percent-net-income-from-oil-and-gas amount, there is an amount of tax preference for excess IDCs which is factored into the amount reported as AMT adjustment to the partners.

Under the bill, the AMT special energy deduction is computed by an oil and gas large partnership. The current-law special energy deduction is limited so that it may not reduce the taxpayer's pre-special energy deduction alternative minimum taxable income by more than 40 percent. Under the bill, an oil and gas large partnership is treated as the taxpayer for this purpose. Thus, the limitation on the special energy deduction is applied at the partnership level using the same 40-percent threshold.

The bill provides that in making partnership-level computations, any item of income, gain, loss, deduction, or credit attributable to a partner who is a disqualified person is disregarded. For example, in computing the partnership's net income from oil and gas for purposes of determining the IDC preference to be reported to partners who are not disqualified persons as part of the AMT adjustment, disqualified persons' distributive shares of the partnership's net income from oil and gas are not to be taken into account.

Regulatory authority

The Secretary of the Treasury is granted authority to prescribe such regulations as may be appropriate to carry out the purposes of the provisions.

Effective Date

The provisions generally apply to partnership taxable years ending on or after December 31, 1992. The deferred sale provision applies to any contribution of property (other than cash) made on or after the date of enactment to a partnership which is, or is reasonably expected to become, a large partnership. The committee intends that no inference be drawn as to the proper treatment of contributions of appreciated or depreciated property to a partnership made prior to the effective date.

2. Simplified audit procedures for large partnerships (sec. 4302 of the bill and secs. 6240, 6241, 6242, 6245, 6246, 6247, 6249, 6251, 6252, 6255, and 6256 of the Code)

Present Law

In general

Prior to 1982, regardless of the size of a partnership, adjustments to a partnership's items of income, gain, loss, deduction, or credit had to be made in separate proceedings with respect to each partner individually. Because a large partnership sometimes had many partners located in different audit districts, adjustments to items of income, gains, losses, deductions, or credits of the partnership had to be made in numerous actions in several jurisdictions, sometimes with conflicting outcomes.

The Tax Equity and Fiscal Responsibility Act of 1982 ("TEFRA") established unified audit rules applicable to all but certain small (10 or fewer partners) partnerships. These rules require the tax treatment of all "partnership items" to be determined at the partnership, rather than the partner, level. Partnership items are those items that are more appropriately determined at the partnership level than at the partner level, as provided by regulations.

Administrative proceedings

Under the TEFRA rules, a partner must report all partnership items consistently with the partnership return or must notify the IRS of any inconsistency. If a partner fails to report any partnership item consistently with the partnership return, the IRS may make a computational adjustment and immediately assess any additional tax that results.

The IRS may challenge the reporting position of a partnership by conducting a single administrative proceeding to resolve the issue with respect to all partners. But the IRS must still assess any resulting deficiency against each of the taxpayers who were partners in the year in which the understatement of tax liability arose.

Any partner of a partnership can request an administrative adjustment or a refund for his own separate tax liability. Any partner also has the right to participate in partnership-level administrative proceedings. A settlement agreement with respect to partnership items binds all parties to the settlement.

Tax Matters Partner

The TEFRA rules establish the "Tax Matters Partner" as the primary representative of a partnership in dealings with the IRS. The Tax Matters Partner is a general partner designated by the partnership or, in the absence of designation, the general partner with the largest profits interest at the close of the taxable year. If no Tax Matters Partner is designated, and it is impractical to apply the largest profits interest rule, the IRS may select any partner as the Tax Matters Partner.

Notice requirements

The IRS generally is required to give notice of the beginning of partnership-level administrative proceedings and any resulting ad-

ministrative adjustment to all partners whose names and addresses are furnished to the IRS. For partnerships with more than 100 partners, however, the IRS generally is not required to give notice to any partner whose profits interest is less than one percent.

Adjudication of disputes concerning partnership items

After the IRS makes an administrative adjustment, the Tax Matters Partner (and, in limited circumstances, certain other partners) may file a petition for readjustment of partnership items in the Tax Court, the district court in which the partnership's principal place of business is located, or the Claims Court.

Statute of limitations

The IRS generally cannot adjust a partnership item for a partnership taxable year if more than 3 years have elapsed since the later of the filing of the partnership return or the last day for the filing of the partnership return.

Reasons for Change

Present audit procedures for large partnerships are inefficient and more complex than those for other large entities. The IRS must assess any deficiency arising from a partnership audit against a large number of partners, many of whom cannot easily be located and some whom are no longer partners. In addition, audit procedures are cumbersome and can be complicated further by the intervention of partners acting individually.

Explanation of Provision

In general

The bill creates a new audit system for large partnerships. The bill defines "large partnership" the same way for audit and reporting purposes (generally partnerships with at least 250 partners) except that certain oil and gas partnerships exempted from the large partnership reporting requirements are large partnerships for the audit rules.

As under present law, large partnerships and their partners are subject to unified audit rules. The tax treatment of "partnership items" are determined at the partnership, rather than the partner, level. The term "partnership items" is defined as under present law.

Unlike present law, however, partnership adjustments generally will flow through to the partners for the year in which the adjustment takes effect. Thus, the current-year partners' share of current-year partnership items of income, gains, losses, deductions, or credits will be adjusted to reflect partnership adjustments that take effect in that year. The adjustments generally will not affect prior-year returns of any partners (except in the case of changes to any partner's distributive shares).

In lieu of flowing an adjustment through to its partners, the partnership may elect to pay an imputed underpayment. The imputed underpayment generally is calculated by netting the adjustments to the income and loss items of the partnership and multi-

plying that amount by the highest tax rate (whether individual or corporate). A partner may not file a claim for credit or refund of his allocable share of the payment.

Regardless of whether a partnership adjustment flows through to the partners, an adjustment must be offset if it requires another adjustment in a year after the adjusted year and before the year the offsetted adjustment takes effect. For example, if a partnership expensed a $1,000 item in year 1, and it was determined in year 4 that the item should have been capitalized and amortized ratably over 10 years, the adjustment in year 4 would be $700, apart from any interest or penalty. (The $900 adjustment for the improper deduction would be offset by $200 of adjustments for amortization deductions.) The year 4 partners would be required to include an additional $700 in income for that year. The partnership may ratably amortize the remaining $700 of expenses in years 4–10.

In addition, the partnership, rather than the partners individually, generally is liable for any interest and penalties that result from a partnership adjustment. Interest is computed for the period beginning on the return due date for the adjusted year and ending on the earlier of the return due date for the partnership taxable year in which the adjustment takes effect or the date the partnership pays the imputed underpayment. Thus, in the above example, the partnership would be liable for 4 years' worth of interest (on a declining principal amount).

Penalties (such as the accuracy and fraud penalties) are determined on a year-by-year basis (without offsets) based on an imputed underpayment. All accuracy penalty criteria and waiver criteria (such as reasonable cause, substantial authority, etc.) are determined as if the partnership were a taxable individual. Accuracy and fraud penalties are assessed and accrue interest in the same manner as if asserted against a taxable individual.

Any payment (for Federal income taxes, interest, or penalties) that a large partnership is required to make is non-deductible.

If a partnership ceases to exist before a partnership adjustment takes effect, the former partners are required to take the adjustment into account, as provided by regulations. Regulations are also authorized to prevent abuse and to enforce efficiently the audit rules in circumstances that present special enforcement considerations (such as partnership bankruptcy).

Administrative proceedings

Under the large partnership audit rules, a partner is not permitted to report any partnership items inconsistently with the partnership return, even if the partner notifies the IRS of the inconsistency. The IRS could treat a partnership item that was reported inconsistently by a partner as a mathematical or clerical error and immediately assess any additional tax against that partner.

As under present law, the IRS could challenge the reporting position of a partnership by conducting a single administrative proceeding to resolve the issue with respect to all partners. Unlike under present law, however, partners will have no right individually to participate in settlement conferences or to request a refund.

Partnership representative

The bill requires each large partnership to designate a partner or other person to act on its behalf. If a large partnership fails to designate such a person, the IRS is permitted to designate any one of the partners as the person authorized to act on the partnership's behalf. After the IRS's designation, a large partnership could still designate a replacement for the IRS-designated partner.

Notice requirements

Unlike under present law, the IRS is not required to give notice to individual partners of the commencement of an administrative proceeding or of a final adjustment. Instead, the IRS is authorized to send notice of a partnership adjustment to the partnership itself by certified or registered mail. The IRS could give proper notice by mailing the notice to the last known address of the partnership, even if the partnership had terminated its existence.

Adjudication of disputes concerning partnership items

As under present law, an administrative adjustment could be challenged in the Tax Court, the district court in which the partnership's principal place of business is located, or the Claims Court. However, only the partnership, and not partners individually, can petition for a readjustment of partnership items.

If a petition for readjustment of partnership items is filed by the partnership, the court with which the petition is filed will have jurisdiction to determine the tax treatment of all partnership items of the partnership for the partnership taxable year to which the notice of partnership adjustment relates, and the proper allocation of such items among the partners. Thus, the court's jurisdiction is not limited to the items adjusted in the notice.

Statute of limitations

Absent an agreement to extend the statute of limitations, the IRS generally could not adjust a partnership item of a large partnership more than 3 years after the later of the filing of the partnership return or the last day for the filing of the partnership return. Special rules apply to false or fraudulent returns, a substantial omission of income, or the failure to file a return. The IRS would assess and collect any deficiency of a partner that arises from any adjustment to a partnership item subject to the limitations period on assessments and collection applicable to the year the adjustment takes effect (secs. 6248, 6501 and 6502).

Regulatory Authority

The Secretary of the Treasury is granted authority to prescribe regulations as may be necessary to carry out the simplified audit procedure provisions, including regulations to prevent abuse of the provisions through manipulation. The regulations may include rules that address transfers of partnership interests, in anticipation of a partnership adjustment, to persons who are tax-favored (e.g., corporations with net operating losses, tax-exempt organizations, and foreign partners) or persons who are expected to be unable to pay tax (e.g., shell corporations). For example, if prior to

the time a partnership adjustment takes effect, a taxable partner transfers a partnership interest to a nonresident alien to avoid the tax effect of the partnership adjustment, the rules may provide, among other things, that income related to the partnership adjustment is treated as effectively connected taxable income, that the partnership adjustment is treated as taking effect before the partnership interest was transferred, or that the former partner is treated as a current partner to whom the partnership adjustment is allocated.

Effective Date

The provision applies to partnership taxable years ending on or after December 31, 1992.

3. Advance due date for furnishing information to partners (sec. 4303 of the bill and sec. 6031(b) of the Code)

Present Law

A partnership required to file an income tax return with the IRS must also furnish an information return to each of its partners on or before the day on which the income tax return for the year is required to be filed, including extensions. Under regulations, a partnership must file its income tax return on or before the fifteenth day of the fourth month following the end of the partnership's taxable year (on or before April 15, for calendar year partnerships). This is the same deadline by which most individual partners must file their tax returns.

Reasons for Change

Information returns that are received on or shortly before April 15 (or later) are difficult for individuals to use in preparing their tax returns (or in computing their payments) that are due on that date.

Explanation of Provision

The bill provides that a large partnership must furnish information returns to partners by the first March 15 following the close of the partnership's taxable year. Large partnerships would be only those partnerships subject to the simplified reporting rules for large partnerships, as described above.

The bill also provides that, if the partnership is required to provide copies of the information returns to the Internal Revenue Service on magnetic media, each schedule (such as each Schedule K-1) with respect to each partner is treated as a separate information return with respect to the corrective periods and penalties that are generally applicable to all information returns.

Effective Date

The provision is effective for taxable years ending on or after December 31, 1992.

4. Partnership returns on magnetic media (sec. 4304 of the bill and sec. 6011 of the Code)

Present Law

Partnerships are permitted, but not required, to provide the tax return of the partnership (Form 1065), as well as copies of the schedules sent to each partner (Form K-1), to the Internal Revenue Service on magnetic media.

Reasons for Change

Most entities that file large numbers of documents with the Internal Revenue Service must do so on magnetic media. Conforming the reporting provisions for large partnerships to the generally applicable information reporting rules will facilitate integration of partnership information into already existing data systems.

Explanation of Provision

The bill authorizes the Internal Revenue Service to require large partnerships and other partnerships with 250 or more partners to provide the tax return of the partnership (Form 1065), as well as copies of the schedules sent to each partner (Form K-1), to the Internal Revenue Service on magnetic media.

Effective Date

For partnerships that are large partnerships (as defined in the simplified reporting provision), the provision is effective for partnership taxable years ending on or after December 31, 1992. For partnerships that are not large partnerships (as defined) but that have 250 or more partners, the provision is effective for partnership taxable years ending on or after December 31, 1998.

Part II—Partnership Proceedings Under TEFRA [75]

1. Clarify the treatment of partnership items in deficiency proceedings (sec. 4311 of the bill and sec. 6234 of the Code)

Present Law

TEFRA partnership proceedings must be kept separate from deficiency proceedings involving the partners in their individual capacities. Prior to the Tax Court's opinion in *Munro v. Commissioner*, 92 T.C. 71 (1989), the IRS computed deficiencies by assuming that all items that were subject to the TEFRA partnership procedures were correctly reported on the taxpayer's return. However, where the losses claimed from TEFRA partnerships were so large that they offset any proposed adjustments to nonpartnership items, no deficiency could arise from a non-TEFRA proceeding, and if the partnership losses were subsequently disallowed in a partnership proceeding, the non-TEFRA adjustments might be uncollectible because of the expiration of the statute of limitations with respect to nonpartnership items.

[75] Tax Equity and Fiscal Responsibility Act of 1982.

Faced with this situation in *Munro*, the IRS issued a notice of deficiency to the taxpayer that presumptively disallowed the taxpayer's TEFRA partnership losses for computational purposes only. Although the Tax Court ruled that a deficiency existed and that the court had jurisdiction to hear the case, the court disapproved of the methodology used by the IRS to compute the deficiency. Specifically, the court held that partnership items (whether income, loss, deduction, or credit) included on a taxpayer's return must be completely ignored in determining whether a deficiency exists that is attributable to nonpartnership items.

Reasons for Change

The opinion in *Munro* creates problems for both taxpayers and the IRS. For example, a taxpayer would be harmed in the case where he has invested in a TEFRA partnership and is also subject to the deficiency procedures with respect to nonpartnership item adjustments, since computing the tax liability without regard to partnership items will have the same effect as if the partnership items were disallowed. If the partnership items were losses, the effect will be a greatly increased deficiency for the nonpartnership items. If, when the partnership proceeding is completed, the taxpayer is ultimately allowed any part of the losses, the taxpayer will receive part of the increased deficiency back in the form of an overpayment. However, in the interim, the taxpayer will have been subject to assessment and collection of a deficiency inflated by items still in dispute in the partnership proceeding. In essence, a taxpayer in such a case would be deprived of a prepayment forum with respect to the partnership item adjustments. The IRS would be harmed if a taxpayer's income is primarily from a TEFRA partnership, since the IRS may be unable to adjust nonpartnership items such as medical expense deductions, home mortgage interest deductions or charitable contribution deductions because there would be no deficiency since, under *Munro*, the income must be ignored.

Explanation of Provision

The bill is intended to overrule *Munro* and allow the IRS to return to its prior practice of computing deficiencies by assuming that all TEFRA items whose treatment has not been finally determined had been correctly reported on the taxpayer's return. This will eliminate the need to do special computations that involve the removal of TEFRA items from a taxpayer's return, and will restore to taxpayers a prepayment forum with respect to the TEFRA items. In addition, the bill provides a special rule to address the factual situation presented in *Munro*.

Specifically, the bill provides a declaratory judgment procedure in the Tax Court for adjustments to an oversheltered return. An oversheltered return is a return that shows no taxable income and a net loss from TEFRA partnerships. In such a case, the IRS is authorized to issue a notice of adjustment with respect to non-TEFRA items, notwithstanding that no deficiency would result from the adjustment. However, the IRS may only issue such a notice if a defi-

ciency would have arisen in the absence of the net loss from TEFRA partnerships.

The Tax Court would be granted jurisdiction to determine the correctness of such an adjustment as well as to make a declaration with respect to any other item for the taxable year to which the notice of adjustment relates, except for partnership items and affected items which require partner-level determinations. No tax would be due upon such a determination, but a decision of the Tax Court would be treated as a final decision, permitting an appeal of the decision by either the taxpayer or the IRS. An adjustment determined to be correct would thus have the effect of increasing the taxable income that would be deemed to have been reported on the taxpayer's return. If the taxpayer's partnership items were then adjusted in a subsequent proceeding, the IRS would have preserved its ability to collect tax on any increased deficiency attributable to the nonpartnership items.

Alternatively, if the taxpayer chooses not to contest the notice of adjustment within the 90-day period, the bill provides that when the taxpayer's partnership items are finally determined, the taxpayer has the right to file a refund claim for tax attributable to the items adjusted by the earlier notice of adjustment for the taxable year. Although a refund claim is not generally permitted with respect to a deficiency arising from a TEFRA proceeding, such a rule is appropriate with respect to a defaulted notice of adjustment because taxpayers may not challenge such a notice when issued since it does not require the payment of additional tax.

In addition, the bill incorporates a number of provisions intended to clarify the coordination between TEFRA audit proceedings and individual deficiency proceedings. Under these provisions, any adjustment with respect to a non-partnership item that caused an increase in tax liability with respect to a partnership item would be treated as a computational adjustment and assessed after the conclusion of the TEFRA proceeding. Accordingly, deficiency procedures would not apply with respect to this increase in tax liability, and the statute of limitations applicable to TEFRA proceedings would be controlling.

Effective Date

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

2. Permit the IRS to rely on partnership returns to determine the proper audit procedures (sec. 4312 of the bill and sec. 6231 of the Code)

Present Law

TEFRA established unified audit rules applicable to all partnerships, except for partnerships with 10 or fewer partners, each of whom is a natural person (other than a nonresident alien) or an estate, and for which each partner's share of each partnership item is the same as that partner's share of every other partnership item. Partners in the exempted partnerships are subject to regular deficiency procedures.

Reasons for Change

The IRS often finds it difficult to determine whether to follow the TEFRA partnership procedures or the regular deficiency procedures. If the IRS determines that there were fewer than 10 partners in the partnership but was unaware that one of the partners was a nonresident alien or that there was a special allocation made during the year, the IRS might inadvertently apply the wrong procedures and possibly jeopardize any assessment. Permitting the IRS to rely on a partnership's return would simplify the IRS' task.

Explanation of Provision

The bill permits the IRS to apply the TEFRA audit procedures if, based on the partnership's return for the year, the IRS reasonably determines that those procedures should apply. Similarly, the bill permits the IRS to apply the normal deficiency procedures if, based on the partnership's return for the year, the IRS reasonably determines that those procedures should apply.

Effective Date

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

3a. Suspend Statute When an Untimely Petition is Filed (Sec. 4313(a) and sec. 6229 of the Code).

Present Law

In a deficiency case, section 6503(a) provides that if a proceeding in respect of the deficiency is placed on the docket of the Tax Court, the period of limitations on assessment and collection is suspended until the decision of the Tax Court becomes final, and for 60 days thereafter. The counterpart to this provision with respect to TEFRA cases is contained in section 6229(d). That section provides that the period of limitations is suspended for the period during which an action may be brought under section 6226 and, if an action is brought during such period, until the decision of the court becomes final, and for 1 year thereafter. As a result of this difference in language, the running of the statute of limitations in a TEFRA case will only be tolled by the filing of a timely petition whereas in a deficiency case, the statute of limitations is tolled by the filing of any petition, regardless of whether the petition is timely.

Reasons for Change

Under present law, if an untimely petition is filed in a TEFRA case, the statute of limitations can expire while the case is still pending before the court. To prevent this from occurring, the IRS must make assessments against all of the investors during the pendency of the action and if the action is in the Tax Court, presumably abate such assessments if the court ultimately determines that the petition was timely. These steps are burdensome to the IRS and to taxpayers.

Explanation of Provision

The provision is designed to conform the suspension rule for the filing of petitions in TEFRA cases with the rule under section 6503(a) pertaining to deficiency cases. Under the provision, the statute of limitations in TEFRA cases would be suspended by the filing of any petition under section 6226, regardless of whether the petition is timely or valid, and the suspension will remain in effect until the decision of the court becomes final, and for one year thereafter. Hence, if the statute of limitations is open at the time that an untimely petition is filed, the limitations period will no longer continue to run and possibly expire while the action is pending before the court.

Effective Date

The provision is effective with respect to all cases in which the period of limitations has not expired under present law as of the date of enactment.

3b. Suspend statute of limitations during bankruptcy proceedings (sec. 4313(b) of the bill and sec. 6229 of the Code)

Present Law

The period for assessing tax with respect to partnership items generally is the longer of the periods provided by section 6229 or section 6501. For partnership items that convert to nonpartnership items, section 6229(f) provides that the period for assessing tax shall not expire before the date which is 1 year after the date that the items become nonpartnership items. Section 6503(h) provides for the suspension of the limitations period during the pendency of a bankruptcy proceeding. However, this provision only applies to the limitations periods provided in sections 6501 and 6502.

Under present law, because the suspension provision in section 6503(h) applies only to the limitations periods provided in section 3501 and 6502, some uncertainty exists as to whether section 6503(h) applies to suspend the limitations period pertaining to converted items provided in section 6229(f) when a petition naming a partner as a debtor in a bankruptcy proceeding is filed. As a result, the limitations period provided in section 6229(f) may continue to run during the pendency of the bankruptcy proceeding, notwithstanding that the IRS is prohibited from making an assessment against the debtor because of the automatic stay provisions of the Bankruptcy Code.

Reasons for Change

The ambiguity in present law makes it difficult for the IRS to adjust partnership items that convert to nonpartnership items by reason of a partner going into bankruptcy. In addition, any uncertainty may result in increased requests for the bankruptcy court to lift the automatic stay to permit the IRS to make an assessment with respect to the converted items.

Explanation of Provision

The bill clarifies that the statute of limitations is suspended for a partner who is named in a bankruptcy petition. The suspension period is for the entire period during which the IRS is prohibited by reason of the bankruptcy proceeding from making an assessment, and for 60 days thereafter. The provision is not intended to create any inference as to the proper interpretation of present law.

Effective Date

The provision is effective with respect to all cases in which the period of limitations has not expired under present law as of the date of enactment.

3c. Extend Statute of Limitations for Bankrupt TMPs (sec. 4313(c) and sec. 6229 of the Code)

Present Law

Section 6229(b)(1)(B) provides that the statute of limitations is extended with respect to all partners in the partnership by an agreement entered into between the tax matters partner (TMP) and the IRS. However, Temp. Treas. Reg. secs. 301.6231(a)(7)-1T(1)(4) and 301.6231(c)-7T(a) provide that upon the filing of a petition naming a partner as a debtor in a bankruptcy proceeding, that partner's partnership items convert to nonpartnership items, and if the debtor was the tax matters partner, such status terminates. These rules are necessary because of the automatic stay provision contained in 11 U.S.C. sec. 362(a)(8). As a result, if a consent to extend the statute of limitations is signed by a person who would be the TMP but for the fact that at the time that the agreement is executed the person was a debtor in a bankruptcy proceeding, the consent would not be binding on the other partners because the person signing the agreement was no longer the TMP at the time that the agreement was executed.

Reasons for Change

The IRS is not automatically notified of bankruptcy filings and cannot easily determine whether a taxpayer is in bankruptcy, especially if the audit of the partnership is being conducted by one district and the taxpayer resides in another district, as is frequently the situation in TEFRA cases. If the IRS does not discover that a person signing a consent is in bankruptcy, the IRS may mistakenly rely on that consent. As a result, the IRS may be precluded from assessing any tax attributable to partnership item adjustments with respect to any of the partners in the partnership.

Explanation of Provision

The bill provides that unless the IRS is notified of a bankruptcy proceeding in accordance with regulations, the IRS can rely on a statute extension signed by a person who would be the tax matters partner but for the fact that said person was in bankruptcy at the time that the person signed the agreement. Statute extensions granted by a bankrupt TMP in these cases will be binding on all of

the partners in the partnership. The provision is not intended to create any inference as to the proper interpretation of present law.

Effective Date

The provision is effective for extension agreements entered into after the date of enactment.

4. Expand small partnership exception from TEFRA (sec. 4314 of the bill and sec. 6231 of the Code)

Present Law

TEFRA established unified audit rules applicable to all partnerships, except for partnerships with 10 or fewer partners, each of whom is a natural person (other than a nonresident alien) or an estate, and for which each partner's share of each partnership item is the same as that partner's share of every other partnership item. Partners in the exempted partnerships are subject to regular deficiency procedures.

Reasons for Change

The mere existence of a C corporation as a partner or of a special allocation does not warrant subjecting the partnership and its partners of an otherwise small partnership to the TEFRA procedures.

Explanation of Provision

The bill permits a small partnership to have a C corporation as a partner or to specially allocate items without jeopardizing its exception from the TEFRA rules. However, the bill retains the prohibition of present law against having a flow-through entity (other than an estate of a deceased partner) as a partner for purposes of qualifying for the small partnership exception.

Effective Date

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

5. Exclude partial settlements from 1-year assessment rule (sec. 4315 of the bill and sec. 6229(f) of the Code)

Present Law

The period for assessing tax with respect to partnership items generally is the longer of the periods provided by section 6229 or section 6501. For partnership items that convert to nonpartnership items, section 6229(f) provides that the period for assessing tax shall not expire before the date which is 1 year after the date that the items become nonpartnership items. Section 6231(b)(1)(C) provides that the partnership items of a partner for a partnership taxable year become nonpartnership items as of the date the partner enters into a settlement agreement with the IRS with respect to such items.

Reasons for Change

When a partial settlement agreement is entered into, the assessment period for the items covered by the agreement may be different than the assessment period for the remaining items. This fractured statute of limitations poses a significant tracking problem for the IRS and necessitates multiple computations of tax with respect to each partner's investment in the partnership for the taxable year.

Explanation of Provision

The bill provides that if a partner and the IRS enter into a settlement agreement with respect to some but not all of the partnership items in dispute for a partnership taxable year and other partnership items remain in dispute, the period for assessing any tax attributable to the settled items would be determined as if such agreement had not been entered into. Consequently, the limitations period that is applicable to the last item to be resolved for the partnership taxable year shall be controlling with respect to all disputed partnership items for the partnership taxable year. The provision is not intended to create any inference as to the proper interpretation of present law.

Effective Date

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

6. Extend time for filing a request for administrative adjustment (sec. 4316 of the bill and sec. 6227 of the Code)

Present Law

If an agreement extending the statute is entered into with respect to a non-TEFRA statute of limitations, that agreement also extends the statute of limitations for filing refund claims (sec. 6511(c)). There is no comparable provision for extending the time for filing refund claims with respect to partnership items subject to the TEFRA partnership rules.

Reasons for Change

The absence of an extension for filing refund claims in TEFRA proceedings hinders taxpayers that may want to agree to extend the TEFRA statute of limitations but want to preserve their option to file a refund claim later.

Explanation of Provision

The bill provides that if a TEFRA statute extension agreement is entered into, that agreement also extends the statute of limitations for filing refund claims attributable to partnership items or affected items until 6 months after the expiration of the limitations period for assessments.

Effective Date

The provision is effective as if included in the amendments made by section 402 of the Tax Equity and Fiscal Responsibility Act of 1982.

7. Provide innocent spouse relief for TEFRA proceedings (sec. 4317 of the bill and sec. 6230 of the Code)

Present Law

In general, an innocent spouse may be relieved of liability for tax, penalties and interest if certain conditions are met (sec. 6013(e)). However, existing law does not provide the spouse of a partner in a TEFRA partnership with a judicial forum to raise the innocent spouse defense with respect to any tax or interest that relates to an investment in a TEFRA partnership.

Reasons for Change

Providing a forum in which to raise the innocent spouse defense with respect to liabilities attributable to adjustments to partnership items (including penalties, additions to tax and additional amounts) would make the innocent spouse rules more uniform.

Explanation of Provision

The bill provides both a prepayment forum and a refund forum for raising the innocent spouse defense in TEFRA cases.

With respect to a prepayment forum, the bill provides that within 60 days of the date that a notice and demand for payment (or notice of computational adjustment) relating to partnership items is mailed to the spouse of a partner, the spouse may request that the assessment be abated. Upon receipt of such a request, the assessment will be abated and any reassessment will be subject to the deficiency procedures. If an abatement is requested, the statute of limitations will not expire before the date which is 60 days after the date of the abatement. If the spouse files a petition with the Tax Court, the Tax Court will only have jurisdiction to determine whether the requirements of section 6013(e) have been satisfied. In making this determination, the treatment of the partnership items that gave rise to the liability in question will be conclusive.

Alternatively, the bill provides that the spouse of a partner may file a claim for refund to raise the innocent spouse defense. The claim must be filed within 6 months from the date that the notice and demand (or notice of computational adjustment) is mailed to the spouse. If the claim is not allowed the spouse may file a refund action. For purposes of any claim or suit under this provision, the treatment of the partnership items that gave rise to the liability in question will be conclusive.

Effective Date

The provision is effective as if included in the amendments made by section 402 of the Tax Equity and Fiscal Responsibility Act of 1982.

8. Determine penalties at the partnership level (sec. 4318 of the bill and sec. 6221 of the Code)

Present Law

Partnership items include only items that are required to be taken into account under the income tax subtitle. Penalties are not partnership items since they are contained in the procedure and administration subtitle. As a result, penalties may only be asserted against a partner through the application of the deficiency procedures following the completion of the partnership-level proceeding.

Reasons for Change

Many penalties are based upon the conduct of the taxpayer. With respect to partnerships, the relevant conduct often occurs at the partnership level. In addition, applying penalties at the partner level through the deficiency procedures following the conclusion of the unified proceeding at the partnership level increases the administrative burden on the IRS and can significantly increase the Tax Court's inventory.

Explanation of Provision

The bill provides that the partnership level proceeding is to include a determination of the applicability of penalties at the partnership level. However, the bill allows partners to raise any partner-level defenses in a refund forum.

Effective Date

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

9. Clarify jurisdiction of the Tax Court (sec. 4319 of the bill and secs. 6225 and 6226 of the Code)

Present Law

Improper assessment and collection activities by the IRS during the 150-day period for filing a petition or during the pendency of any Tax Court proceeding, "may be enjoined in the proper court." Present law may be unclear as to whether this includes the Tax Court.

For a partner other than the Tax Matters Partner to be eligible to file a petition for redetermination of partnership items in any court or to participate in an existing case, the period for assessing any tax attributable to the partnership items of that partner must not have expired. Since such a partner would only be treated as a party to the action if the statute of limitations with respect to them was still open, the law is unclear whether the partner would have standing to assert that the statute of limitations had expired with respect to them.

Reasons for Change

Clarifying the Tax Court's jurisdiction simplifies the resolution of tax cases.

Explanation of Provision

The bill clarifies that an action to enjoin premature assessments of deficiencies attributable to partnership items may be brought in the Tax Court. The bill also permits a partner to participate in an action or file a petition for the sole purpose of asserting that the period of limitations for assessing any tax attributable to partnership items has expired for that person. Additionally, the bill clarifies that the Tax Court has overpayment jurisdiction with respect to affected items.

Effective Date

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

10. Treatment of premature petitions filed by certain partners (sec. 4320 of the bill and sec. 6226 of the Code)

Present Law

The Tax Matters Partner is given the exclusive right to file a petition for a readjustment of partnership items within the 90-day period after the issuance of the notice of a final partnership administrative adjustment (FPAA). If the Tax Matters Partner does not file a petition within the 90-day period, certain other partners are permitted to file a petition within the 60-day period after the close of the 90-day period. There are ordering rules for determining which action goes forward and for dismissing other actions.

Reasons for Change

A petition that is filed within the 90-day period by a person who is not the Tax Matters Partner is dismissed. Thus, if the Tax Matters Partner does not file a petition within the 90-day period and no timely and valid petition is filed during the succeeding 60-day period, judicial review of the adjustments set forth in the notice of FPAA is foreclosed and the adjustments are deemed to be correct.

Explanation of Provision

The bill treats premature petitions filed by certain partners within the 90-day period will be treated as being filed on the last day of the following 60-day period under specified circumstances, thus affording the partnership with an opportunity for judicial review that is not available under present law.

Effective Date

The bill is effective with respect to petitions filed after the date of enactment.

11. Clarify bond requirement for appeals from TEFRA proceedings (sec. 4321 of the bill and sec. 7485 of the Code)

Present Law

A bond must be filed to stay the collection of deficiencies pending the appeal of the Tax Court's decision in a TEFRA proceeding. The amount of the bond must be based on the court's estimate of the aggregate deficiencies of the partners.

Reasons for Change

The Tax Court cannot easily determine the aggregate changes in tax liability of all of the partners in a partnership who will be affected by the Court's decision in the proceeding. Clarifying the calculation of the bond amount would simplify the Tax Court's task.

Explanation of Provision

The bill clarifies that the amount of the bond should be based on the Tax Court's estimate of the aggregate liability of the parties to the action (and not all of the partners in the partnership). For purposes of this provision, the amount of the bond may be estimated by applying the highest individual rate to the total adjustments determined by the Tax Court and doubling that amount to take into account interest and penalties.

Effective Date

The provision is effective as if included in the amendments made by section 402 of the Tax Equity and Fiscal Responsibility Act of 1982.

12. Suspend interest where there is a delay in computational adjustment resulting from TEFRA settlements (sec. 4322 of the bill and sec. 6601 of the Code)

Present Law

Interest on a deficiency generally is suspended when a taxpayer executes a settlement agreement with the IRS and waives the restrictions on assessments and collections, and the IRS does not issue a notice and demand for payment of such deficiency within 30 days. Interest on a deficiency that results from an adjustment of partnership items in TEFRA proceedings, however, is not suspended.

Reasons for Change

Processing settlement agreements and assessing the tax due takes a substantial amount of time in TEFRA cases. A taxpayer is not afforded any relief from interest during this period.

Explanation of Provision

The bill suspends interest where there is a delay in making a computational adjustment relating to a TEFRA settlement.

Effective Date

The provision is effective with respect to settlements entered into after the date of enactment.

Subtitle D—Foreign Provisions

1. Deferral of tax on income earned through foreign corporations and exceptions to deferral (secs. 4401-4404 of the bill and secs. 453, 532, 535, 542, 543, 551-558, 563, 851, 954, 1246-1247, 1291-1297, and 4982 of the Code)

Present Law

Direct and indirect operations

U.S. citizens and residents and U.S. corporations (collectively, "U.S. persons") are taxed currently by the United States on their worldwide income, subject to a credit against U.S. tax on foreign income based on foreign income taxes paid with respect to such income. Income earned by a foreign corporation, the stock of which is owned in whole or in part by U.S. persons, generally is not taxed by the United States until the foreign corporation repatriates those earnings by payment to its U.S. stockholders. Therefore, two different sets of U.S. tax rules apply to U.S. taxpayers that control business operations in foreign countries; which rules apply depends on whether the business operations are conducted directly, for example, through a foreign branch, or indirectly through a separately incorporated foreign company.[76]

U.S. persons that conduct foreign operations directly (that is, not through a foreign corporation) include income (or loss) from those operations on the U.S. tax return for the year the income is earned or the loss is incurred. The United States taxes that income currently. The foreign tax credit may reduce or eliminate the U.S. tax on that income, however.

U.S. persons that conduct foreign operations through a foreign corporation generally pay no U.S. tax on the income from those operations until the foreign corporation repatriates its earnings to the United States. The income appears on the U.S. owner's tax return for the year it comes home, and the United States imposes tax on it then. The foreign tax credit may reduce the U.S. tax.[77]

In general, two kinds of transactions are repatriations that end deferral and trigger tax. First, in the case of any foreign corporation, an actual dividend payment ends deferral; any U.S. recipient must include the dividend in income. Second, in the case of a "controlled foreign corporation" (defined below), an investment in U.S. property, such as a loan to the lender's U.S. parent or the purchase of U.S. real estate, is also treated as a repatriation that ends deferral (Code sec. 956). In addition to these two forms of repatriation, a sale of shares of a foreign corporation may trigger tax, sometimes at ordinary income tax rates (secs. 1246, 1248, and 1291).

[76] To the extent that foreign corporations operate in the United States rather than in foreign countries, they generally pay U.S. tax like U.S. corporations.

[77] The foreign corporation itself generally will not pay U.S. tax unless it has income effectively connected with a trade or business carried on in the United States, or has certain generally passive types of U.S. source income.

Since 1937, the Code has set forth one or more regimes providing exceptions to the general rule deferring U.S. tax on income earned indirectly through a foreign corporation. Today the Code sets forth the following anti-deferral regimes: the controlled foreign corporation rules (secs. 951–964); the foreign personal holding company rules (secs. 551–558); passive foreign investment company (PFIC) rules (secs. 1291–1297); the personal holding company rules (secs. 541–547); the accumulated earnings tax (secs. 531–537); and rules for foreign investment companies (sec. 1246) and electing foreign investment companies (sec. 1247). The operation and application of these regimes are discussed in the following sections.

Controlled foreign corporations

General definitions

A controlled foreign corporation is defined in the Code generally as any foreign corporation if U.S. persons own more than 50 percent of the corporation's stock (measured by vote or value), taking into account only those U.S. persons that own at least 10 percent of the stock (measured by vote only) (sec. 957).[78] Stock ownership includes not only stock owned directly, but also all stock owned indirectly or constructively (sec. 958).

Deferral of U.S. tax on undistributed income of a controlled foreign corporation is not available for certain kinds of income (sometimes referred to as "subpart F income") under the Code's subpart F provisions. When a controlled foreign corporation earns subpart F income, the United States generally taxes the corporation's 10-percent U.S. shareholders currently on their pro rata share of the subpart F income. In effect, the Code treats those U.S. shareholders as having received a current distribution out of the subpart F income. In this case, also, the foreign tax credit may reduce the U.S. tax.

Subpart F income typically is income that is relatively movable from one taxing jurisdiction to another and that is subject to low rates of foreign tax. Subpart F income consists of foreign base company income (defined in sec. 954), insurance income (defined in sec. 953), and certain income relating to international boycotts and other violations of public policy (defined in sec. 952(a)(3)-(5)). Subpart F income does not include the foreign corporation's income that is effectively connected with the conduct of a trade or business within the United States, which income is subject to current tax in the United States (sec. 952(b)).

Foreign base company income

In general.—Foreign base company income includes five categories of income: foreign personal holding company income, foreign base company sales income, foreign base company services income, foreign base company shipping income, and foreign base company oil-related income (sec. 954(a)). In computing foreign base company income, amounts of income in these five categories are reduced by

[78] A controlled foreign corporation is defined differently in the case of a foreign corporation engaging in certain insurance activities (*see* secs. 953(c) and 957(b)).

allowable deductions (including taxes and interest) properly allocable, under regulations, to such amounts of income (sec. 954(b)(5)).

Foreign personal holding company income.—One category of foreign base company income is foreign personal holding company income (sec. 954(c)). For subpart F purposes, foreign personal holding company income generally includes interest, dividends, and annuities; some rents and royalties; related party factoring income; net commodities gains; net foreign currency gains; and net gains from sales or exchanges of certain other property.

This last category of net gains from sales of property generally includes the excess of gains over losses from sales and exchanges of non-income producing property and property that gives rise to interest, dividends, rents, royalties, and annuities. Thus, foreign personal holding company income includes gain on the sale of property that was held for investment purposes, but does not include gain on the sale of land, buildings, or equipment that was used by the seller in an active trade or business of the seller (Temporary Reg. sec. 1.954-2T(e)(3)). Stock and securities gains generally are treated as foreign personal holding company income. However, foreign personal holding company income does not include gains on property sales that are realized by regular dealers. Gains from the sale or exchange of property which, in the hands of the seller, is inventory property (sec. 1221(1)) are also excluded from foreign personal holding company income.

Income received by a foreign insurance company, including income derived from its investments of funds, generally is subject to taxation under section 953. (See discussion at "*Insurance income, in general,*" below.) Treasury regulations specify that taxation of an insurance company's income under section 953 takes precedence over taxation of that income as foreign personal holding company income under section 954 (Proposed Treas. Reg. sec. 1.953-6(g)). When dividends, interest, or securities gains derived by a controlled foreign insurance company are not taxed under section 953, they generally are taxed as foreign personal holding company income under section 954.

Foreign personal holding company income under subpart F does not include certain dividends and interest received from a related corporation organized and operating in the same foreign country as the recipient, and certain rents and royalties received from a related corporation for the use of property within the country in which the recipient was created or organized (sec. 954(c)(3)). This exclusion, however, is restricted by a rule that takes into account the subpart F income of related-party payors. Under this rule, interest, rent, and royalty payments do not qualify for the exclusion to the extent that such payments reduce subpart F income of the payor.

Other categories of foreign base company income.—Foreign base company income also includes foreign base company sales and services income, consisting respectively of income attributable to related party purchases and sales routed through the income recipient's country if that country is neither the origin nor the destination of the goods, and income from services performed outside the country of the corporation's incorporation for or on behalf of related persons. Foreign base company income also includes foreign base company shipping income. Finally, foreign base company income gener-

ally includes "downstream" oil-related income, that is, foreign oil-related income other than extraction income.

Insurance income

In general.—Subpart F insurance income is another category of income that is subject to current taxation under subpart F (sec. 953). Subpart F insurance income includes any income attributable to the issuing (or reinsuring) of any insurance or annuity contract in connection with risks in a country other than that in which the insurer is created or organized.[79] For this purpose, a qualified insurance branch of a controlled foreign corporation may be treated as a corporation created or organized in the country of its location (sec. 964(d)).

The amount of income subject to current tax under subpart F as insurance income is the amount that would be taxed under subchapter L of the Code if it were the income of a domestic insurance company (subject to the modifications provided in sec. 953(b)). In addition, as described above, investment income associated with same-country risk insurance is also included in subpart F income as foreign personal holding company income. Thus, for an insurance controlled foreign corporation, deferral generally is limited to underwriting income from same-country risk insurance.

For purposes of subpart F insurance income, a controlled foreign corporation is specially defined to include, in addition to any corporation that meets the usual test of 50-percent ownership by 10-percent shareholders (discussed above), any foreign corporation that satisfies a test of 25-percent ownership by 10-percent shareholders if more than 75 percent of the corporation's gross premium income is derived from the reinsurance or issuance of insurance or annuity contracts with respect to third-country risks (sec. 957(b)).

Related person (captive) insurance income.—In addition, subpart F insurance income that is related person insurance income generally is taxable under subpart F to an expanded category of U.S. persons (sec. 953(c)). For purposes of taking into account such income under subpart F, the U.S. ownership threshold for controlled foreign corporation status is reduced to 25 percent or more. Any U.S. person who owns (directly or indirectly) any stock in a controlled foreign corporation, whatever the degree of ownership, is treated as a U.S. shareholder of such corporation for purposes of this 25-percent U.S. ownership threshold and exposed to current tax on the corporation's related person insurance income.

Certain operating rules

Income inclusion.—When a controlled foreign corporation earns subpart F income, the United States generally taxes the corporation's U.S. shareholders currently on their pro rata share of the subpart F income (sec. 951).[80] In the case of a corporation that is a controlled foreign corporation for its entire taxable year, and a U.S. shareholder that owns the same proportion of stock in the cor-

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[79] In addition, subpart F applies to income attributable to an insurance contract in connection with same-country risks as the result of an arrangement under which another corporation receives a substantially equal amount of premiums for insurance of other-country risks.

[80] Current taxation applies only if the foreign corporation is a controlled foreign corporation for an uninterrupted period of at least 30 days during the taxable year.

poration throughout the corporation's taxable year, the U.S. shareholder's pro rata share of subpart F income is the amount that would have been distributed with respect to the shareholder's stock if on the last day of the corporation's taxable year the controlled foreign corporation had distributed all of its subpart F income pro rata to all of its shareholders. The pro rata share definition provides for adjustments where the corporation is a controlled foreign corporation for less than the entire year or where actual distributions are made with respect to stock the shareholder owns for less than the entire year.

In addition, the United States generally taxes the corporation's U.S. shareholders currently on their pro rata share of the corporation's increase in earnings invested in U.S. property for the taxable year.

De minimis and full inclusion rules.—None of a controlled foreign corporation's gross income for a taxable year is treated as foreign base company income or subpart F insurance income if the sum of the corporation's gross foreign base company income and gross subpart F insurance income for the year is less than the lesser of 5 percent of its gross income, or $1 million (sec. 954(b)(3)(A)). The Code provides that if more than 70 percent of a controlled foreign corporation's gross income is foreign base company income and/or subpart F insurance income, then all of its income is treated as foreign base company income or insurance income (whichever is appropriate) (sec. 954(b)(3)(B)). This 70-percent full inclusion rule does not apply, however, to income of a company that is a controlled foreign corporation only for purposes of the captive insurance company provision. (See Proposed Treas. Reg. sec. 1.953-6(k).)

Exception for certain income subject to high foreign taxes.—Income otherwise subject to current taxation as foreign base company income can be excluded from subpart F if the income was not in fact routed through a controlled foreign corporation in which the income bore a materially lower tax than would be due on the same income earned directly by a U.S. corporation (sec. 954(b)(4)). Subpart F employs an objective test to determine whether income that has been earned through a controlled foreign corporation in fact has been subject to less tax than it would have borne if the income had been earned directly. Under this rule, subpart F income (other than foreign base company oil-related income) does not include items of income received by a controlled foreign corporation if the taxpayer establishes to the satisfaction of the Secretary that the income, measured under U.S. tax rules, was subject to an effective rate of foreign tax equal to at least 90 percent of the maximum U.S. corporate tax rate.

Section 954(b)(4) applies solely at the taxpayer's election. That is, the provision applies only if the taxpayer endeavors to establish to the Secretary's satisfaction that the income in question was subject to the requisite foreign tax, and the taxpayer succeeds in doing so. The Secretary may not apply the provision without the taxpayer's consent.

Treatment of investments in U.S. property.—As discussed above, a U.S. shareholder of a controlled foreign corporation generally is taxable on its pro rata share of the foreign corporation's subpart F

income. In addition, a U.S. shareholder generally is taxable on its pro rata share of the foreign corporation's earnings and profits attributable to non-subpart F income to the extent of the increase for the year in such earnings that are invested in U.S. property (secs. 951(a)(1)(B) and 956). Such increase is measured by comparing the controlled foreign corporation's total amount of earnings invested in U.S. property at the close of the current taxable year with the corresponding amount at the close of the preceding taxable year.

The increase for the current taxable year in the earnings of a controlled foreign corporation invested in U.S. property generally is computed by subtracting the amount of the corporation's investment in U.S. property at the end of the prior year (to the extent that amount would have been a dividend if it had been distributed) from its investment in U.S. property at the end of the current year (to the extent that amount would have been a dividend if it had been distributed).

In addition, where earnings previously taxed under sections 951(a)(1)(B) and 956 are actually distributed, without reduction of the controlled foreign corporation's investment in U.S. property, subsequent earnings are included in the U.S. shareholder's income under sections 951(a)(1)(B) and 956 with no further increase in U.S. investment. This rule is intended to account for the fact that, in effect, new earnings are funding existing investments in U.S. assets, and should therefore be taxed.[81]

Distributions of previously taxed income.—Earnings and profits of a controlled foreign corporation that are (or previously have been) included in the incomes of the U.S. shareholders are not taxed again when such earnings are actually distributed to the U.S. shareholders (sec. 959(a)(1)). Similarly, such previously taxed income is not included in the incomes of the U.S. shareholders in the event that such earnings are invested in U.S. property (sec. 959(a)(2)). Previously taxed income actually distributed from a lower-tier controlled foreign corporation to a higher-tier controlled foreign corporation is disregarded in determining the subpart F income of the higher-tier controlled foreign corporation that is included in the income of the U.S. shareholders. In the event that stock in the controlled foreign corporation is transferred subsequent to the income inclusion but prior to the actual distribution of previously taxed income, the transferee shareholder is similarly exempt from tax on the distribution to the extent of the proven identity of shareholder interest.

Distributions by a controlled foreign corporation are allocated first to previously taxed income, then to other earnings and profits (sec. 959(c)). Therefore, a controlled foreign corporation may distribute its previously taxed income to its shareholders, resulting in no additional U.S. income taxation, before it makes any taxable dividend distributions of any current or accumulated non-subpart F earnings and profits.

Allowance of foreign tax credit.—U.S. corporate shareholders of a controlled foreign corporation who include subpart F income in

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[81] "If this were not done it would be possible to retain the [U.S.] investments in the corporation and make actual distributions out of other property to the shareholders which would not be taxable to them." H.R. Rep. No. 1447, 87th Cong., 2d Sess. 64 n.1 (1962).

their own gross incomes are also treated as having paid the foreign taxes actually paid by the controlled foreign corporation on that income, to the same general extent as if they had received a dividend distribution of that income (sec. 960). Therefore, the U.S. corporate shareholders may claim foreign tax credits for those taxes to the same general extent as if they had received a dividend. Actual distributions by a controlled foreign corporation are not treated as dividends, and thus generally do not carry further eligibility for deemed-paid foreign tax credits, to the extent that the distributions are of previously taxed income.[82]

Individual U.S. shareholders of a controlled foreign corporation who include subpart F income in their own gross incomes may elect to be taxed as corporations on their subpart F income (sec. 962). Therefore, electing individual U.S. shareholders, like corporate shareholders, may claim foreign tax credits for the foreign taxes actually paid by the controlled foreign corporation on that income to the same general extent as if they had received a dividend.

Adjustments to basis and computation of earnings and profits.—The inclusion of an amount of a controlled foreign corporation's subpart F income in the gross income of a U.S. shareholder generally results in a corresponding increase in the shareholder's basis in the stock with respect to which the subpart F income was included (sec. 961(a)). In addition, the distribution of previously taxed income to a U.S. shareholder of a controlled foreign corporation generally results in a corresponding decrease in the shareholder's basis in the stock (sec. 961(b)).

The determination of the earnings and profits (or deficit in earnings and profits) of a controlled foreign corporation follows rules that are substantially similar to those applicable to domestic corporations (sec. 964(a)). One specific similarity is that any illegal bribes, kickbacks, or other payments that are not deductible under section 162(c) (such as payments that would be unlawful under the Foreign Corrupt Practices Act of 1977 if paid by a U.S. person) are not taken into account to reduce earnings and profits (or increase a deficit in earnings and profits).

Attribution of ownership.—In determining stock ownership for purposes of the controlled foreign corporation rules, a U.S. person generally is considered to own a proportionate share of stock owned, directly or indirectly, by or for a foreign corporation, foreign partnership, or foreign trust or estate of which the U.S. person is a shareholder, partner, or beneficiary (sec. 958(a)).

Additional rules for constructive ownership apply for purposes of determining whether or not a U.S. person is a U.S. shareholder (within the meaning of sec. 951(b), as discussed above), whether or not the foreign corporation meets the relevant definition of control (within the meaning of secs. 957(a), 957(b), or 953(c)(1), as discussed above), and whether or not two persons are related (within the meaning of sec. 954(d)(3), as discussed above), but not for purposes of including amounts in a shareholder's gross income under section 951(a). These constructive ownership rules include, among other

[82] Certain actual distributions of previously taxed income can carry further eligibility for foreign tax credits (secs. 960(a)(3) and (b)).

rules, provisions treating an individual as owning stock owned, directly or indirectly, by the individual's spouse, children, grandchildren, and parents; a 10-percent shareholder of a corporation as owning its proportionate share (100 percent, in the case of a more-than-50-percent shareholder) of stock owned, directly or indirectly, by the corporation; a partner or beneficiary as owning its proportionate share (100 percent, in the case of a more-than-50-percent partner or beneficiary) of stock owned, directly or indirectly, by the partnership or estate; a corporation as owning all stock owned, directly or indirectly, by 10-percent shareholders; a partnership or estate as owning all stock owned, directly or indirectly, by its partners or beneficiaries; and the holder of an option as owning the stock subject to the option (sec. 958(b)). However, these constructive ownership rules do not operate to treat stock owned by a nonresident alien individual as owned by a U.S. citizen or a resident alien individual (sec. 958(b)(1)).

Gain from certain sales or exchanges of stock in certain foreign corporations

If a U.S. person sells or exchanges stock in a foreign corporation, or receives a distribution from a foreign corporation that is treated as an exchange of stock, and, at any time during the five-year period ending on the date of the sale or exchange, the foreign corporation was a controlled foreign corporation and the U.S. person was a 10-percent shareholder (counting stock owned directly, indirectly, and constructively), then the gain recognized on the sale or exchange is included in the shareholder's income as a dividend, to the extent of the earnings and profits of the foreign corporation which were accumulated during the period that the shareholder held stock while the corporation was a controlled foreign corporation (sec. 1248).[83] For this purpose, earnings and profits of the foreign corporation do not include amounts that had already been subject to current U.S. taxation (whether imposed on the foreign corporation itself or the U.S. shareholders), such as amounts included in gross income under section 951, amounts included in gross income under section 1247 (applicable to foreign investment companies, which are discussed below), amounts included in gross income under section 1293 (applicable to certain passive foreign investment companies, which are discussed below), or amounts that were effectively connected with the conduct of a trade or business within the United States (sec. 1248(d)). The Code provides certain special rules to adjust the proper scope and application of section 1248 (sec. 1248(e)-(i)).

Amounts subject to treatment under section 1248, in accordance with their characterization as dividends, carry deemed-paid foreign tax credits that may be claimed by corporate taxpayers under section 902.

[83] A special limitation applies in the case of the sale or exchange by an individual of stock held as a long-term capital asset (sec. 1248(b)).

Foreign personal holding companies

In general

Congress enacted the foreign personal holding company rules (secs. 551-558) to prevent U.S. taxpayers from accumulating income tax-free in foreign "incorporated pocketbooks." If five or fewer U.S. citizens or residents own, directly or indirectly, more than half of the outstanding stock (in vote or value) of a foreign corporation that has primarily foreign personal holding company income, that corporation will be a foreign personal holding company. In that case, all the foreign corporation's U.S. shareholders are subject to U.S. tax on their pro rata share of the corporation's undistributed foreign personal holding company income.

Operating rules

A foreign corporation is a foreign personal holding company if it satisfies both a stock ownership requirement (sec. 552(a)(2)) and a gross income requirement (sec. 552(a)(1)). The stock ownership requirement is satisfied if, at any time during the taxable year, more than 50 percent of either (1) the total combined voting power of all classes of stock of the corporation that are entitled to vote, or (2) the total value of the stock of the corporation, is owned (directly, indirectly, or constructively) by or for five or fewer individual citizens or residents of the United States. The gross income requirement is satisfied initially if at least 60 percent of the corporation's gross income is foreign personal holding company income. Once the corporation is a foreign personal holding company, however, the gross income threshold each year will be only 50 percent until the expiration of either one full taxable year during which the stock ownership requirement is not satisfied, or three consecutive taxable years for which the gross income requirement is not satisfied at the 50-percent threshold.

Foreign personal holding company income generally includes passive income such as dividends, interest, royalties (but not including active business royalties), and rents (if rental income does not amount to 50 percent of gross income) (sec. 553(a)). It also includes, among other things, gains (other than gains of dealers) from stock and securities transactions, commodities transactions, and amounts received with respect to certain personal services contracts. If a foreign personal holding company is a shareholder in another foreign personal holding company, the first company includes in its gross income, as a dividend, its share of the undistributed foreign personal holding company income of the second foreign personal holding company.

Excluded from characterization as foreign personal holding companies are corporations that are exempt from tax under subchapter F (sections 501 and following) of the Code, as well as certain corporations that are organized and doing business under the banking and credit laws of a foreign country (sec. 552(b)).

If a foreign corporation is a foreign personal holding company, all of its undistributed foreign personal holding company income is treated as distributed as a dividend on a pro-rata basis to all of its U.S. shareholders, including U.S. citizens, residents, and corporations (sec. 551(b)). That is, though only the five largest individual

shareholders count in the determination of foreign personal holding company status, all individual shareholders as well as persons other than individuals may be subject to current tax on their pro rata shares of the undistributed income of the foreign personal holding company. The undistributed foreign personal holding company income that is deemed distributed is treated as recontributed by the shareholders to the foreign personal holding company as a contribution to capital. Accordingly, the earnings and profits of the corporation are reduced by the amount of the deemed distribution (sec. 551(d)), and each shareholder's basis in his or her stock in the foreign personal holding company is increased by the shareholder's pro rata portion of the deemed distribution (sec. 551(e)).

Attribution of ownership for characterization as a foreign personal holding company

The foreign personal holding company provisions contain constructive ownership rules that determine whether a foreign corporation is more than 50 percent owned by five or fewer U.S. citizens or residents. These rules generally treat an individual as owning stock owned, directly or indirectly, by or for his or her partners, brothers and sisters (whether by the whole or half blood), spouse, ancestors, and lineal descendants. However, ownership of stock actually owned by a nonresident alien is not attributed to the alien's U.S. brothers and sisters (whether by the whole or half blood), ancestors, and lineal descendants who do not own stock in the foreign corporation. For example, a foreign corporation 40 percent of whose shares belong to a U.S. citizen and 60 percent of whose shares belong to the nonresident alien sister of the U.S. citizen will be a foreign personal holding company if it meets the other criteria for foreign personal holding company status. Similarly, ownership of stock actually owned by a nonresident alien will not be attributed to the alien's U.S. partners if the alien's U.S. partners do not own, directly or indirectly, any stock in the foreign corporation and if the alien's partners do not include members of the same family as a U.S. citizen or resident who owns, directly or indirectly, any stock in the foreign corporation. For example, if the nonresident alien partner of a U.S. citizen owns 60 percent of a foreign corporation, while a second U.S. citizen (who is wholly unrelated to the first U.S. citizen and to the nonresident alien) owns the remaining 40 percent, the foreign corporation is not a foreign personal holding company.

These constructive ownership rules also apply to deem income to be foreign personal holding company income in two cases: (1) when a foreign corporation has contracted to furnish personal services that an individual who owns (or who owns constructively) 25 percent or more in value of the outstanding stock of the corporation has performed, is to perform, or may be designated to perform; and (2) when an individual who owns (or who owns constructively) 25 percent or more in value of the outstanding stock of the corporation is entitled to use corporate property and when the corporation in any way receives compensation for use of that property. This latter rule prevents foreign corporations from avoiding foreign personal holding company status by generating what appear to be large amounts of rental income.

Passive foreign investment companies

The 1986 Act established an anti-deferral regime for passive foreign investment companies (PFICs) and established separate rules for each of two types of PFICs. One set of rules applies to PFICs that are "qualified electing funds," where electing U.S. shareholders include currently in gross income their respective shares of a PFIC's total earnings, with a separate election to defer payment of tax, subject to an interest charge, on income not currently received. The second set of rules applies to PFICs that are not qualified electing funds ("nonqualified funds"), whose U.S. shareholders pay tax on income realized from a PFIC and an interest charge which is attributable to the value of deferral.

Definition of passive foreign investment company

General definition.—A passive foreign investment company is any foreign corporation if (1) 75 percent or more of its gross income for the taxable year consists of passive income, or (2) 50 percent or more of the average fair market value of its assets consists of assets that produce, or are held for the production of, passive income (sec. 1296(a)).[84] Passive income for these purposes generally means income that satisfies the definition of foreign personal holding company income under subpart F (as discussed above); except as provided in regulations, however, passive income does not include certain active-business banking or insurance income, or certain amounts received from a related party (to the extent that the amounts are allocable to income of the related party which is not passive income, as discussed below) (sec. 1296(b)). Passive assets for this purpose are those assets that produce or are held for the production of passive income. Assets that are property which, in the hands of the foreign corporation, are inventory property (as defined in sec. 1221(1)), or are held by a regular dealer in that property, and are specifically identified as such inventory, are treated as nonpassive assets, even where that property generates foreign personal holding company income (as defined in sec. 954(c)), such as in the case of a securities broker-dealer that holds debt securities as inventory (Notice 88-22, 1988-1 C.B. 489, as modified by Notice 89-81, 1989-2 C.B. 399).

Look-through rules.—In determining whether foreign corporations that own subsidiaries are PFICs, look-through treatment is provided in certain cases (sec. 1296(c)). Under this look-through rule, a foreign corporation that owns, directly or indirectly, at least 25 percent of the value of the stock of another corporation is treated as owning a proportionate part of the other corporation's assets and income. Thus, amounts such as interest and dividends received from foreign or domestic subsidiaries are eliminated from the shareholder's income in applying the income test, and the stock or debt investment is eliminated from the shareholder's assets in applying the asset test.

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[84] A foreign corporation can elect to apply the asset test using the adjusted bases of the corporation's assets rather than the fair market value of its assets. Thus, under this election, a foreign corporation with less than 50 percent passive assets by adjusted basis will not be a PFIC (assuming the income test is not met), even if its assets are 50 percent or more passive by fair market value. The election, once made, is revocable only with the consent of the Secretary.

In addition to the look-through rule applicable to 25-percent-owned subsidiaries, interest, dividends, rents, and royalties received from related persons that are not subject to section 1296(c) look-through treatment are excepted from treatment as passive income to the extent that, under regulations prescribed by the Secretary, those amounts are allocable to income of the payor that is not passive income (sec. 1296(b)(2)(C)).[85] As a corollary, the characterization of the assets that generate the income will follow the characterization of the income so that, for example, a loan to a related person will be treated as a nonpassive asset if the interest on the loan is treated as nonpassive income. Together, these rules provide that earnings of certain related corporations, which earnings would be excluded from foreign personal holding company income under the related-person same-country exception of subpart F (sec. 954(c)(3)) if distributed to the shareholders, are subject to look-through treatment whether or not the related party is 25-percent owned.

In addition, stock of certain U.S. corporations owned by another U.S. corporation which is at least 25-percent owned by a foreign corporation is treated as a nonpassive asset (sec. 1297(b)(8)). Under this rule, in determining whether a foreign corporation is a PFIC, stock of a regular domestic C corporation owned by a 25-percent owned domestic corporation is treated as an asset which does not produce passive income (and is not held for the production of passive income), and income derived from that stock is treated as income which is not passive income. Thus, a foreign corporation, in applying the look-through rule available to 25-percent owned corporations, is treated as owning nonpassive assets in these cases. This rule does not apply, however, if, under a treaty obligation of the United States, the foreign corporation is not subject to the accumulated earnings tax, unless the corporation agrees to waive the benefit under the treaty. This rule is designed to mitigate the potential disparate tax treatment between U.S. individual shareholders who hold U.S. stock investments through a U.S. holding company and those who hold those investments through a foreign holding company. If a foreign investment company attempts to use this rule to avoid the PFIC provisions, it will be subject to the accumulated earnings tax and, thus, the shareholders of that company essentially will be denied deferral on the earnings of the foreign company, with an effect in some ways similar to application of the PFIC provisions.

Special exceptions from PFIC classification apply to start-up companies (sec. 1297(b)(2)) and corporations changing businesses during the taxable year (sec. 1297(b)(3)). In both such cases, a corporation may have a substantially higher proportion of passive assets (and passive income, in some cases) than at other times in its history.

General rule—nonqualified funds

General rule.—United States persons who are shareholders in PFICs that are not "qualified electing funds" (or have not been qualified electing funds for all PFIC years in the holding period of

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[85] A related person is defined by reference to the related person definition in subpart F (that is, sec. 954(d)(3)).

the taxpayer) pay U.S. tax and an interest charge based on the value of tax deferral at the time the shareholder disposes of stock in the PFIC or on receipt of an "excess" distribution (sec. 1291). Under this rule, gain recognized on disposition of stock in a non-qualified fund or income on receipt of an "excess" distribution from a nonqualified fund is treated as ordinary income and is treated as earned pro rata over the shareholder's holding period of his or her investment. The portion treated as earned before the current year during the post-1986 period during which the foreign corporation was a PFIC is taxed at the highest applicable tax rate in effect for each respective year, and is subject to an interest charge. The interest charge is treated as interest for tax purposes. The total of such tax and interest is referred to as the "deferred tax amount."

Availability of foreign tax credits.—Distributions from nonqualified funds are eligible for direct and deemed-paid foreign tax credits (under secs. 901 and 902) under the following method. The U.S. investor first computes the total amount of creditable foreign taxes with respect to the distribution it receives. This amount includes the amount of direct foreign taxes paid by the investor with respect to the distribution (for example, any withholding taxes) and the amount of the PFIC's foreign taxes deemed paid by the investor with respect to the distribution under section 902 (if any) to the extent the direct and indirect taxes are creditable under general foreign tax credit principles and the investor chooses to claim those taxes as a credit. The investor then determines the amount of the creditable foreign taxes that are attributable to the portion of the distribution that is an excess distribution (the "excess distribution taxes"). This determination is made by apportioning the total amount of creditable foreign taxes between the amount of the distribution that is an excess distribution and the amount of the distribution that is not an excess distribution on a pro rata basis. For purposes of determining the amount of the distribution from the PFIC (and the amount of the excess distribution), the gross-up under section 78 is included in the amount of money or other property received.

The U.S. investor then allocates the excess distribution taxes ratably to each day in the holding period of its stock. To the extent the taxes are allocated to days in taxable years prior to the year in which the foreign corporation became a PFIC and to the current taxable year, the taxes are taken into account for the current year under the general foreign tax credit rules. To the extent the taxes are allocated to days in any other taxable year (that is, to days in years on which the deferred tax amount is imposed), then the foreign tax credit limitation provisions of section 904 are applied separately to those taxes. Under this rule, the taxes allocable to a particular year can reduce the increase in tax for that year on which interest is computed, but not below zero. In the event the taxes allocable to that year are in excess of any increase in tax, no interest will be due, but no carryover will be allowed since the foreign tax credit limitations are applied with respect to excess distributions occurring within each taxable year.

Definition of excess distribution.—An "excess" distribution is any current year distribution in respect of a share of stock that exceeds

125 percent of the average amount of distributions in respect of the share of stock received during the 3 preceding years (or, if shorter, the total number of years of the taxpayer's holding period prior to the current taxable year) (sec. 1291(b)). The determination of an excess distribution excludes from the 3-year average distribution base that part of a prior-year excess distribution that is considered attributable to deferred earnings (i.e., that part of the excess distribution that was not allocable to pre-1986 or pre-PFIC years or to the current year). Any gain from the sale or disposition of such stock is also treated as an excess distribution.

Anti-avoidance rules.—Regulatory authority is provided to disregard any nonrecognition provision of the Code on any transfer of PFIC stock (sec. 1291(f)). For example, regulations may treat a gift of stock in a nonqualified fund to a non-taxpaying entity, such as a charity or a foreign person, as a disposition for purposes of those rules in order that the deferred tax and interest charge attributable to that stock not be eliminated.

Qualified electing funds

General rule.—A U.S. person who owns stock in a PFIC may elect that the PFIC be treated as a "qualified electing fund" with respect to that shareholder (sec. 1295), with the result that the shareholder must include currently in gross income his or her pro rata share of the PFIC's total earnings and profits (sec. 1293). This inclusion rule generally requires current payment of tax, absent a separate election to defer tax.

Qualified fund election.—The election for treatment as a qualified electing fund, which is made at the shareholder level, is available only where the PFIC complies with the requirements prescribed in Treasury regulations to determine the income of the PFIC and to ascertain any other information necessary to carry out the purposes of the PFIC provisions. The effect of the election is to treat a PFIC as a qualified electing fund with respect to each electing investor so that, for example, an electing investor will not be subject to the deferred tax and interest charge rules of section 1291 on receipt of a distribution if the election has been in effect for each of the PFIC's taxable years for which the company was a PFIC and which includes any portion of the investor's holding period.

Inclusion of income.—The amount currently included in the income of an electing shareholder is divided between a shareholder's pro rata share of the ordinary income of the PFIC and net capital gain income of the PFIC. The characterization of income, and the determination of earnings and profits, is made pursuant to general Code rules with two modifications. These modifications apply only when the qualified electing fund is also a controlled foreign corporation and the U.S. investor in the fund is also a U.S. shareholder in the controlled foreign corporation (as both terms are defined under subpart F).

Under the first modification, if the U.S. investor establishes to the satisfaction of the Secretary that an item of income derived by a fund was subject to an effective rate of income tax imposed by a foreign country greater than 90 percent of the maximum rate of U.S. corporate tax, then that item of income is excluded from the

ordinary earnings and net capital gain income of the fund for purposes of determining the U.S. investor's pro rata share of income.

Under the second modification, the qualified electing fund's ordinary earnings and net capital gain income do not include income from U.S. sources that is effectively connected with the conduct by the fund of a U.S. trade or business so long as that income is not exempt from U.S. taxation (or subject to a reduced rate of tax) pursuant to a treaty obligation of the United States.

Pro rata share of income.—Pro rata share of income generally is determined by aggregating a PFIC's income for the taxable year and attributing that income ratably over every day in the PFIC's year. Electing investors then include in income for the period in which they hold stock in the PFIC their daily ownership interest in the PFIC multiplied by the amount of income attributed to each day.

As a special rule, the Code permits that, to the extent provided in regulations, if a qualified electing fund establishes to the Secretary's satisfaction that it maintains records that determine investors' pro rata shares of income more accurately than allocating a taxable year's income ratably over a daily basis (for example, by allocating a month's income ratably over a daily basis), the fund can determine the investors' pro rata shares of income on that basis. This provision is designed to allow those funds that maintain appropriate records to more accurately determine U.S. investors' pro rata shares of income, which may be important in cases where the investors own their stock for only parts of a year.

Distributions and basis adjustments.—The distribution of earnings and profits that were previously included in the income of an electing shareholder under these rules is not treated as a dividend to the shareholder, but does reduce the PFIC's earnings and profits (sec. 1293(c)). The basis of an electing shareholder's stock in a PFIC is increased by amounts currently included in income under these rules, and is decreased by any amount that is actually distributed but treated as previously taxed under section 1293(c) (sec. 1293(d)).

Availability of foreign tax credit.—Foreign tax credits are allowed against U.S. tax on amounts included in income from a qualified electing fund to the same extent, and under the same rules, as in the case of income inclusions from a controlled foreign corporation (sec. 1293(f)).

The Code provides special rules to characterize income inclusions from qualified electing funds for foreign tax credit purposes. In the case of a qualified electing fund that is also a controlled foreign corporation, where the U.S. person that has the income inclusion is a U.S. shareholder in the corporation (as defined under the subpart F rules), look-through treatment determines the foreign tax credit limitation characterization of the income inclusion. In addition, where the qualified electing fund is a noncontrolled section 902 corporation (as defined in sec. 904(d)(2)(E)) with respect to the taxpayer, the income inclusion is treated for foreign tax credit purposes as a dividend, and thus, is subject to the separate limitation applicable to those dividends. Where neither of the above conditions is satisfied, the income inclusion is characterized as passive income for foreign tax credit purposes.

Election to defer current payment of tax.—U.S. investors in qualified electing funds may generally, subject to the payment of interest, elect to defer payment of U.S. tax on amounts included currently in income but for which no current distribution has been received (sec. 1294). An election to defer tax is treated as an extension of time to pay tax for which a U.S. shareholder is liable for interest.

The disposition of stock in a PFIC generally terminates all previous extensions of time to pay tax with respect to the earnings attributable to that stock. Disposition for this purpose generally means any transfer of ownership, regardless of whether the transfer constitutes a realization or recognition event under general Code rules. For example, a transfer at death or by gift of stock in a qualified electing fund is treated as a disposition for these purposes.

Special rules applicable to both types of funds

Coordination of section 1291 with taxation of shareholders in qualified electing funds.—Gain recognized on disposition of stock in a PFIC by a U.S. investor, as well as distributions received from a PFIC in a year the PFIC is a qualified electing fund, are not taxed under the rules applicable to nonqualified funds (that is, sec. 1291) if the PFIC is a qualified electing fund for each of the fund's taxable years which begin after December 31, 1986 and which includes any portion of the investor's holding period (sec. 1291(d)(1)). Therefore, if for any taxable year beginning after December 31, 1986, a foreign corporation is a PFIC but is not a qualified electing fund with respect to the U.S. investor, gains and distributions in any subsequent year will be subject to the rules applicable to nonqualified funds. The section 1291 coordinating provision as it relates to distributions prevents a fund from retaining its annual income while it is not a qualified electing fund, and then distributing the accumulated income in a subsequent year after it becomes a qualified electing fund without incurring any interest charge.

Any U.S. person who owns stock (directly or indirectly under the attribution rules) in a PFIC which previously was not a qualified electing fund for a taxable year but which becomes one for the subsequent taxable year may elect to be taxed on the unrealized appreciation inherent in his or her PFIC stock up through the first day of the subsequent taxable year, pay all prior deferred tax and interest, and acquire a new basis and holding period in his or her PFIC investment (sec. 1291(d)(2)). Thereafter, the shareholder is subject to the rules applicable to qualified electing funds.

An alternative election is available to shareholders in a controlled foreign corporation. Under this alternative, instead of recognizing the entire gain in the value of his or her stock, a U.S. person that holds stock (directly or indirectly under the attribution rules) in a controlled foreign corporation (as defined for subpart F purposes) that is a PFIC and that becomes a qualified electing fund can elect to include in gross income as a dividend his or her share of the corporation's earnings and profits accumulated after 1986 and since the corporation was a PFIC. Upon this election, the U.S. person's stock basis is increased by the amount included in income and the shareholder is treated as having a new holding period in

his or her stock. Thereafter, the shareholder is subject to the rules applicable to qualified electing funds. The total amount treated as a dividend under the above election is an excess distribution and is to be assigned, for purposes of computing the deferred tax and interest charge, to the shareholder's stock interest on the basis of post-December 31, 1986 ownership.

Attribution of ownership.—In determining stock ownership, a U.S. person is considered to own his or her proportionate share of the stock of a PFIC owned by any partnership, trust, or estate of which the person is a partner or beneficiary (or in certain cases, a grantor), or owned by any foreign corporation if the U.S. person owns 50 percent or more of the value of the corporation's stock (sec. 1297(a)). However, if a U.S. person owns any stock in a PFIC, the person is considered to own his or her proportionate share of any lower-tier PFIC stock owned by the upper-tier PFIC, regardless of the percentage of his or her ownership in the upper-tier PFIC. Under regulations, any person who has an option to acquire stock may be treated as owning the stock.

Anti-avoidance rules.—The Code provides authority to the Secretary to prescribe regulations that are necessary to carry out the purposes of the PFIC provisions and to prevent circumvention of the interest charge (sec. 1297(d)). In addition, if a U.S. person is treated as owning stock in a PFIC by virtue of the attribution rules, regulations may treat any distribution of money or other property to the actual holder of the stock as a distribution to the U.S. person, and any disposition (whether by the U.S. person or the actual holder of the stock) which results in the U.S. person being treated as no longer owning the stock as a disposition by the U.S. person (sec. 1297(b)(5)).

Other anti-deferral regimes

Personal holding companies

In addition to the corporate income tax, the Code imposes a tax at the rate of 28 percent [86] on the undistributed income of a personal holding company (sec. 541). This tax substitutes for the tax that would have been incurred by the shareholders on dividends actually distributed by the personal holding company. A personal holding company generally is defined as any corporation (with certain specified exceptions) if (1) at least 60 percent of its adjusted gross income for the taxable year is personal holding company income, and (2) at any time during the last half of the taxable year more than 50 percent in value of its outstanding stock is owned, directly or indirectly, by or for not more than five individuals (sec. 542(a)).

This definition is very similar to that of a foreign personal holding company, discussed above, but does not depend on the U.S. citizenship or residence status of the shareholders. However, the specified exceptions to the definition of a personal holding company pre-

[86] A technical correction to the Omnibus Budget Reconciliation Act of 1990, pending in the Senate, would change the personal holding company tax rate to 31 percent, to conform to the increase in the top individual tax rate from 28 to 31 percent. Section 102(a)(4) of H.R. 1555, 102d Cong., 1st Sess. (1991), passed by the House of Representatives and received in the Senate on November 26, 1991.

clude the application of the personal holding company tax to, among others, any foreign personal holding company, most foreign corporations owned solely by nonresident alien individuals, and any PFIC (paragraphs (5), (7), and (10) of sec. 542(c)). Therefore, the personal holding company tax could apply to only a small class of foreign corporations, such as foreign corporations with at least 60 percent but less than 75 percent passive-type income, and majority owned by a group of five or fewer individuals of whom at least one is a U.S. person and at least one of whom is a nonresident alien.

Accumulated earnings tax

In addition to the corporate income tax, the Code also imposes a tax, at the rate of 28 percent, on the accumulated taxable income of any corporation (with certain exceptions) formed or availed of for the purpose of avoiding income tax with respect to its shareholders (or the shareholders of any other corporation), by permitting its earnings and profits to accumulate instead of being distributed (secs. 531, 532(a)). The specified tax-avoidance purpose generally is determined by the fact that the earnings and profits of the corporation are allowed to accumulate beyond the reasonable needs of the business (sec. 533). Like the personal holding company tax, the accumulated earnings tax acts as a substitute for the tax that would have been incurred by the shareholders on dividends actually distributed by the corporation.

The accumulated earnings tax does not apply to any personal holding company, foreign personal holding company, or PFIC (sec. 532(b)). These exceptions, along with the current inclusion of subpart F income in the gross incomes of the U.S. shareholders of a controlled foreign corporation, have resulted, in practice, in very limited application of the accumulated earnings tax to foreign corporations.

Foreign investment companies

A foreign investment company generally is defined as any foreign corporation that either is registered under the Investment Company Act of 1940 (as amended) as a management company or as a unit investment trust, or is engaged (or holding itself out as being engaged) primarily in the business of investing, reinvesting, or trading in securities or commodities or any interest (including a futures or forward contract or option) in securities or commodities, at a time when 50 percent or more of the vote or value of the stock was held (directly or indirectly) by U.S. persons (sec. 1246(b)). In the case of the sale or exchange of stock in a foreign investment company, gain on the sale generally is treated as ordinary income to the extent of the taxpayer's ratable share of the undistributed earnings and profits of the foreign investment company (sec. 1246(a)). However, if a foreign investment company so elected by December 31, 1962, it can avoid the application of section 1246 to its shareholders by annually distributing at least 90 percent of its taxable income (determined as if the foreign corporation were a domestic corporation), and complying with other information-reporting and administrative requirements as the Secretary of the Treasury deems necessary (sec. 1247).

Coordination among anti-deferral regimes

The Code provides that, if an item of income of a foreign corporation would be includable in the gross income of a U.S. shareholder both under the controlled foreign corporation rules and under the foreign personal holding company rules, that item of income is included only under the controlled foreign corporation rules (sec. 951(d)). This rule of precedence operates only to the extent that the controlled foreign corporation rules and the foreign personal holding company rules overlap on an item-by-item basis. Income includible under only one set of rules (foreign personal holding company rules or subpart F rules) is includible under that set of rules. A taxpayer taxable under subpart F on amounts other than subpart F income (on such items as withdrawals from foreign base company shipping income and investments in U.S. property) is taxable under subpart F whether or not the taxpayer is also taxable on the undistributed foreign personal holding company income of the foreign corporation under the foreign personal holding company rules.

If an item of income of a foreign corporation would be includable in the gross income of a U.S. shareholder both under the controlled foreign corporation rules and under the rules relating to the current taxation of income from certain passive foreign investment companies, that item of income is included only under the controlled foreign corporation rules (sec. 951(f)). In addition, if an item of income of a foreign corporation would be includable in the gross income of a U.S. shareholder both under the controlled foreign corporation rules and under the rules relating to the current taxation of income from electing foreign investment companies, that item of income is included only under the foreign investment company rules (sec. 951(c)). Any amount that is taxable under only one set of rules is included in gross income pursuant to that set of rules.

In the case of a foreign corporation that is both a foreign personal holding company and a passive foreign investment company, to the extent that the income of the foreign corporation would be taxable to a U.S. person both under the foreign personal holding company rules and under section 1293 (relating to current taxation of income of certain passive foreign investment companies), that income is treated as taxable to the U.S. person only under the foreign personal holding company rules (sec. 551(g)).

In the case of a PFIC that is a qualified electing fund, the amount of income treated as a dividend on a sale or exchange of stock in a controlled foreign corporation (under sec. 1248) does not include any amount of income included previously under the qualified electing fund rules to the extent that that amount of income has not been distributed from the PFIC prior to the sale or exchange of the stock. In addition, section 1248 does not apply to the sale or disposition of stock in a PFIC that is not a qualified electing fund.

In the case of a PFIC that is a qualified electing fund and that owns stock in a second-tier PFIC that is also a qualified electing fund, amounts distributed by the second-tier fund to the first-tier fund that have been included previously in income by U.S. investors—because they are deemed to own stock in the second-tier fund—are not to be included in the ordinary earnings of the first-

tier fund. This rule prevents U.S. persons from including amounts in income twice. This relief provision also applies in the case of a second- (or lower-) tier PFIC that is a qualified electing fund and that is also a controlled foreign corporation. In this case, amounts that are included in a U.S. person's income under the subpart F provisions and that would have been included under the qualified electing fund provisions (but for the coordination provision of sec. 951(f)) are prevented from being included in income again under this relief provision.

In the case of a PFIC that is not a qualified electing fund, the Code eliminates the potential for double taxation by providing for proper adjustments to excess distributions for amounts that are taxed currently under the Code's other current inclusion rules. Thus, for example, excess distributions will not include any amounts that are treated as previously taxed income under section 959(a) when distributed by a controlled foreign corporation that is also a PFIC that is not a qualified electing fund.

As noted above, the personal holding company tax does not apply to any foreign personal holding company or PFIC, and the accumulated earnings tax does not apply to any personal holding company, foreign personal holding company, or PFIC.

Section 1246 does not apply to the earnings and profits of any foreign investment company for any year after 1986 if the company is a PFIC for that year (sec. 1297(b)(7)). In addition, an electing foreign investment company under section 1247 is excluded from the definition of a PFIC (sec. 1296(d)).

Reasons for Change

Some of the different anti-deferral regimes were enacted or modified at different times and reflect historically different Congressional policies. Different regimes provide different thresholds (either by type of income or asset at the foreign corporation level, or of U.S. stock ownership at the shareholder level) to their application. They provide for different mechanisms by which U.S. stockholders are denied the benefits of deferral. Some of the regimes have features directed at policy goals applicable to foreign corporations owned by U.S. corporations (e.g., the allowance of indirect foreign tax credits); others have features primarily directed at issues applicable to foreign corporations owned by U.S. individuals (e.g., the basis of property acquired from a decedent). Some regimes preserve the character of the income earned in the hands of a foreign corporation while others do not. Some provide for movement of losses between years of a single foreign corporation or between multiple corporations while others do not. While a consistent theme of these regimes is to provide current taxation for certain types of interest, dividend, rental, royalty, and other similar income, the different regimes apply different criteria to these items of income to determine their current inclusion or noninclusion. Different regimes have different ordering rules for determining which dividends from foreign corporations subject to the regimes are subject to tax on repatriation and which are untaxed distributions of previously taxed income.

Simply because of the differences among the various anti-deferral regimes, U.S. taxpayers frequently are faced with the need to consult multiple sets of anti-deferral rules when they hold stock in a foreign corporation.

Moreover, the interactions of the rules cause additional complexity. There is significant overlap among the several regimes. This overlap requires the Code to provide specific rules of priority for income inclusions among the regimes, as well as additional coordination provisions pertaining to other operational differences among the several regimes. The overlapping or multiple application of anti-deferral regimes to a single corporation can result in significant additional complexity with little or no ultimate tax consequences.

Consolidation of the several anti-deferral regimes can achieve two major types of simplification. First, by reducing the number of separate definitions of entities among the anti-deferral regimes, taxpayers can be spared the burden of understanding and complying with a multiplicity of separate anti-deferral regimes with separate definitions and requirements. Moreover, where the committee believes that operating rules of one current inclusion regime provide taxpayers with appropriate income measurement rules not contained in another regime (e.g., the qualified deficit rules present in subpart F but absent in the PFIC rules), consolidation of the operating rules permits more uniform extension of those benefits to all taxpayers subject to a current inclusion regime.

Second, from an operational perspective, the number of anti-deferral regimes that can apply to any one shareholder in a foreign corporation can be reduced to one. As discussed above, the operational differences, including the overlapping applicability of the six present-law anti-deferral regimes, is a source of complexity. Under a consolidated regime, however, deferral can be denied for many corporations (whether in full or in part) solely through the provisions of subpart F. In the case of a controlled foreign corporation, for example, being subject to the rules for full denial of deferral (such as the PFIC or foreign personal holding company provisions under present law) can, if only a single set of rules applies, result in fewer additional compliance burdens and less administrative and operational complexity.

Another source of complexity under present law is the need for shareholders of controlled foreign corporations to make "protective" current-inclusion elections in order to avoid adverse future consequences under the interest-charge method should the controlled foreign corporation also prove to be a PFIC. By replacing elective current-inclusion treatment for PFICs that are also controlled foreign corporations by mandatory current inclusion through subpart F for passive foreign corporations that are also controlled foreign corporations, a consolidated regime can eliminate both the burdens of making protective elections and the risks of failing to do so.

The committee understands that the interest-charge method of the present-law PFIC rules is a significant source of complexity both separately and in its interaction with other provisions of the Code. Even without eliminating the interest-charge method, significant simplification can be achieved by minimizing the number of

taxpayers that may be subject to the method and by making certain modifications that may reduce the complexity engendered by the interest-charge method. Further, because some taxpayers have argued that they would have preferred choosing the current-inclusion method afforded by the qualified fund election, but were unable to do so because they could not obtain required corporate-level information, the committee believes that the mark-to-market system provides a fair alternative method for measuring income and imposing an appropriate level of income tax.

Explanation of Provision

In general

The bill replaces the separate anti-deferral regimes of present law with a unified set of rules providing for either partial or full elimination of deferral depending on the circumstances. The bill preserves the present-law approach under which partial current taxation is a function of the type of income earned by the foreign corporation and a level of U.S. ownership in the corporation exceeding some threshold (as currently embodied in subpart F). The bill also preserves the present-law approach under which full current taxation is a function of a type of income or assets of the corporation exceeding some threshold (as currently embodied in subpart F, the PFIC rules, and the foreign personal holding company rules). The bill eliminates regimes that are redundant or marginally applicable, and ensures that no more than one set of rules generally will apply to a shareholder's interest in any one corporation in any one year.

Generally, the bill retains the subpart F rules as the foundation of its unified anti-deferral regime (with certain modifications described below and also in item 2., following, describing secs. 4411-4413 of the bill). It includes a modified version of the PFIC rules while eliminating the other regimes as redundant to one or the other. The bill's unified anti-deferral regime sets forth various thresholds for subjecting U.S. persons to full or partial inclusions of corporate income. In addition, where deferral is eliminated by U.S. shareholder inclusions of foreign corporate-level income, the bill applies a single set of rules (the subpart F rules) for basis adjustments, characterization of actual distributions, foreign tax credits, and similar issues. As under present law, the bill in some cases affords U.S. persons owning stock in foreign corporations a choice of technique for recognizing income from the elimination of deferral. However, in a greater number of cases than under present law, the bill provides only one method of eliminating deferral.

Replacement of current law regimes for full elimination of deferral

The bill creates a single definition of a passive foreign corporation (PFC) that will unify and replace the foreign personal holding company and PFIC definitions. The rules applicable to PFCs represent a hybrid of characteristics of the foreign personal holding company rules, the PFIC rules, and the controlled foreign corporation rules (subpart F), plus a new mark-to-market regime, as well as a variety of simplifying or technical changes to rules under the existing systems. The following discussion explains the differences be-

tween the PFIC provisions of present law and the PFC provisions applicable under the bill.

A PFC is any foreign corporation if (1) 60 percent or more of its gross income is passive income, (2) 50 percent or more of its assets (on average during the year, measured by value) produce passive income or are held for the production of passive income, or (3) it is registered under the Investment Company Act of 1940 (as amended) either as a management company or as a unit investment trust.[87] As under the PFIC rules, the foreign corporation is permitted to elect to measure its assets based on their adjusted bases rather than their value.

As under present law, passive income for this purpose is defined in the bill generally as any income of a kind which would be foreign personal holding company income as defined in section 954(c), subject to the current law exceptions for banking and insurance income and the current look-through rules for certain payments from related persons (current sec. 1296(b)(2)).[88]

The bill adds a new exception to the definition of passive income. Under the bill, to the extent that any asset is properly treated as not held for the production of passive income (and therefore is treated as not a passive asset for purposes of the asset test), all income derived from the asset is treated as active income for purposes of the income test. Ordinarily the character of an asset as passive or active depends on the income generated by that asset. However, as explained above, some assets (for example, stocks or securities held for sale to customers in the ordinary course of business by a regular dealer in such property, and properly identified as inventory property) may be treated as active even though those assets generate, among other things, passive income. It is unclear whether this was intended when the PFIC rules were enacted.[89]

The bill establishes that, to the extent an asset is properly treated as active, all of the income from that asset is treated as active for purposes of the income test. The bill is not intended to change the outcome of the application of the asset test under present law. For example, the committee does not intend to limit the IRS's authority to prescribe limits, as it did in Notice 88-22, on the cases in which assets generating what could be passive income are treated as active assets.[90] In addition, the committee intends that where

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[87] The committee understands that a mutual insurance company can be treated under the bill and under present law as a passive foreign corporation, notwithstanding the fact that such a company does not actually issue "stock."

[88] Thus, the bill retains the exception for income derived in the active conduct of an insurance business by a corporation which is predominantly engaged in an insurance business and which would be subject to tax under subchapter L if it were a domestic corporation. The committee intends that in determining whether a corporation is "predominantly engaged" for this purpose, the Secretary may require a higher standard or threshold than the definition of an insurance company under Treasury Regulations section 1.801-3(a).

[89] Active asset treatment of certain securities held for sale to the public is confirmed in Notice 88-22, 1988-1 C.B. 489, 490, and S. Rep. No. 100-445, 100th Cong., 2d Sess. 281 (1988). The legislative history of the 1986 Act further suggested a view that all income from such inventory would be treated as active. "[S]ecurities held for sale to the public[] are assets that do not give rise to subpart F FPHC income by virtue of the dealer exception in sec. 954(c). . . ." Staff of the Joint Committee on Taxation, 100th Cong., 1st Sess., *General Explanation of the Tax Reform Act of 1986*, at 1025 (1987).

[90] Under the Notice, for example, the IRS conditioned active asset treatment of securities inventories on compliance with an identification requirement and a reasonable needs requirement. 1988-1 C.B. at 490.

one item of property is properly viewed as two separate assets, a portion of the property can be treated as a passive asset that generates passive income while another portion of the same item of property can be treated as a nonpassive asset that generates nonpassive income. For example, assume that a taxpayer owns a six-story office building, and occupies two floors for use in its active business while renting out the other four floors. Assume that the two floors used in the active business are properly viewed as a nonpassive asset, while the four leased floors are properly viewed as a passive asset. The committee intends that the rental income from the four leased floors in this example be treated as passive income.

The committee understands that securities sale and repurchase transactions (so-called "repos" and "reverses") engaged in by regular dealers in stocks or securities are treated under the present-law tax rules as loan transactions generating interest income generally treated as passive under the PFIC rules. (The committee understands that the bill's new exception to the definition of passive income does not alter this treatment for purposes of the PFC rules.) The committee has been informed that companies may engage in offsetting repo and reverse transactions—i.e., may run a "matched book" with respect to such transactions. The committee intends that a study be conducted by the Treasury Department as to the tax treatment for purposes of the PFC rules of running such a matched book, and the consequences and merits of possible changes in such current-law tax treatment.

In addition, the bill provides two clarifications to present law. First, the bill clarifies that, as indicated in the legislative history of the 1988 Act, the same-country exceptions from the definition of foreign personal holding company income in section 954(c) are disregarded.[91] Second, the bill clarifies that any foreign trade income of a foreign sales corporation does not constitute passive income for purposes of the PFIC definition (*cf.* sec. 951(e)).

The bill modifies the present law application of the asset test by treating certain leased property as assets held by the foreign corporation for purposes of the PFC asset test. This rule applies to tangible personal property with respect to which the foreign corporation is the lessee under a lease with a term of at least 12 months. Under the bill, the value of leased property for purposes of applying the asset test is the lesser of the fair market value of the property or the unamortized portion of the present value of the payments under the lease. Regulations are to provide for determining the unamortized portion of the present value of the payments. Present value is to be determined, under regulations, as of the beginning of the lease term, and, except as provided in regulations, by using a discount rate equal to the applicable Federal rate determined under the rules applicable to original discount instruments (sec. 1274(d)), substituting under those rules the term of the lease for the term of the debt instrument. In applying those rules, options to renew or extend the lease are not to be taken into account. Also, the special rule to be applied under section 1274(d)(2) in the case of a sale or exchange is disregarded. Property leased by a cor-

[91] H.R. Rep. No. 100-795, 100th Cong., 2d Sess. 272 (1988); S. Rep. No. 100-445, 100th Cong., 2d Sess. 285 (1988).

poration is not taken into account in testing for PFC status under the asset test either if the lessor is a related person (as that term is defined under the foreign base company rules) with respect to the lessee, or if a principal purpose of leasing the property was to avoid the PFC provisions.

The bill also modifies the present law rules that provide an exception from the definition of a PFIC in the case of a company changing businesses. Under the bill, if a foreign corporation holds 25 percent or more of the stock of a second corporation that qualifies for the change-of-business exception (current sec. 1297(b)(3)), then in applying the look-though rules (current sec. 1296(c)), the first corporation may treat otherwise passive assets or income of the second corporation as active.[92]

The bill generally retains those provisions of current law the application of which depends upon whether a foreign corporation was a PFIC for years after 1986 (e.g., current sec. 1291(d)), but modifies these provisions to test whether the foreign corporation was a PFC for years after 1986. As a transitional definition, the bill provides that a foreign corporation that was treated as a PFIC for any taxable year beginning before the introduction of the bill is treated as having been a PFC for each such year.

The bill provides a new election that will allow certain passive foreign corporations to be treated as domestic corporations. A foreign corporation is eligible to make this election if (1) it would qualify for treatment as a regulated investment company (RIC) under the relevant provisions of the Code if it actually were a domestic corporation, (2) it meets such requirements as the Secretary may prescribe to ensure the collection of taxes imposed by the Internal Revenue Code on the passive foreign corporation, and (3) the electing passive foreign corporation waives all benefits which are granted by the United States under any treaty (including treaties other than tax treaties) and to which the corporation is otherwise entitled by reason of being a resident of another country. The rules governing such an election generally will be similar to those applicable to the election by a foreign insurance company to be treated as a domestic corporation under section 953(d). The rules governing the election under the PFC rules, however, will not include rules similar to the special rules applicable under section 953(d) for pre-effective-date earnings and profits (sec. 953(d)(4)(B)).

The bill provides a special rule regarding the application of the PFC rules to tax-exempt organizations that own stock in passive foreign corporations. The PFC rules, under the bill, apply to any stock held by a tax-exempt organization (under section 501) in a passive foreign corporation only to the extent that a dividend on that stock would be taken into account in determining the organization's unrelated business taxable income. To that extent, the PFC rules apply with respect to amounts taken into account in computing unrelated business taxable income in the same manner as if the organization were fully taxable. Even if a dividend on the PFC

[92] The bill retains the present law rules that provide an exception from the definition of a PFIC in the case of a start-up company (current sec. 1297(b)(2)). Under the bill, the committee intends that the start-up company exception be applied, where necessary to carry out the purposes of the PFC rules, by treating as one corporation all related foreign corporations that transferred assets to the start-up company.

stock would not be taken into account in determining the organization's unrelated business taxable income, however, the committee intends that any U.S. corporation regardless of its tax-exempt status will be treated as a U.S. person for purposes of determining whether or not a PFC is U.S. controlled.

Tax treatment under full elimination of deferral

The benefits of deferral are eliminated with respect to the income of a PFC under three alternative methods: current inclusion, mark-to-market, or interest charge on excess distributions.

Current inclusion method

Mandatory current inclusion.—If a passive foreign corporation is U.S. controlled, the bill will subject every U.S. person owning (directly or indirectly) stock in the PFC to income inclusions under a modified version of the controlled foreign corporation rules. If a PFC is not U.S. controlled, every U.S. person owning (directly or indirectly) 25 percent or more of the vote or value of the stock of the PFC will be subject to the same rules. Under the bill, the entire gross income of the passive foreign corporation (subject to applicable deductions) is treated as foreign base company income, and thus is included (net of appropriate deductions) on a pro rata basis in the income of each U.S. person directly or indirectly owning stock in the PFC, under a modified application of the rules of sections 951 and 961.[93] Actual distributions of earnings by such a PFC are treated similarly to distributions of previously taxed income under sections 959 and 961. These rules supersede all application of the present-law rules applicable to foreign personal holding companies, under which earnings are deemed distributed and then contributed to the capital of the foreign personal holding company.

In applying the subpart F inclusion rules to PFC inclusions, the bill applies the subpart F high-tax exception (under sec. 954(b)(4)) only to those shareholders in the PFC who are treated as "U.S. shareholders" of a controlled foreign corporation under the general rules of subpart F (i.e., those who own, whether directly, indirectly, or constructively, at least 10 percent of the voting power of the controlled foreign corporation). This limitation on the application of the controlled foreign corporation rules preserves present law to the extent that no high-tax exception is available to PFICs that are not also controlled foreign corporations. However, because the bill repeals the foreign personal holding company provisions of the Code, the effect of this high-tax exception is to increase the possibility for deferral in the case of a company that under present law meets the definitions of both a controlled foreign corporation and a foreign personal holding company.

Also in general conformity with present law, the bill permits the character of the PFC's income as either ordinary income or capital gain to be passed through to those shareholders of the PFC who are not treated as "U.S. shareholders" of a controlled foreign cor-

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[93] The treatment of PFC income as foreign base company income for purposes of subpart F is not intended to affect the application of look-through treatment of that income for purposes of the foreign tax credit limitation.

poration under the general rules of subpart F (i.e., those who do not own, whether directly, indirectly, or constructively, at least 10 percent of the voting power of the controlled foreign corporation).

In addition, the bill modifies the application of subpart F to PFCs by including foreign base company income of a PFC in the income of U.S. persons without regard to otherwise applicable reductions pursuant to the export trade corporation rules (secs. 970 and 971). This modification to the application of the controlled foreign corporation rules preserves present law in that the PFIC provisions apply in full force to export trade corporations.

The committee is aware of the equity issues that have been raised with regard to the application of the PFIC rules to export trade corporations. Accordingly, the committee will schedule consideration of this matter at the earliest possible date.

A passive foreign corporation is treated under the bill as U.S. controlled for this purpose either if it would be treated as a controlled foreign corporation under the rules of subpart F, or if, at any time during the taxable year, more than 50 percent of the vote or value of the corporation's stock was owned directly or indirectly by five or fewer U.S. persons (including but not limited to individuals, and including all U.S. citizens regardless of their residence). Indirect stock ownership under the bill generally refers to stock ownership through foreign entities within the meaning of section 958(a)(2). In addition, for the purpose of determining whether a foreign corporation is U.S. controlled by virtue of the ownership of more than 50 percent of its stock by five or fewer U.S. persons, the constructive ownership principles of the present-law foreign personal holding company rules generally apply. In the case of pass-through entities such as partnerships, S corporations, estates, and trusts, the constructive ownership principles of the present-law foreign personal holding company rules apply except as provided in regulations. The committee contemplates that regulations may modify the constructive ownership rules, for example, in the case of a trust in which the beneficial interests may be contingent, subject to determination or adjustment within the discretion of the trustee, or otherwise variable or indeterminate.

Elective current inclusion.—A U.S. person not subject to the above mandatory current inclusion rules—that is, a U.S. person owning less than 25 percent of the stock in a PFC that is not U.S. controlled—may elect application of those rules. As under current law, the PFC is characterized as a "qualified electing fund" with respect to such a U.S. person. In the application of the elective current-inclusion rules, the passive foreign corporation is treated as a controlled foreign corporation with respect to the taxpayer, and the taxpayer is treated as a U.S. shareholder of the corporation. For foreign tax credit purposes, amounts included in the taxpayer's gross income under this modified application of the controlled foreign corporation rules are treated as dividends received from a foreign corporation which is not a controlled foreign corporation. Thus, an amount would be treated as a dividend from a noncontrolled section 902 corporation, or as passive income, depending on the shareholder's percentage ownership and status as an individual or a corporation.

The application and operation of the shareholder-level election for treatment as a qualified electing fund generally are the same as under the present-law PFIC rules. The committee intends that, in the case of PFC stock owned through a foreign partnership, a partner-level election for treatment as a qualified electing fund will be permitted (except in the case of a foreign partnership that is subject to the simplified reporting rules available to certain large partnerships under subtitle C of the bill's simplification provisions).

Mark-to-market method

Less-than-25-percent shareholders of passive foreign corporations that are not U.S.-controlled, and who do not elect current inclusion ("nonelecting shareholders"), are subject under the bill to one of two methods for taxing the economic equivalent of the PFC's current income: the mark-to-market method or the interest-charge method. The mark-to-market method does not apply to the stock of a U.S. person in any PFC that is U.S. controlled (as discussed above), to the stock of a person choosing qualified electing fund treatment, or to stock of a U.S. person who is a 25-percent shareholder (as defined above).

Under the bill, nonelecting shareholders of a PFC with marketable stock are required to mark their PFC shares to market annually. Under the mark-to-market method, the U.S. person is required to include in gross income each taxable year an amount equal to the excess (if any) of the fair market value of the PFC stock as of the close of the taxable year over the adjusted basis of the stock. In the event the adjusted basis of the stock exceeds its fair market value, the U.S. person is allowed a deduction for the taxable year equal to the lesser of the amount of the excess or the "unreversed inclusions" with respect to the stock. The bill defines the term "unreversed inclusions" to mean, with respect to any stock in a passive foreign corporation, the excess (if any) of the total amount of mark-to-market gains with respect to the stock included by the taxpayer for prior taxable years, over the amount of mark-to-market losses with respect to such stock that were allowed as deductions for prior taxable years.

The adjusted basis of stock in a passive foreign corporation is increased by the amount of mark-to-market gain included in gross income, and is decreased by the amount of mark-to-market losses allowed as deductions with respect to such stock. In the case of stock owned indirectly by the U.S. person, such as through a foreign partnership, foreign estate or foreign trust (as discussed below), the basis adjustments for mark-to-market gains and losses apply to the basis of the PFC stock in the hands of the intermediary owner, but only for purposes of the subsequent application of the PFC rules to the tax treatment of the indirect U.S. owner. In addition, similar basis adjustments are made to the adjusted basis of the property actually held by the U.S. person by reason of which the U.S. person is treated as owning PFC stock.

All amounts of mark-to-market gain on PFC stock, as well as gain on the actual sale or distribution of PFC stock, are treated as ordinary income. Similarly, ordinary loss treatment applies to the deductible portion of any mark-to-market loss on PFC stock, as well as to any loss realized on the actual sale or other disposition

of PFC stock to the extent that the amount of such loss does not exceed the unreversed inclusions with respect to that stock. These loss deductions are treated as deductions allowable in computing adjusted gross income.

The source of any amount of mark-to-market gain on PFC stock is determined in the same manner as if the amount of income were actual gain from the sale of stock in the passive foreign corporation. Similarly, the source of any amount allowed as a deduction for mark-to-market loss on PFIC stock is determined in the same manner as if that amount were an actual loss incurred on the sale of stock in the passive foreign corporation.

Definition of "marketable stock."—The mark-to-market method under the bill only applies to passive foreign corporations the stock of which is "marketable." PFC stock is treated as marketable if it is regularly traded on a qualified exchange, whether inside or outside the United States. An exchange qualifies for this treatment if it is a national securities exchange which is registered with the Securities and Exchange Commission or the national market system established pursuant to section 11A of the Securities and Exchange Act of 1934, or if the Secretary is satisfied that the requirements for trading on that exchange ensure that the market price on that exchange represents a legitimate and sound fair market value for the stock. The committee intends that the Secretary may adopt a definition of the term "regularly traded" that differs from definitions provided for other purposes under the Code. Further, the committee intends that the Secretary not be bound by definitions applied for purposes of enforcing other laws, including Federal securities laws. Similarly, in identifying qualified foreign exchanges for these purposes, the committee intends that the Secretary not be required to include exchanges that satisfy standards established under Federal securities laws and regulations. PFC stock is also treated as marketable, to the extent provided in Treasury regulations, if the PFC continuously offers for sale or has outstanding any stock (of which it is the issuer) that is redeemable at its net asset value in a manner comparable to a U.S. regulated investment company (RIC).

In addition, the bill treats as marketable any stock in a passive foreign corporation that is owned by a RIC that continuously offers for sale or has outstanding any stock (of which it is the issuer) that is redeemable at its net asset value. The committee believes that the RIC's determination of PFC stock value for this non-tax purpose would ensure a sufficiently accurate determination of the fair market value of PFC stock owned by the RIC. The bill also treats as marketable any stock in a passive foreign corporation that is held by any other RIC, except to the extent provided in regulations. The committee believes that even for RICs that do not make a market in their own stock, but that do regularly report their net asset values in compliance with the securities laws, inaccurate valuations may bring exposure to legal liabilities, and this exposure may ensure the reliability of the values such RICs assign to the stock they hold in PFCs. However, the committee intends that Treasury regulations will disallow mark-to-market treatment for nonmarketable stock held by any RIC that is not required to perform such a net asset valuation at the close of each taxable year,

that does not publish such a valuation, or that otherwise does not provide what the Secretary regards as sufficient indicia of the reliability of its valuations under the relevant circumstances.

Coordination with RIC rules.—The bill coordinates the application of the mark-to-market method with the tax rules generally applicable to RICs. The bill treats mark-to-market gain on PFC stock as a dividend for purposes of both the 90-percent investment income test of section 851(b)(2) and the 30-percent short-short limitation of section 851(b)(3). In addition, the bill permits RICs to determine their mark-to-market gain using a fiscal year ending on October 31 of each year, solely for purposes of determining their ordinary income for purposes of the excise tax on the undistributed income of regulated investment companies (sec. 4982). Reductions in value of the PFC stock between October 31 and the end of the RIC's normal taxable year are treated, to the extent provided in regulations, as occurring in the following taxable year for purposes of computing the RIC's investment company taxable income (sec. 852(b)) and the RIC's earnings and profits (sec. 852(c)).[94]

Marketable stock not directly owned by a U.S. person.—In the case of a controlled foreign corporation (including a passive foreign corporation that is treated under the bill as a controlled foreign corporation) that owns or is treated as owning stock in a passive foreign corporation, the mark-to-market method generally is applied as if the controlled foreign corporation were a U.S. person. For purposes of the application of subpart F to the controlled foreign corporation, mark-to-market gains are treated as if they were foreign personal holding company income of the character of dividends, interest, royalties, rents or annuities, and allowable deductions for mark-to-market losses are treated as deductions allocable to that category of foreign personal holding company income. The source of such income or loss, however, is determined by reference to the actual (foreign) residence of the controlled foreign corporation.

For purposes of the mark-to-market method, any stock in a passive foreign corporation that is owned, directly or indirectly, by or for a foreign partnership or foreign trust or foreign estate is treated as if it were owned proportionately by its partners or beneficiaries, except as provided in regulations.[95] Stock in a passive foreign corporation that is thus treated as owned by a person is treated as actually owned by that person for the purpose of applying the constructive ownership rule at another level. In the case of a U.S. person who is treated as owning stock in a passive foreign corporation by application of this constructive ownership rule, any disposition by the U.S. person or by any other person that results in the U.S. person being treated as no longer owning the stock in the passive foreign corporation, as well as any disposition by the person actually owning the stock of the passive foreign corporation, is treated under the bill as a disposition by the U.S. person of stock in the passive foreign corporation.

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[94] Similar rules apply under present law for currency gains of RICs (secs. 4982(e)(5), 852(b)(8), and 852(c)(2)).

[95] For this purpose, the committee intends that proportionate ownership will take into account any special or discretionary allocations of the distributions or gains with respect to stock in the passive foreign corporation.

Transition to mark-to-market.—The bill provides certain transition rules for PFC stock that becomes subject to the mark-to-market method—that is, generally, marketable PFC stock with respect to which current inclusion rules do not apply. One method applies in general, another applies to PFC stock held by regulated investment companies, and a third method applies to PFC stock held by individuals who become subject to U.S. tax jurisdiction as the result of a change in residence or citizenship.

1. The general rule applies in the case of marketable stock in a PFC that is held by the shareholder on the effective date of the bill, where the PFC was also a PFIC under present law but was not a qualified electing fund with respect to the shareholder for all post-1986 years in the taxpayer's holding period. Under this general rule, tax is imposed under the bill's mark-to-market rule on the amount of mark-to-market gain representing the stock's appreciation (if any) in the first post-effective date year. In addition, if the stock has not depreciated in the first post-effective date year, tax may be imposed on the full amount of mark-to-market gain representing the stock's appreciation prior to the effective date, as if the stock had been sold at the end of the last pre-effective-date year and taxed subject to present law's interest-charge method.

If on the other hand the stock has not appreciated during the first post-effective date year, tax is imposed only on the amount of the net mark-to-market gain representing the stock's appreciation between the beginning of the taxpayer's holding period and the last day of the first post-effective date year. In either case, the difference between the fair market value of the PFC stock at the close of the first taxable year under the bill and the shareholder's adjusted basis in the PFC stock, less the amount of that difference (if any) that represents appreciation during that first taxable year, is treated pursuant to the interest-charge method as having accrued ratably over the shareholder's holding period (ending prior to that first taxable year) in the stock of the PFC.

Both the amount of pre-effective-date appreciation included in gross income (in this case, generally the portion of appreciation treated as having accrued before 1987), and the amount excluded from gross income (but subject to the "deferred tax amount" under the interest-charge method) are treated as an unreversed inclusion for purposes of the application of the mark-to-market method in future years.

In addition, the bill provides an election to defer the payment of tax (similar to the election for qualified electing funds to defer the payment of tax under present law's section 1294) imposed as a result of the recognition of the pre-effective-date gain. Under the bill, this election is treated as terminated to the extent a future mark-to-market loss deduction is allocable to the unreversed inclusion for pre-effective-date appreciation. This election is also terminated to the extent of any distribution received by the shareholder that would be an excess distribution under the interest-charge rules if those rules applied to the stock. In either case, the bill contemplates that regulations will provide rules for determining the appropriate proportion of the deferred tax for which the extension will terminate. As under present law, any direct or indirect loan by the PFC to the shareholder is treated as a distribution for purposes

of determining the extent to which the extension remains in effect. Also, the extension generally is terminated upon disposition of the PFC stock. To the extent provided in regulations, however, a disposition of PFC stock in a nonrecognition transaction does not terminate the extension; rather, the person acquiring the PFC stock succeeds to the transferor's treatment of the PFC stock under the mark-to-market rules.

2. Regulated investment companies are subject to a special transition rule for the PFC stock they hold on the bill's effective date. Instead of applying the interest-charge method to the amount of pre-effective-date appreciation, RICs include the full amount of pre-effective-date appreciation under the mark-to-market method, and pay a separate nondeductible interest charge. No election to defer the payment of tax is available.

3. In the case of a shareholder of a PFC with marketable stock who becomes subject to the tax jurisdiction of the United States as a result of a change in residence or citizenship, no U.S. tax applies under the mark-to-market method or under the interest-charge method to the appreciation of the stock's value prior to the time that the shareholder becomes subject to the tax jurisdiction of the United States. The bill implements this rule by treating the greater of (1) the fair market value of the PFC stock at the time that the shareholder enters U.S. tax jurisdiction, or (2) the shareholder's basis in the PFC stock, as the shareholder's basis in the PFC stock solely for purposes of the mark-to-market method.

Interest-charge method

Nonelecting shareholders [96] of a PFC with stock that is not marketable are subject to the interest-charge method, based on the PFIC interest-charge method that is currently provided in Code section 1291, with certain modifications.

First, although allowable foreign tax credits may reduce a U.S. person's net U.S. tax liability on an excess distribution, the interest charge computed on that excess distribution is computed, under the bill, without regard to reductions in net U.S. tax liability on account of direct foreign tax credits.

The PFIC provisions of present law, to the extent provided in regulations, impose recognition of gain in the case of a transfer of interest-charge PFIC stock in a transaction that would otherwise qualify for the nonrecognition provisions of the Code. The bill imposes that result as a general rule, except as otherwise provided in Treasury regulations. The committee anticipates that under those regulations, nonrecognition provisions may apply to the gain, but only to the extent that the transferee will be subject to the interest-charge method on a subsequent distribution by the PFC or disposition of the PFC stock.

In addition, the bill requires that proper adjustment be made to the basis of property, held by the U.S. person, through which the U.S. person is treated as owning stock in the passive foreign corporation.

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[96] All citizens (and residents) of the United States are included, irrespective of residence in a U.S. commonwealth or possession.

The PFIC provisions of present law apply rules for the attribution of ownership of PFIC stock to U.S. persons, including a rule that attributes PFIC stock owned by a corporation to any person who owns, directly or indirectly, 50 percent or more of the value of the stock of the corporation. Under the bill, the 50-percent threshold applies not only to stock owned directly or indirectly, but also to stock treated as owned by application of the family attribution rules of the personal holding company provisions (sec. 544 (c)(2)).

The PFIC provisions of present law provide special rules for the application of the interest-charge method in the case of PFIC stock held by an U.S. person through an intermediary entity. These rules describe the dispositions that are treated as dispositions of PFIC stock by the U.S. person, and include rules to eliminate the possibility of double taxation (sec. 1297(b)(5)). The bill clarifies that, under regulations, these rules apply to any transaction that results in the U.S. person being treated as no longer owning the PFC stock, as well as any disposition of the PFC stock by the entity actually owning the PFC stock. These rules apply regardless of whether the transaction involves a disposition of the PFC stock, and regardless of whether the parties to the transaction include the U.S. person, the entity actually owning the PFC stock, or some other entity. For example, these rules apply to the issuance of additional stock by an intermediary corporation to an unrelated party in a case where, by increasing the total outstanding stock of the intermediary corporation, the transaction causes the U.S. person to fall below the ownership threshold for indirect ownership of the PFC stock. The bill also clarifies that an income inclusion under the interest-charge method takes precedence over an income inclusion under subpart F resulting from the same disposition. The second clarification ensures that the interest charge is imposed without regard to the structure of the transaction.

Under the bill, the interest-charge method applies to any stock in a passive foreign corporation unless either the stock is marketable (and therefore the mark-to-market method applies) as of the time of the distribution or disposition involved, or the stock in the passive foreign corporation was subject to the current inclusion method (under the bill or under prior law) for each taxable year beginning after December 31, 1986 which includes any portion of the taxpayer's holding period in the PFC stock. In the event that PFC stock, not subject to the current inclusion method, becomes marketable during the taxpayer's holding period, the interest-charge method applies to any distributions and dispositions during the year in which the stock becomes marketable, as well as to the mark-to-market gain (if any) as of the close of that year. In the event that PFC stock was initially marketable, and later becomes unmarketable and subject to the interest-charge method, the taxpayer's holding period in the PFC stock for purposes of the interest-charge method is treated as beginning on the first day of the first taxable year beginning after the last taxable year for which the mark-to-market method applies to the taxpayer's stock in the PFC.

Under the bill, as under the present-law PFIC rules, stock in a foreign corporation generally is treated as PFC stock if, at any time during the taxpayer's holding period of that stock, the foreign

corporation (or any predecessor) is a passive foreign corporation subject to the interest-charge method (current sec. 1297(b)(1)). (This rule is sometimes referred to as the "once-a-PFIC-always-a-PFIC" rule.) Under present law this rule generally does not affect a taxpayer holding stock in a foreign corporation if at all times during the holding period of the taxpayer with respect to the stock when the foreign corporation (or any predecessor) is a PFIC, qualified electing fund treatment applies with respect to the taxpayer. Under the bill, the similar once-a-PFC-always-a-PFC rule does not apply if during the taxpayer's entire holding period with respect to the stock when the foreign corporation (or any predecessor) is a PFC, either (a) mark-to-market treatment applies, (b) mandatory current inclusion of income applies (either because the corporation is U.S. controlled or because the taxpayer is a 25-percent shareholder), or (c) elective current inclusion of income applies.[97] Thus, for example, a shareholder of a controlled foreign corporation is subject to current inclusion with respect to all the corporation's income in any year for which the corporation is a PFC, but is subject to current inclusion only to the extent provided under subpart F in any year for which the controlled foreign corporation is not a PFC.

The bill also provides for full basis adjustment for partnerships and S corporations that own stock in a passive foreign corporation subject to the interest-charge method. Although tax is imposed on a distribution or disposition under the interest-charge method without including the distribution or disposition in gross income, thus precluding the natural basis adjustments for amounts included in gross income, the bill grants regulatory authority for appropriate basis adjustments to partnerships and S corporations based on the amount of income subject to tax under the interest-charge method and thereby excluded from gross income.

The bill includes a broad grant of regulatory authority, as does the present-law PFIC statute. In addition, the bill specifies that necessary or appropriate regulations under the PFC rules may include regulations providing that gross income should be determined without regard to the operation of the interest-charge method for such purposes as may be specified in the regulations. Such regulations may relieve pressure on many aspects of the Code that result from the operation of the interest-charge method other than through gross income. In addition, the bill specifies that necessary or appropriate PFC regulations may include regulations dealing with changes in residence status or citizenship by shareholders in passive foreign corporations (e.g., a resident alien becoming a nonresident, or a nonresident U.S. citizen renouncing U.S. citizenship). The committee intends that no inference be drawn from this explicit regulatory authority as to the Secretary's author-

[97] In the case of a PFC that was a PFIC prior to the effective date of the bill, even if the PFC is subject to either mark-to-market treatment or mandatory current inclusion, the once-a-PFC-always-a-PFC rule applies unless the PFIC was subject to elective current inclusion for the entire portion of the taxpayer's holding period prior to the effective date of the bill. In the case of a PFC that was *not* a PFIC prior to the effective date of the bill, the application of the once-a-PFC-always-a-PFC rule is determined without regard to the portion of the taxpayer's holding period prior to the effective date of the bill.

ity to issue similar regulations under the authority of the PFIC provisions of present law.

Modification or repeal of other antideferral regimes

While the bill includes in the passive foreign corporation rules most of the provisions that it preserves from the present-law PFIC, foreign personal holding company, and foreign investment company regimes, the bill modifies subpart F in one respect to reflect a present-law provision of the foreign personal holding company rules (sec. 553(a)(5)). The bill treats as foreign personal holding company income for subpart F purposes an amount received under a personal service contract if a person other than the corporation has the right to designate (by name or by description) the individual who is to perform the services, or if the individual who is to perform the services is designated (by name or by description) in the contract. The bill similarly treats as foreign personal holding company income for subpart F purposes any amount received from the sale or distribution or disposition of such a contract. This rule applies only if at some time during the taxable year 25 percent or more of the value of the corporation's stock is owned (directly, indirectly, or constructively) by or for the individual who may be designated to perform the services.[98] Income from such personal service contracts is not, however, treated as passive for foreign tax credit purposes.

The bill repeals the foreign personal holding company provisions, the PFIC provisions (except as modified and preserved as the passive foreign corporation provisions), and the foreign investment company provisions. The bill also excludes all foreign corporations from the application of the accumulated earnings tax and the personal holding company tax. The committee understands that the purposes of all the anti-deferral regimes are adequately served by the passive foreign corporation provisions as set forth in the bill, in conjunction with the controlled foreign corporation provisions as modified by the bill.

In addition, the bill denies installment sales treatment for any installment obligation arising out of a sale of stock in a passive foreign corporation that is subject to the interest-charge regime.

As a conforming amendment to the special rules applicable to RICs holding PFC stock, the bill confirms that the income of a RIC from either a controlled foreign corporation or a PFC, which income is derived from the active conduct of the business of investing in stocks or securities, is a type of income that counts toward meeting the 90-percent investment income test of section 851(b)(2).

In addition, as a conforming amendment to the elimination of the present-law PFIC rules, distributions from a PFC of amounts that previously were included in a shareholder's income under the elective current-inclusion rules of present law are treated, under the bill, as previously taxed income under the subpart F rules (sec. 959).

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[98] This rule was included in the definition of foreign personal holding company income for purposes of subpart F prior to the amendments included in the 1986 Act.

Effective Date

The bill generally is effective for taxable years of U.S. persons beginning after December 31, 1992, and taxable years of foreign corporations ending with or within such taxable years of U.S. persons.

The denial of installment sales treatment is effective for sales or dispositions after December 31, 1992.

The bill does not affect the determination of the basis of any stock that was acquired from a decedent in a taxable year beginning before January 1, 1993.

2. Treatment of Controlled Foreign Corporations (secs. 4411-4413 of the bill and secs. 951, 952, 959, 960, 961, 964, and 1248 of the Code)

Present Law

Treatment of controlled foreign corporation earnings

In general

A U.S. shareholder generally treats dividends from a controlled foreign corporation as ordinary income from foreign sources that carries both direct and indirect foreign tax credits. Under look-through rules, the income and credits are subject to those foreign tax credit limitations which are consistent with the character of the income of the foreign corporation.

Several Code provisions result in similar tax treatment of a U.S. shareholder if it either disposes of the controlled foreign corporation stock, or the controlled foreign corporation realizes certain types of income (including income with respect to lower-tier controlled foreign corporations). First, under section 1248, gain resulting from the disposition by a U.S. person of stock in a foreign corporation that was a controlled foreign corporation with respect to which the U.S. person was a U.S. shareholder in the previous five years is treated as a dividend to the extent of allocable earnings.

Second, a controlled foreign corporation has subpart F income when it realizes gain on disposition of stock and, ordinarily, when it receives a dividend. Under sections 951 and 960, such subpart F income may result in taxation to the U.S. shareholder similar (but not identical) to that on a dividend from the controlled foreign corporation. In addition to provisions for characterizing income and credits in these situations, the Code also provides certain rules that adjust basis, or otherwise result in modifying the tax consequences of subsequent income, to account for these and other subpart F income inclusions.

Third, when in exchange for property any corporation (including a controlled foreign corporation) acquires stock in another corporation (including a controlled foreign corporation) controlled by the same persons that control the acquiring corporation, earnings of the acquiring corporation (and possibly the acquired corporation) may be treated under section 304 as having been distributed as a dividend to the seller.

For foreign tax credit separate limitation purposes, a controlled foreign corporation is not treated as a noncontrolled section 902

corporation with respect to any distribution out of its earnings and profits for periods during which it was a controlled foreign corporation and except as provided in regulations, the recipient of the distribution was a U.S. shareholder in such corporation. The consequence of not being treated as a section 902 corporation is application of the so-called "look-through" rule. That is, dividends paid by such controlled foreign corporation to its U.S. shareholder are characterized for separate limitation purposes by reference to the character of the underlying earnings of the controlled foreign corporation.

Lower-tier controlled foreign corporations

For purposes of applying the separate foreign tax credit limitations, receipt of a dividend from a lower-tier controlled foreign corporation by an upper-tier controlled foreign corporation may result in a subpart F income inclusion for the U.S. shareholder that is treated as income in the same limitation category as the income of the lower-tier controlled foreign corporation. The income inclusion of the U.S. shareholder may carry deemed-paid credits for foreign taxes paid by the lower-tier controlled foreign corporation, and the basis of the U.S. shareholder in the stock of the first-tier controlled foreign corporation is increased by the amount of the inclusion. If, on the other hand, the upper-tier controlled foreign corporation sells stock of a lower-tier controlled foreign corporation, then the gain generally is also included in the income of the U.S. shareholder as subpart F income and the U.S. shareholder's basis in the stock of the first-tier controlled foreign corporation is increased to account for the inclusion, but the inclusion is not treated for foreign tax credit limitation purposes by reference to the nature of the income of the lower-tier controlled foreign corporation. Instead it generally is treated as passive income.

If subpart F income of a lower-tier controlled foreign corporation is included in the gross income of a U.S. shareholder, no provision of present law allows adjustment of the basis of the upper-tier controlled foreign corporation's stock in the lower-tier controlled foreign corporation.

Subpart F inclusions in year of disposition

The subpart F income earned by a foreign corporation during its taxable year is taxed to the persons who are U.S. shareholders of the corporation on the last day, in that year, on which the corporation is a controlled foreign corporation. In the case of a U.S. shareholder who acquired stock in a controlled foreign corporation during the year, such inclusions are reduced by all or a portion of the amount of dividends paid in that year by the foreign corporation to any person other than the acquirer with respect to that stock. The reduction is the lesser of the amount of dividends with respect to such stock received by other persons during the year or the amount determined by multiplying the subpart F income for the year by the proportion of the year during which the acquiring shareholder did not own the stock.

Distributions of previously taxed income

If in a year after the year of a subpart F income inclusion, a U.S. shareholder in the controlled foreign corporation receives a distribution from the corporation, the distribution may be deemed to come first out of the corporation's previously taxed income and, therefore, may be excluded from the U.S. shareholder's income. However, a distribution by a foreign corporation to a domestic corporation of earnings and profits previously taxed under subpart F is treated as an actual dividend, solely for purposes of determining the indirect foreign tax credit available to the domestic corporation (sec. 960(a)(3)).

In addition, the domestic corporation is permitted to increase its foreign tax credit limitation in the year of the distribution of previously taxed earnings and profits in an amount equal to the excess of the amount by which its foreign tax credit limitation for the year of the subpart F inclusion was increased as a result of that inclusion, over the amount of foreign taxes which were allowable as a credit in that year and which would not have been so allowable but for the subpart F inclusion (sec. 960(b)). The increase in the foreign tax credit limitation may not, however, exceed the amount of the foreign taxes taken into account under this provision with respect to the distribution of previously taxed earnings and profits. In order for this rule to apply, the domestic corporation either must have elected to credit foreign taxes in the year of the subpart F inclusion or must not have paid or accrued any foreign taxes in such year, and it must elect the foreign tax credit in the year of the distribution of previously taxed earnings and profits.

Treatment of United States source income earned by a controlled foreign corporation

As a general rule, subpart F income does not include income earned from sources within the United States if the income is effectively connected with the conduct of a U.S. trade or business by the controlled foreign corporation. This general rule does not apply, however, if the income is exempt from, or subject to a reduced rate of, U.S. tax pursuant to a provision of a U.S. treaty.

Reasons for Change

The committee believes that complexities have been caused by uncertainties and gaps in the statutory schemes for taxing gains on dispositions of stock in controlled foreign corporations as dividend income or subpart F income. These uncertainties and gaps may prompt taxpayers to refrain from behavior that would otherwise be the result of rational business decisions, for fear of excessive tax—for example, double corporate-level taxation of income. In many cases, concerns about excessive taxation can be allayed, but only at the cost of avoiding the simpler and more rational economic behavior in favor of tax-motivated planning.

The committee understands that, as a general matter, other aspects of the tax system may have interfered with rational economic decision making by prompting taxpayers to engage in tax-motivated planning in order to eliminate taxation in cases where income is in fact earned. Some such characteristics of the tax system have in

the past been altered by Congress in order to reduce excessive interference by the tax system in labor, investment, and consumption decisions of taxpayers.[99] The committee believes that in the context of tax simplification, it generally is appropriate to reduce complexities caused by aspects of the rules governing controlled foreign corporations that provide for nonuniform tax results from dividends, on the one hand, and stock disposition proceeds to the extent earnings and profits underlie those proceeds, on the other.

In light of the bill's provisions extending section 1248 treatment to dispositions of stock in lower-tier companies, the committee believes it appropriate to repeal the limitation on look-through treatment (for foreign tax credit separate limitation purposes) of dividends from controlled foreign corporations to U.S. shareholders out of earnings from periods in which the payor was a controlled foreign corporation but the dividend recipient was not a U.S. shareholder of the controlled foreign corporation. By extending section 1248 treatment to dispositions of stock in lower-tier companies, the committee believes that earnings and profits (and related foreign tax credits) of lower-tier controlled foreign corporations cannot readily be transferred from the control of one U.S taxpayer to another. Moreover, the committee believes that repeal of this limitation on look-through treatment will avoid significant complexity that would otherwise be engendered by practical application of the limitation.

The committee understands that the present-law provisions which permit an indirect foreign tax credit and an increased foreign tax credit limitation to be claimed in the event of a distribution of previously taxed earnings by a controlled foreign corporation are particularly difficult to administer. This difficulty arises because taxpayers are required to compute and keep track of excess foreign tax credit limitation accounts with respect to subpart F income inclusions on a foreign corporation by foreign corporation basis, as well as on a year by year basis. Additional complexities arise as taxpayers are required, as a result of distributions, to trace earnings and profits up chains of foreign corporations. The committee believes that affording regulatory authority to modify and simplify these rules may result in alleviating some of the system-wide recordkeeping and computations involved, without undermining the operation of the provision.

Explanation of Provisions

In general

The bill makes a number of modifications in the treatment of income derived from the disposition of stock in a controlled foreign corporation. The bill provides deemed dividend treatment for gains on dispositions of lower-tier controlled foreign corporations. Where the lower-tier controlled foreign corporation previously earned subpart F income, the bill permits the amount of gain taxed to the U.S. shareholder to be adjusted for previous income inclusions. Where proceeds from the sale of stock to a controlled foreign corpo-

[99] See, e.g., Staff of the Joint Committee on Taxation, 100th Cong., 1st Sess. *General Explanation of the Tax Reform Act of 1986* at 6 et seq. (1987) ("General Reasons For The Act").

ration that previously has earned subpart F income would be treated as a dividend under the principles of section 304, the bill expressly permits exclusion of the deemed section 304 dividend from taxation to the extent of the previously taxed earnings and profits of the controlled foreign corporation from which the property was deemed to be distributed. (Appropriate basis adjustments also are permitted to be made.) Where a controlled foreign corporation (whether or not it is a lower-tier controlled foreign corporation) earns subpart F income in a year in which a U.S. shareholder sells its stock, in a transaction that does not result in the foreign corporation ceasing to be a controlled foreign corporation, the bill contains statutory language providing for a proportional reduction in the taxation of the subpart F income in that year to the acquiring U.S. shareholder.

The bill contains three additional provisions related to controlled foreign corporations. First, the bill repeals the limitation on look-through treatment (for foreign tax credit separate limitation purposes) of dividends from controlled foreign corporations to U.S. shareholders out of earnings from periods in which the payor was a controlled foreign corporation, but the dividend recipient was not a U.S. shareholder of the controlled foreign corporation. Second, the bill provides regulatory authority to develop a simplified mechanism for computing indirect foreign tax credits and increases in foreign tax credit limitations resulting upon certain distributions by controlled foreign corporations of previously taxed earnings and profits. Third, the bill clarifies the effect of a treaty exemption or reduction of the branch profits tax on the determination of subpart F income.

Lower-tier controlled foreign corporations

Characterization of gain on stock disposition

The bill provides that if a controlled foreign corporation is treated as having gain from the sale or exchange of stock in a foreign corporation, the gain is treated as a dividend to the same extent that it would have been so treated under section 1248 if the controlled foreign corporation were a U.S. person. This provision, however, does not affect the determination of whether the corporation whose stock is sold or exchanged is a controlled foreign corporation.

Thus, for example, if a U.S. corporation owns 100 percent of the stock of a foreign corporation, which owns 100 percent of the stock of a second foreign corporation, then under the bill, any gain of the first corporation upon a sale or exchange of stock of the second corporation is treated as a dividend for purposes of subpart F income inclusions to the U.S. shareholder, to the extent of earnings and profits of the second corporation attributable to periods in which the first foreign corporation owned the stock of the second foreign corporation while the latter was a controlled foreign corporation with respect to the U.S. shareholder.

As another example, assume that the U.S. corporation has always owned 40 percent of the voting stock and 60 percent of the value of all of the stock of a foreign corporation, which has always owned 40 percent of the voting stock and 60 percent of the value of

all of the stock of a second foreign corporation. All the other stock of the foreign corporations has always been owned by foreign individuals unrelated to the U.S. corporation. In this case, the second foreign corporation has never been a controlled foreign corporation. Therefore, none of the gain of the first corporation upon a sale of stock of the second corporation is treated as a dividend.

Gain on disposition of stock in a related corporation created or organized under the laws of, and having substantial part of assets in a trade or business in, the same foreign country as the gain recipient, even if recharacterized as a dividend under the bill, is not therefore excluded from foreign personal holding company income under the same-country exception that applies to actual dividends.

The bill provides that for purposes of this provision, a controlled foreign corporation is treated as having sold or exchanged stock if, under any provision of subtitle A of the Code, the controlled foreign corporation is treated as having gain from the sale or exchange of such stock. Thus, for example, if a controlled foreign corporation distributes to its shareholder stock in a foreign corporation, and the distribution results in gain being recognized by the controlled foreign corporation under section 311(b) as if the stock were sold to the shareholder for fair market value, the bill makes clear that for purposes of this provision, the controlled foreign corporation is treated as having sold or exchanged the stock.

The bill also repeals a provision added to the Code by the Technical and Miscellaneous Revenue Act of 1988 [100] (the "1988 Act") which, except as provided by regulations, requires a recipient of a distribution from a controlled foreign corporation to have been a United States shareholder of that controlled foreign corporation for the period during which the earnings and profits which gave rise to the distribution were generated in order to avoid treating the distribution as one coming from a noncontrolled section 902 corporation. Thus, under the bill, a controlled foreign corporation is not treated as a noncontrolled section 902 corporation with respect to any distribution out of its earnings and profits for periods during which it was a controlled foreign corporation, whether or not the recipient of the distribution was a U.S. shareholder of the corporation when the earnings and profits giving rise to the distribution were generated.

Adjustments to basis of stock

The bill also provides that when a lower-tier controlled foreign corporation earns subpart F income, and stock in that corporation is later disposed of by an upper-tier controlled foreign corporation, the resulting income inclusion of the U.S. shareholders are, under regulations, adjusted to account for previous inclusions, in a manner similar to the adjustments currently provided to the basis of stock in a first-tier controlled foreign corporation. Thus, just as the basis of a U.S. shareholder in a first-tier controlled foreign corporation rises when subpart F income is earned and falls when previously taxed income is distributed, so as to avoid double taxation of the income on a later disposition, it is intended that by regula-

[100] P.L. 100-647, sec. 1012(a)(10).

tion the subpart F income from gain on the disposition of a lower-tier controlled foreign corporation generally would be reduced by income inclusions of earnings that were not subsequently distributed by the lower-tier controlled foreign corporation. The committee intends that the Secretary will have sufficient flexibility in promulgating regulations under this provision to permit adjustments only in those cases where, by virtue of the historical ownership structure of the corporations involved, the Secretary is satisfied that the inclusions for which adjustments can be made can be clearly identified.

For example, assume that a U.S person is the owner of all of the stock of a first-tier controlled foreign corporation which, in turn, is the sole shareholder of a second-tier controlled foreign corporation. In year 1, the second-tier controlled foreign corporation earns $100 of subpart F income which is included in the U.S. person's gross income for that year. In year 2, the first-tier controlled foreign corporation disposes of the second-tier controlled foreign corporation's stock and recognizes $300 of income with respect to the disposition. All of that income would constitute subpart F foreign personal holding company income. Under the bill, the Secretary is granted regulatory authority to reduce the U.S. person's year 2 subpart F inclusion by $100—the amount of year 1 subpart F income of the second-tier controlled foreign corporation that was included, in that year, in the U.S. person's gross income. Such an adjustment would, in effect, allow for a step-up in the basis of the stock of the second-tier controlled foreign corporation to the extent of its subpart F income previously included in the U.S. person's gross income.

As another example, assume the same facts as in the preceding paragraph except that in year 2, the first-tier controlled foreign corporation distributes the stock of the second-tier controlled foreign corporation to the U.S. person. Assume that as a result of the distribution, the first-tier controlled foreign corporation recognizes taxable income of $300 under section 311(b). This income represents subpart F income, $100 of which is due to no adjustment having been made to the basis of the second-tier controlled foreign corporation's stock for its year 1 subpart F income. The bill contemplates that in such a situation, the $300 of subpart F income would be reduced under regulations to $200 to account for the year 1 subpart F income inclusion.

Subpart F inclusions in year of disposition

If a U.S. shareholder acquires the stock of a controlled foreign corporation from another U.S. shareholder during a taxable year of the controlled foreign corporation in which it earns subpart F income, the bill reduces the acquirer's subpart F inclusion for that year by a portion of the amount of the dividend deemed (under sec. 1248) to be received by the transferor. The portion by which the inclusion is reduced (as is currently the case if a dividend was paid to the previous owner of the stock) would not exceed the lesser of the amount of dividends with respect to such stock deemed received (under sec. 1248) by other persons during the year or the amount determined by multiplying the subpart F income for the year by the proportion of the year during which the acquiring shareholder did not own the stock.

Avoiding double inclusions in other cases

The bill clarifies the appropriate scope of regulatory authority with respect to the treatment of cross-chain section 304 dividends out of the earnings of controlled foreign corporations that were previously included in the income of a U.S. shareholder under subpart F. The bill contemplates that in such a case, the Secretary in his discretion may by regulation treat such dividends as distributions of previously taxed income, with appropriate basis adjustments. The committee also anticipates that other occasions may arise where the exercise of similar regulatory authority may be appropriate to avoid double income inclusions, or an inclusion or exclusion of income without a corresponding basis adjustment. Therefore, the bill states that, in addition to cases involving section 304, the Secretary may by regulation modify the application of subpart F in any other case where there would otherwise be a multiple inclusion of any item of income (or an inclusion or exclusion without an appropriate basis adjustment) by reason of the structure of a U.S. shareholder's holdings in controlled foreign corporations or by reason of other circumstances. The bill is not intended to create any inference as to the application of present law in these cases.

Foreign tax credit in year of receipt of previously taxed income

With respect to the present-law provisions which permit a foreign tax credit to be claimed in the case of a distribution of previously taxed income, the bill provides authority for Treasury regulations to establish a simplified method for computing the increase in foreign tax credit limitation that results from the application of these provisions. The committee understands that the Secretary has regulatory flexibility in the determination of the amount of creditable foreign taxes on or with respect to the accumulated earnings and profits of a foreign corporation from which a distribution of previously taxed income is made, which were not deemed paid by the domestic corporation in a prior taxable year.

The bill makes clear that the regulations may require taxpayers to use any simplified methods so established, rather than making the use of such methods elective by taxpayers. The bill does not mandate, however, that regulations provide such simplified methods, or in the case that such methods are provided, that they be made uniformly applicable to all taxpayers.

For example, in certain situations the Treasury Secretary might deem it appropriate not to require taxpayers to trace specific items of previously taxed income of specific controlled foreign corporations and to associate those items with specific amounts of excess foreign tax credit limitation. Rather, regulations might allow for some sort of simplified approach for accounting for excess limitation amounts (allocated to the various foreign tax credit separate limitation categories from which they originally arose) and for utilization of portions of these amounts upon distributions of previously taxed income from the same categories.

Treatment of United States income earned by a controlled foreign corporation

The bill provides that an exemption or reduction by treaty of the branch profits tax that would be imposed under section 884 on a controlled foreign corporation does not affect the general statutory exemption from subpart F income that is granted for U.S. source effectively connected income. For example, assume a controlled foreign corporation earns income of a type that generally would be subpart F income, and that income is earned from sources within the United States in connection with business operations therein. Further assume that repatriation of that income is exempted from the U.S. branch profits tax under a provision of an applicable U.S. income tax treaty. The bill provides that, notwithstanding the treaty's effect on the branch tax, the income is not treated as subpart F income as long as it is not exempt from U.S. taxation (or subject to a reduced rate of tax) under any other treaty provision.

Effective Dates

Lower-tier controlled foreign corporations

The provision of the bill treating gains on dispositions of stock in lower-tier controlled foreign corporations as dividends under section 1248 principles applies to gains recognized on transactions occurring after date of enactment of the bill. The provision of the bill that expands look-through treatment, for foreign tax credit limitation purposes, of dividends from controlled foreign corporations, is effective for distributions after the date of the bill's enactment.

The bill's provision providing for regulatory adjustments to U.S. shareholder inclusions, with respect to gains of controlled foreign corporations from dispositions of stock in lower-tier controlled foreign corporations that previously had subpart F income, is effective for determining inclusions for taxable years of U.S. shareholders beginning after December 31, 1992. Thus, the bill permits regulatory adjustments to an inclusion occurring after the effective date to account for previous subpart F income inclusions occurring both prior to and subsequent to the effective date of the provision.

Subpart F inclusions in year of disposition

The provision of the bill permitting dispositions of stock to be taken into consideration in determining a U.S. shareholder's subpart F inclusion for a taxable year is effective with respect to dispositions occurring after the date of enactment of the bill.

Distributions of previously taxed income

The provision of the bill allowing the Secretary to make regulatory adjustments to avoid double inclusions in cases such as those to which section 304 applies takes effect on the date the bill is enacted.

Foreign tax credit in year of receipt of previously taxed income

The provision of the bill granting regulatory authority to establish simplified methods for determining the amount of increase in foreign tax credit limitation resulting from a distribution of previ-

ously taxed income is effective as of the date of enactment of the bill.

Treatment of United States source income earned by a controlled foreign corporation

The provision of the bill concerning the effect of treaty exemptions from or reductions of the branch profits tax on the determination of subpart F income is effective for taxable years beginning after December 31, 1986.

3. Translation of foreign taxes into U.S. dollar amounts (sec. 4421 of the bill and secs. 905(c) and 986(a) of the Code)

Present Law

Translation of foreign taxes

Foreign income taxes paid in foreign currencies are required to be translated into U.S. dollar amounts using the exchange rate as of the time such taxes are paid to the foreign country or U.S. possession (sec. 986(a)(1)). This rule applies equally to foreign taxes paid directly by U.S. taxpayers, which are creditable only in the year paid or accrued (or during a carryover period), and to foreign taxes paid by foreign corporations that are deemed paid by a U.S. corporation, and hence creditable, in the year that the U.S. corporation receives a dividend or income inclusion.

Redetermination of foreign taxes

For taxpayers who utilize the accrual basis of accounting for determining creditable foreign taxes, accrued and unpaid foreign tax liabilities denominated in foreign currencies are translated into U.S. dollar amounts at the exchange rate as of the last day of the taxable year of accrual.[101] In certain cases where a difference exists between the dollar value of accrued foreign taxes and the dollar value of those taxes when paid, a redetermination (or adjustment) of foreign taxes is required.[102] Generally, such an adjustment may be attributable to one of three causes. One such cause would be a refund of foreign taxes. Second, a foreign tax redetermination may be required because the amount of foreign currency units actually paid differs from the amount of foreign currency units accrued. These first two cases generally give rise to a so-called "section 905(c) regular adjustment." Third, a redetermination may arise due to fluctuations in the value of the foreign currency relative to the dollar between the date of accrual and the date of payment giving rise to a so-called "section 905(c) translation adjustment."

As a general matter, a redetermination of foreign tax paid or accrued directly by a U.S. person requires notification of the Internal Revenue Service and a redetermination of U.S tax liability for the taxable year for which the foreign tax was claimed as a credit. Exceptions to this rule apply for de minimis amounts of foreign tax redeterminations.[103] In the case of redeterminations of foreign

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[101] Temp. Treas. Reg. sec. 1.905-3T(b)(1).
[102] Temp. Treas. Reg. sec. 1.905-3T(c).
[103] Temp. Treas. Reg. sec. 1.905-3T(d)(1).

taxes that qualify for the deemed-paid foreign tax credit under sections 902 and 960, taxpayers generally are required to make appropriate adjustments to the pools of earnings and profits and foreign taxes.[104]

Reasons for Change

If each foreign income tax payment is required to be translated at a separate daily exchange rate for the day of the payment, the number of currency exchange rates that are relevant to foreign tax credit calculations varies directly with the frequency of foreign income tax payments. Where U.S. corporations are deemed to pay a portion of the "pool" of foreign taxes paid by foreign corporations, the correct amount of tax in the pool is the product of each tax payment times the relevant translation rate. The longer the period between the time the income is earned and the time it is repatriated to the U.S. corporation (or otherwise included in the U.S. corporation's income), the greater the period over which the amounts of tax payments and translation rates are relevant to the determination of net U.S. tax liability.

The committee believes that the recordkeeping, verification, and examination burdens—both on the IRS and on taxpayers—associated with the advantages of deferral and the foreign tax credit (including the indirect credit) are not insignificant. For example, if events that happened in one year affected only the return filed for that year, and each tax return was affected only by events that happened in the year for which that return was filed, then presumably tax-related records would need to be maintained only between the time the taxable year began and the year that the assessment period for that year expired. On the other hand, for example, if income earned in years 1 through 5 is taxed in year 6, then the amount of documentation relevant to the year-6 return potentially is increased five-fold, and the period over which that information must be maintained is at least five years longer.

U.S. persons who pay foreign income taxes directly and choose the benefits of the foreign tax credit have always been required to maintain detailed foreign tax payment documentation, including exchange rate data for the dates on which they paid foreign income taxes, and U.S. corporations that operate through foreign corporations have been required to maintain documentation regarding the earnings and foreign tax payments of the foreign corporations.[105] Some have argued, however, that relief is warranted for taxpayers that would otherwise bear the combined currency translation responsibilities applicable to direct foreign taxpayers with the extended recordkeeping responsibilities applicable to taxpayers that receive the benefits of deferral.

The committee believes that an appropriate response to this combination of burdens is to permit regulatory modification of the "time of payment" concept, in such a way that preserves the uniformity of treatment of branches and foreign subsidiaries of U.S.

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[104] Temp. Treas. Reg. sec. 1.905-3T(d)(2); Notice 90-26, 1990-1 C.B. 336.

[105] Also, note that in *Commissioner v. American Metal Co.*, 221 F.2d 134,141 (2d. Cir.), *cert. denied*, 350 U.S. 879 (1955), where a foreign corporation kept its books in U.S. dollars, foreign taxes were translated as of their payment date.

taxpayers, but permits recourse to reasonably accurate average translation rates for the period in which the tax payments are made. Simplification may be provided in this way by reducing, sometimes substantially, the number of translation calculations that are required to be made. There may be situations in which the use of an average exchange rate over a specified time period, to be applied to all tax payments made in that currency during that period, would provide results not substantially different than those that would be derived under present law. This could result, for example, where the value of a foreign currency as it relates to the U.S. dollar does not fluctuate significantly over the specified period.

In addition, the committee believes that in certain cases, taxpayers who are on the accrual basis of accounting for purposes of determining creditable foreign taxes should be permitted to translate those taxes into U.S. dollar amounts in the year to which those taxes relate, and should not be required to make adjustments or redeterminations to those translated amounts, if actual tax payments are made—within a reasonably short period of time—after the close of such year. Moreover, the committee believes that it is appropriate to mandate the use of an average exchange rate for the taxable year with respect to which such foreign taxes relate for purposes of translating those taxes. On the other hand, the committee believes that a foreign tax not paid within a reasonably short period after the close of the year to which the taxes relate should not be treated as a forcign tax for such year; in such a case permitting the foreign tax credit for that year is less a mechanism for preventing double taxation, and more one resulting in the avoidance of all tax. By drawing a bright line between those foreign tax payment delays that do and do not require a redetermination, the committee believes that a reasonable degree of certainty and clarity will be added to the law in this area. The committee anticipates that in most cases, the combination of translating accrued taxes in this manner and exempting certain translation differences from redetermination should significantly alleviate present-law complexities, but should not provide results that are materially different from those that would appropriately be reached under present law.

One of the fundamental premises behind the amendments enacted in 1986 with respect to the translation of foreign taxes was that foreign taxes paid by foreign corporations should be translated in the same manner as foreign taxes paid by foreign branches of U.S. persons. In keeping with that premise, the committee believes that any provision to allow the use of average exchange rates for this purpose or to allow for translation in years to which accrued taxes relate should be made equally applicable to foreign branches and subsidiaries.

Explanation of Provision

In general

The bill sets forth two sets of operating rules for the translation of foreign taxes. The first set establishes new rules for the transla-

tion of certain accrued foreign taxes. The other set modifies the rules of present law for translating all other foreign taxes.

Translation of foreign taxes

Translation of certain accrued foreign taxes

With respect to taxpayers who take foreign income taxes into account when accrued for purposes of determining the foreign tax credit, the bill generally permits foreign taxes to be translated at the average exchange rate for the taxable year to which such taxes relate. If tax in excess of the accrued amount is actually paid, such excess amount would be translated using the exchange rate in effect as of the time of payment.

This set of rules does not apply (1) to taxpayers that are not on the accrual basis for determining creditable foreign taxes, (2) with respect to taxes of an accrual-basis taxpayer that are actually paid in a taxable year prior to the year to which they relate, or (3) to the extent provided in regulations, to tax payments denominated in a currency determined to be an inflationary currency in accordance with such regulations. The committee intends that the Secretary will have discretion to define "inflationary" for this purpose so as to take into account the particular need under this provision to avoid distortions in the computation of the foreign tax credit. In addition, as discussed in detail below, this set of rules does not apply to, and thus a redetermination of foreign tax is required for, any foreign income tax paid after the date two years after the close of the taxable year to which such taxes relate.

For example, assume that in year 1 a taxpayer accrues 1,000 units of foreign tax that relate to year 1. Further assume that as of the end of year 1 the tax is unpaid and the currency involved is not treated as inflationary by the Secretary for translation purposes. In this case, the bill provides that the taxpayer would translate 1,000 units of accrued foreign tax into U.S. dollars at the average exchange rate for year 1.[106] If the 1,000 units of tax were paid by the taxpayer in either year 2 or year 3, no redetermination of foreign tax would be required. If, any portion of the tax so accrued remained unpaid as of the end of year 3, however, the taxpayer would be required to redetermine its foreign tax accrued in year 1 to account for the accrued but unpaid tax.

As another example, assume a taxpayer accrues 1,000 units of foreign tax in year 2, but pays the tax in year 1. Also assume that the tax relates to year 2. In this case, the taxpayer would translate the tax using the exchange rate as of the time the tax is paid (i.e., using the applicable year 1 exchange rate) since the tax is paid in a year prior to the year to which it relates.

As an illustration of what is meant by the taxable year to which taxes relate, assume that a foreign corporation is charged by a foreign government with an income tax of 100 units for 1993. Assume that the currency involved is not treated as inflationary by the Secretary for translation purposes under the bill. Due to a contest between the foreign government and the corporation that ends in

[106] The same result would occur if the 1,000 units of tax were both accrued and paid in year 1.

1994, the 100 units of tax are not paid until 1994. Assume that under the U.S. rules governing accrual, the foreign tax accrues *for* 1993 but does not do so *until* 1994.[107] Under the bill, the taxes will be translated at the rate in effect for 1993, because the taxes relate to 1993, even though they did not accrue until 1994. If instead the contest was over, and the taxes were accrued and paid, in 1998, the translation rate used would be that of 1998, rather than 1993 because 1998 is more than 2 years after the end of 1993. Now assume that the contest was over in 1998, but the taxes were deposited in 1994 and not accrued until 1998. These taxes are paid before the beginning of the year in which the taxes were accrued (1998), but after the year to which the taxes relate (1993). Thus, under the bill, the taxes may be translated at the rate for the year (1993) to which the taxes relate. If the taxes are instead paid in 1996, under the bill they will be translated at the relevant rate for 1996 because 1996 is more than 2 years after the end of 1993.

Finally, assume that under foreign law, a foreign income tax liability accrues in 1998 under a long-term contract method of accounting, but advance deposits of that liability accruing in 1998 are made in each of the years 1993 through 1997. The committee intends that if the payments in 1993 through 1997 are treated as relating to 1998, these payments are nevertheless to be translated at the relevant rates for 1993 through 1997. Although the bill provides a rule for translation of the taxes in this case, no change is intended as to the application of present law accounting rules determining the year for which the taxes are eligible for credit or deduction for U.S. income tax purposes.

Translation of all other foreign taxes

Foreign taxes not eligible for application of the preceding rules generally are translated into U.S. dollars using the exchange rates as of the time such taxes are paid. The bill grants the Secretary of the Treasury authority to issue regulations that would allow foreign tax payments made by a foreign corporation or by a foreign branch of a U.S. person to be translated into U.S. dollar amounts using an average U.S. dollar exchange rate for a specified period. The committee anticipates that the applicable average exchange rate would be the rate as published by a qualified source of exchange rate information for the period during which the tax payments were made.

Redetermination of foreign taxes

As revised by the bill, section 905(c) requires foreign tax redeterminations to occur in three cases: (1) if accrued taxes when paid (in foreign currency) differ from the amounts claimed (in foreign currency) as credits by the taxpayer, (2) if accrued taxes are not paid before the date two years after the close of the taxable year to which such taxes relate, and (3) if any tax paid is refunded in whole or in part. Thus, for example, the bill provides that if at the close of the second taxable year after the close of the accrual year any tax so accrued has not yet been paid, a foreign tax redetermi-

[107] *See, e.g.*, Rev. Rul. 84-125, 1984-2 C.B. 125.

nation under section 905(c) is required for the amount of such unpaid tax. That is, the accrual of any tax that is unpaid as of that date would be retroactively denied. In cases where a redetermination is required, as under present law, the bill specifies that the taxpayer must notify the Secretary, who shall redetermine the amount of the tax for the year or years affected.

The bill provides that in the case of accrued taxes not paid within the date two years after the close of the taxable year to which such taxes relate, whether or not such taxes were previously accrued, any such taxes if subsequently paid are taken into account for the taxable year in which paid, and no redetermination with respect to the original year of accrual is required on account of such payment. In such a case, those taxes would be translated into U.S. dollar amounts using the exchange rates in effect for the period during which such taxes are paid. Nothing in the bill is intended to change present law as to the length of time after the year to which the redetermination relates within which redeterminations may be made or required.[108]

Effective Date

This section of the bill is effective for taxes paid (in the case of taxpayers using the cash basis for determining the foreign tax credit) or accrued (in the case of taxpayers using the accrual basis for determining the foreign tax credit) in taxable years beginning after December 31, 1991.

4. Foreign tax credit limitation under the alternative minimum tax (sec. 4422 of the bill and sec. 59(a) of the Code)

Present Law

Computing foreign tax credit limitations requires the allocation and apportionment of deductions between items of foreign source and U.S. source income. Foreign tax credit limitations must be computed both for regular tax purposes and for purposes of the alternative minimum tax (AMT). Consequently, after allocating and apportioning deductions for regular tax foreign tax credit limitation purposes, additional allocations and apportionments generally must be performed in order to compute the AMT foreign tax credit limitation.

Reasons for Change

The process of allocating and apportioning deductions for purposes of calculating the regular and AMT foreign tax credit limitations can be complex. Taxpayers that have allocated and apportioned deductions for regular tax foreign tax credit purposes generally must reallocate and reapportion the same deductions for AMT foreign tax credit purposes, based on assets and income that reflect AMT adjustments (including depreciation). However, the differences between regular taxable income and alternative minimum taxable income are often relevant primarily to U.S. source income.

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[108] *See* sec. 6501(c)(5). *See also, e.g., Pacific Metals Corp. v. Commissioner*, 1 T.C. 1028 (1943); *Texas Co. (Caribbean) Ltd. v. Commissioner*, 12 T.C. 925 (1949).

As a result of the combined effects of these differences, the committee believes that foreign source alternative minimum taxable income generally will not differ significantly from foreign source regular taxable income. By permitting taxpayers to use foreign source regular taxable income in computing their AMT foreign tax credit limitation, the bill eliminates the need to reallocate and reapportion every deduction.

Explanation of Provision

The bill permits taxpayers to elect to use as their AMT foreign tax credit limitation fraction the ratio of foreign source *regular* taxable income to entire alternative minimum taxable income, rather than the ratio of foreign source *alternative minimum* taxable income to entire alternative minimum taxable income. Foreign source regular taxable income may be used, however, only to the extent it does not exceed entire alternative minimum taxable income.

The election under the bill is available only in the first taxable year beginning after December 31, 1992, for which the taxpayer claims an AMT foreign tax credit. A taxpayer will be treated, for this purpose, as claiming an AMT foreign tax credit for any taxable year for which the taxpayer chooses to have the benefits of the foreign tax credit, and in which the taxpayer is subject to the alternative minimum tax or would be subject to the alternative minimum tax but for the availability of the AMT foreign tax credit. The election applies to all subsequent taxable years, and may be revoked only with the permission of the Secretary of the Treasury.

Effective Date

The provision applies to taxable years beginning after December 31, 1992.

5. Inbound and outbound transfers (secs. 4423 and 4424 of the bill and secs. 367, 1057, and 1491-1494 of the Code)

Present Law

Outbound transfers

Corporate nonrecognition provisions

Certain types of exchanges relating to the organization, reorganization, and liquidation of a corporation can be made without recognition of gain to the corporation involved or to its shareholders. In 1932 Congress enacted an exception to the nonrecognition rules, which became section 367 of the 1954 Code, for the case where such an exchange involves a foreign corporation. The legislative history indicates that the exception was enacted in order to prevent tax avoidance that might have otherwise occurred upon the transfer of appreciated property outside U.S. tax jurisdiction.[109] Under that provision, in determining the extent to which gain (but not loss) was recognized in these exchanges, a foreign corporation was not

[109] H.R. Rep. No. 708, 72d Cong., 1st Sess. 20 (1932).

considered a corporation unless it was established to the satisfaction of the IRS that the exchange was not in pursuance of a plan having as one of its principal purposes the avoidance of Federal income taxes.

The Code now provides that if a U.S. person transfers property to a foreign corporation in connection with certain corporate organizations, reorganizations, or liquidations, the foreign corporation will not, for purposes of determining the extent to which gain is recognized on such transfer, be considered to be a corporation (sec. 367(a)(1)). Various exceptions to the operation of this rule are provided, including a broad grant of authority to provide exceptions by regulation. The statutory language has changed substantially since 1932, but it has retained in large part its primary operative result—that of treating a foreign corporation as not a corporation. Since corporate status is essential to qualify for the tax-free organization, reorganization, and liquidation provisions, failure to satisfy the requirements of section 367 could result in the recognition of gain to the participant corporations and shareholders.

Excise tax on transfers to a foreign entity

At the same time that Congress enacted the original predecessor of current section 367, Congress also enacted an excise tax on outbound transfers that might not constitute income tax recognition events even after imposition of the anti-avoidance income tax rule adopted for corporate transactions. As in the case of the corporate nonrecognition override provision, the purpose of the excise tax was to check transfers of property in which there was a large appreciation in value to foreign entities for the purpose of avoidance of taxes on capital gains.[110] Therefore, as in the case of the corporate provision, the excise tax generally has been imposed only in certain cases where it has been believed necessary or appropriate to preserve U.S. tax on appreciated assets.

Under present law, the excise tax generally applies on transfers of property by a U.S. person to a foreign corporation—as paid-in surplus or as a contribution to capital—or to a foreign estate, trust, or partnership. The tax is 35 percent of the amount of gain inherent in the property transferred, but not recognized for income tax purposes at the time of the transfer (sec. 1491). For income tax purposes, the basis of the property whose appreciation and transfer triggers the tax is not increased to account for imposition of the tax.

The excise tax does not apply in certain cases where the transferee is exempt from U.S. tax under Code sections 501–505 (sec. 1492(1)). In addition, the excise tax does not apply in some cases where income tax rules governing outbound transfers apply, either by their terms or by the election of the taxpayer. Thus, the excise tax does not apply to a transfer described in section 367, or to a transfer not described in section 367 but with respect to which the taxpayer elects (before the transfer) the application of principles similar to the principles of section 367 (sec. 1492(2)).

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[110] *Id.* at 52.

In addition, a taxpayer may elect (under regulations prescribed by the Secretary) to treat a transfer described in section 1491 as a sale or exchange of the property transferred and to recognize as gain (but not loss) in the year of the transfer the excess of the fair market value of the property transferred over the adjusted basis (for determining gain) of the property in the hands of the transferor (sec. 1057; Treas. Reg. sec. 7.0). To the extent that gain is recognized pursuant to the election in the year of the transfer, the transfer is not subject to the excise tax, and the basis of the property in the hands of the transferee will be increased by the amount of gain received (sec. 1492(3)). The legislative history of the elective income recognition provision indicates that the making of an election which has as one of its principle purposes the avoidance of Federal income taxes is not permitted.[111]

The excise tax is due at the time of the transfer (sec. 1494(a)). Under regulations, the excise tax may be abated, remitted, or refunded if the taxpayer, after the transfer, elects the application of principles similar to the principles of section 367 (sec. 1494(b)).

Inbound corporate transfers

Although the legislative history of the 1932 Act indicated a concern with outbound transfers, the statutory standard for determining that a transaction did not have as one of its principal purposes tax avoidance evolved through administrative interpretation into a requirement that, in the case of transfers into the United States by a foreign corporation, tax-free treatment generally would be permitted only if the U.S. tax on accumulated earnings and profits was paid. For example, in 1968, the IRS issued guidelines (Rev. Proc. 68-23, 1968-1 C.B. 821) as to when favorable rulings "ordinarily" would be issued. As a condition of obtaining a favorable ruling with respect to certain transactions, the section 367 guidelines required the taxpayer to agree to include certain items in income (the amount to be included was called the section 367 toll charge). For example, if the transaction involved the liquidation of a foreign corporation into a domestic parent corporation, a favorable ruling was issued if the domestic parent agreed to include in its income as a dividend for the taxable year in the which the liquidation occurred the portion of the accumulated earnings and profits of the foreign corporation which were properly attributable to the domestic corporation's stock interest in the foreign corporation (Rev. Proc. 68-23, sec. 3.01(1); see also sec. 3.03(1)(b)).

Absence of a toll charge on accumulated earnings of a foreign corporation upon liquidation or asset reorganization into a U.S. corporation clearly would permit avoidance of tax. For example, if a U.S. corporation owns 100 percent of the stock of a U.S. subsidiary, no tax is imposed either on a dividend from the subsidiary to the parent (sec. 243) or the liquidation of the subsidiary into the parent (secs. 332 and 337). In each case, the earnings of the subsidiary already have been subject to U.S. tax jurisdiction, and the liquidation provisions allow nonrecognition of gain inherent in appreciated property of the subsidiary. On the other hand, if a U.S. cor-

[111] Staff of the Joint Committee on Taxation, 94th Cong., 2d Sess., *General Explanation of the Tax Reform Act of 1976*, at 226 (1976).

poration owns 100 percent of the stock of a foreign subsidiary, earnings of the subsidiary generally are not subject to current U.S. tax. Instead, tax generally is imposed on a dividend from the subsidiary to the parent, net of creditable foreign taxes. If a liquidation of the subsidiary could be accomplished tax-free under the Code, U.S. tax on its earnings would be avoided; more generally, the parent would be able to succeed to the basis and other tax attributes of the foreign corporation without having subjected to U.S. tax jurisdiction the earnings that gave rise to those tax attributes.

Outbound transfers since the Tax Reform Act of 1976

For purposes of the transactions described above, section 367 (and its predecessors) remained largely unchanged between 1932 and 1976. In 1976, however, a number of problems caused Congress to revise section 367. One result of the 1976 revision was to separate the provision into 2 sets of rules: one set dealing with outbound transfers, where the statutory aim is to prevent the removal of appreciated assets or inventory from U.S. tax jurisdiction prior to their sale (sec. 367(a)), and the other set dealing with both transfers into the United States and those which are exclusively foreign (sec. 367(b)).

Section 367(b) now provides, in part, that in the case of certain exchanges in connection with which there is no transfer of property described in section 367(a)(1), a foreign corporation will be considered to be a corporation except to the extent provided in regulations which are necessary or appropriate to prevent the avoidance of Federal income taxes.

Although it is clear that absence of a toll charge on accumulated earnings of a foreign corporation upon liquidation or reorganization into a U.S. corporation leads to avoidance of tax, and Congress in 1976 noted without disapproval the adoption of IRS positions that would prevent the avoidance of tax in these cases,[112] neither section 367(b) as revised in 1976, nor its predecessors, were drafted in such a way that directly causes tax to be imposed on foreign earnings.

For example, assume that a U.S. corporation owns 100 percent of the stock of a liquidating foreign corporation, and, pursuant to regulations under section 367(b), the foreign corporation is not treated as a corporation for purposes of section 332. In that case, the U.S. corporation would be required under the Code to recognize the difference between the basis and the value of its stock in the foreign corporation. That gain, however, may be more or less than the accumulated earnings of the foreign corporation attributable to the period when the U.S. corporation owned the stock of the foreign corporation.

Perhaps as a result, neither the present temporary regulations nor the recently proposed regulations under section 367(b) mandate a tax based on the accumulated earnings of a foreign corporation that liquidates or reorganizes into a U.S. corporation. The temporary regulations allow the taxpayer to elect treatment of the foreign corporation as a corporation if the tax on earnings is paid. If

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[112] E.g., Staff of the Joint Comm. on Taxation, 94th Cong., 2d Sess., *General Explanation of the Tax Reform Act of 1976*, at 264 (1976).

the taxpayer chooses not to make the election, the foreign corporation is not treated as a corporation under the relevant nonrecognition provision (e.g., sec. 332, 354), but *is* treated as a corporation for other purposes, such as for purposes of the basis rules (secs. 334, 358, 362), and carryover provisions (sec. 381) (Temp. Treas. Reg. secs. 7.367(b)-5(b) and 7.367(b)-7(c)(2)). The proposed regulations generally require that the foreign corporation be treated as a corporation, and permit the taxpayer to elect either to pay the tax on earnings, or to pay tax on the gain; but if the latter option is chosen, adjustments must be made to either net operating loss carryovers, capital loss carryovers, or asset bases (Proposed Treas. Reg. sec. 1.367(b)-3(b)(2)).

Reasons for Change

Outbound transfers

The excise tax was intended to prevent U.S. taxpayers from transferring appreciated property to foreign entities in attempts to avoid the payment of a capital gains tax. During the 60 years since its enactment, the excise tax potentially due on a transfer has only roughly approximated the income tax consequences that would have flowed from gain recognition. In some cases the excise tax has been much harsher than that income tax.[113] Nevertheless, it is and has been the case that any taxpayer could properly avoid the excise tax by subjecting itself to the income tax. The committee understands that in some cases taxpayers are subject to the excise tax only because of inadvertent failure to elect to be subject to income tax. The committee understands that in order to defeat the tax avoidance possibilities of outbound transfers, in appropriate cases taxpayers need be subject to income tax on transfers of appreciated property to foreign entities, but not an excise tax.

Some have argued that partnership and trust provisions added to the Code since 1932 generally obviate any need for either the excise tax or any new alternative provision. The committee does not agree. Implementation of many of those provisions requires regulations that may or may not exist, and may or may not adequately prevent the tax avoidance that prompted enactment of the excise tax. The committee believes that other statutes, while representing an improvement over pre-1932 law from the standpoint of preventing abuses, do not in all cases represent an adequate backstop where there is a failure to elect gain recognition or application of section 367 principles.

Inbound transfers

The committee believes that the uncertainty surrounding the IRS authority to impose conditions on the treatment of a foreign corporation as a corporation, in cases other than outbound transfers, is not suited to prevent the avoidance of tax through the use of foreign corporations in the most straightforward fashion.

For example, assume that a U.S. corporation establishes a 100 percent-owned foreign corporation with capital of $100 cash.

[113] When the excise tax was enacted, the income tax on capital gains of individuals was 12.5 percent; the excise tax was 25 percent (Revenue Act of 1932, secs. 101 and 901).

Assume that the foreign corporation spends $50 on operating assets and $50 on investment assets, and that the operating assets generate $100 of earnings and profits. Assume that the value and tax basis of operating assets maintained by the company remains at $50, while the value of the investment assets declines to $25, so that the stock in the foreign corporation is worth $175. Upon liquidation of the foreign corporation, assume that the taxpayer could avail itself of a gain limitation. Potentially, the taxpayer might achieve a double deduction of the $25 loss on the investment; once by sheltering $25 of earnings from taxation on repatriation, and again when the loss on the investment asset is realized upon disposition of that asset.[114]

The committee understands that the ambiguity of the statute in this case may foster complexity. For example, in the absence of regulations, the statute authorizes treatment of the foreign corporation as a corporation, and non-taxation of any earnings of the foreign corporation. To prevent this clear avoidance of tax, the IRS is authorized to provide for a different treatment of the foreign corporation by regulations. On one hand, it could be argued that the most the IRS can do in this case is to treat the transaction as if section 332 did not exist (resulting in gain recognition to the parent of $75). On the other hand, it could be argued that the Secretary is authorized to mandate the treatment of the foreign corporation as a corporation, subject to whatever regulations are necessary or appropriate to prevent the avoidance of tax on the repatriated earnings. One result of the ambiguity is a recently proposed regulation under which $75 of the earnings are taxed upon the liquidation, with the remaining $25 of earnings subject to future tax through a mandatory reduction of certain tax attributes, such as bases in the operating assets. The committee believes that requiring full taxation of the repatriated earnings is reasonable as a matter of the historic function of section 367 to prevent tax avoidance in inbound cases, and that such tax-avoidance can be prevented more directly and simply by explicitly authorizing the IRS to dispense with the gain limitation in appropriate cases.

Explanation of Provisions

Outbound transfers

The bill repeals the excise tax on outbound transfers. In its place, the bill requires the full recognition of gain on a transfer of property by a U.S. person to a foreign corporation as paid-in surplus, or as a contribution to capital, or to a foreign estate, trust, or partnership. The Secretary may, however, in lieu of applying this full recognition rule, provide regulations under which principles similar to the principles of section 367 shall apply to any such transfer. Moreover, the Secretary may provide rules under which recognition of gain will not be triggered by section 1491 in cases where the Secretary is satisfied that application of other Code rules (such as those relating to partnerships or trusts) will prevent the avoidance of tax consistent with the purposes of the bill. Full recognition of gain can also be avoided in the case of a transfer de-

[114] Cf. Tech. Advice Memo. 9003005 (Sept. 28, 1989).

scribed in section 367. The committee anticipates that prior to the promulgation of regulations, the Secretary generally will continue to permit taxpayers to elect the application of principles similar to the principles of section 367, provided the election is made by the time for filing the income tax return for the taxable year of the transfer.

Inbound transfers

The bill provides that in the case of certain corporate organizations, reorganizations, and liquidations described in section 332, 351, 354, 355, 356, or 361 in which the status of a foreign corporation as a corporation is a condition for nonrecognition by a party to the transaction, income shall be recognized to the extent provided in regulations prescribed by the Secretary which are necessary or appropriate to prevent the avoidance of Federal income taxes. This provision is limited in its application, under the bill, so as not to apply to a transaction in which the foreign corporation is not treated as a corporation under section 367(a)(1). Thus, the bill permits the IRS to provide by regulations for recognition of income, without regard to the amount of gain that would be recognized in the absence of the relevant nonrecognition provision listed above. As under current law, such regulations will be subject to normal court review as to whether they are necessary or appropriate for the prevention of avoidance of Federal income taxes.

In addition, the bill clarifies that rules for income recognition under section 367(b) may also be applied in a case involving a transfer literally described in section 367(a)(1), where necessary or appropriate to prevent the avoidance of Federal income taxes.[115]

Effective Date

The provision that amends the outbound rules and repeals the excise tax applies to transfers after date of enactment. The provision that amends section 367(b) applies to transfers after December 31, 1993.

Subtitle E—Other Income Tax Provisions

Part I—Provisions Relating to Subchapter S Corporations

1. Determination of whether an S corporation has one class of stock (sec. 4501 of the bill and sec. 1361 of the Code)

Present Law

Under present law, a small business corporation eligible to be an S corporation may not have more than one class of stock. Differences in voting rights are disregarded in determining whether a corporation has more than one class of stock. In addition, certain debt instruments may not be treated as a second class of stock for purposes of this rule.

On October 5, 1990, the Treasury Department issued proposed regulations [116] providing that a corporation has more than one

[115] See Temp. Treas. Reg. sec. 7.367(b)-4(b); Proposed Treas. Reg. sec. 1.367(a)-3(a).
[116] Proposed Treasury Regulation sec. 1.1361-1(l)(2).

class of stock if all of the outstanding shares of stock do not confer identical rights to distribution and liquidation proceeds, regardless of whether any differences in rights occur pursuant to the corporate charter, articles or bylaws, by operation of State law, by administrative action, or by agreement. The proposed regulations also provided that, notwithstanding that all outstanding shares of stock confer identical rights to distribution and liquidation proceeds, a corporation has more than one class of stock if the corporation makes non-conforming distributions (i.e., distributions that differ with respect to timing or amount with respect to each share of stock), with limited exceptions for certain redemptions and certain differences in the timing of distributions. The proposed regulations were to apply to taxable years beginning after December 31, 1982.

On August 8, 1991, the Treasury Department issued revised proposed regulations replacing the proposed regulations described above. The revised proposed regulations provide that a corporation is treated as having only one class of stock if all outstanding shares of stock confer identical rights to distribution and liquidation proceeds. Under the revised proposed regulations, any distributions that differ in timing or amount are to be given appropriate tax effect in accordance with the facts and circumstances. These proposed regulations generally apply to taxable years beginning after December 31, 1991.

Reasons for Change

The provision promotes simplification by clarifying that a corporation will not be ineligible to be an S corporation by reason of having more than one class of stock where the corporation has not issued shares of different classes (disregarding differences in voting rights) and applicable State corporate law does not provide for differing rights to distributions and liquidation proceeds.

Explanation of Provision

The bill provides that a corporation is treated as having only one class of stock if all outstanding shares of stock of the corporation confer identical rights to distribution and liquidation proceeds. Applicable State law, taking into account legally enforceable rights under the corporate charter, articles or bylaws, administrative action, and agreements relating to distributions or liquidation proceeds with respect to shares, determines whether the outstanding shares confer different rights to distributions or liquidation proceeds.

Where an S corporation in fact makes distributions which differ as to timing or amount, the bill in no way limits the Internal Revenue Service from properly characterizing the transaction for tax purposes. For example, if a distribution is properly characterized as compensation, the Service could require it to be so treated for tax purposes. Similarly, if a payment appearing as compensation should be properly characterized as a distribution, the Service could require it to be so treated for purposes of computing taxable income.

Effective Date

The provision applies to taxable years beginning after December 31, 1982.

2. Authority to validate certain invalid elections (sec. 4502 of the bill and sec. 1362 of the Code)

Present Law

Under present law, if the Internal Revenue Service determines that a corporation's Subchapter S election is inadvertently terminated, the Service can waive the effect of the terminating event for any period if the corporation timely corrects the event and if the corporation and shareholders agree to be treated as if the election had been in effect for that period. Present law does not grant the Internal Revenue Service the ability to waive the effect of an inadvertent invalid Subchapter S election.

In addition, under present law, a small business corporation must elect to be an S corporation no later than the 15th day of the third month of the taxable year for which the election is effective. The Internal Revenue Service may not validate a late election.

Reasons for Change

The bill promotes simplification by giving the Secretary the flexibility to validate an invalid S election where the failure to properly elect S status was inadvertent or untimely.

Explanation of Provision

Under the bill, the authority of the Internal Revenue Service to waive the effect of an inadvertent termination is extended to allow the Service to waive the effect of an invalid election caused by an inadvertent failure to qualify as a small business corporation or to obtain the required shareholder consents (including elections regarding qualified subchapter S trusts), or both.

The bill also allows the Internal Revenue Service to treat a late Subchapter S election as timely where the Service determines that there was reasonable cause for the failure to make the election timely.

Effective Date

The provision applies to taxable years beginning after December 31, 1982.[117]

3. Treatment of distributions by S corporations during loss year (sec. 4503 of the bill and secs. 1366 and 1368 of the Code)

Present Law

Under present law, the amount of loss an S corporation shareholder may take into account for a taxable year cannot exceed the sum of shareholder's adjusted basis in his or her stock of the corpo-

[117] This is the effective date of the present-law provision regarding inadvertent terminations.

ration and the adjusted basis in any indebtedness of the corporation to the shareholder. Any excess loss is carried forward.

Any distribution to a shareholder by an S corporation generally is tax-free to the shareholder to the extent of the shareholder's adjusted basis of his or her stock. The shareholder's adjusted basis is reduced by the tax-free amount of the distribution. Any distribution in excess of the shareholder's adjusted basis is treated as gain from the sale or exchange of the stock.

Under present law, income (whether or not taxable) and expenses (whether or not deductible) serve, respectively, to increase and decrease an S corporation shareholder's basis in the stock of the corporation. These rules appear to require that the adjustments to basis for items of both income and loss for any taxable year apply before the adjustment for distributions applies.[118]

These rules limiting losses and allowing tax-free distributions up to the amount of the shareholder's adjusted basis are similar in certain respects to the rules governing the treatment of losses and cash distributions by partnerships. Under the partnership rules (unlike the S corporation rules), for any taxable year, a partner's basis is first increased by items of income, then decreased by distributions, and finally is decreased by losses for that year.[119]

In addition, if the S corporation has accumulated earnings and profits,[120] any distribution in excess of the amount in an "accumulated adjustments account" will be treated as a dividend (to the extent of the accumulated earnings and profits). A dividend distribution does not reduce the adjusted basis of the shareholder's stock. The "accumulated adjustments account" generally is the amount of the accumulated undistributed post-1982 gross income less deductions.

Reasons for Change

The provision promotes simplification by conforming the S corporation rules regarding distributions to the partnership rules and by eliminating uncertainty regarding the treatment of distributions made during the year.

Explanation of Provision

The bill provides that the adjustments for distributions made by an S corporation during a taxable year are taken into account before applying the loss limitation for the year. Thus, distributions during a year reduce the adjusted basis for purposes of determining the allowable loss for the year, but the loss for a year does not reduce the adjusted basis for purposes of determining the tax status of the distributions made during that year.

The bill also provides that in determining the amount in the accumulated adjustment account for purposes of determining the tax treatment of distributions made during a taxable year by an S corporation having accumulated earnings and profits, net negative ad-

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[118] *See* section 1366(d)(1)(A); H. Rep. 97-826, p. 17; S. Rep. 97-640, p. 18.

[119] Treas. Reg. sec. 1.704 [illegible](2); Rev. Rul. 66-94, 1966-1 C.B. 166.

[120] An S corporation may [illegible]e earnings and profits from years prior to its subchapter S election or from pre-1983 subchapter S years.

justments (i.e., the excess of losses and deductions over income) for that taxable year are disregarded.

The following examples illustrate the application of these provisions:

Example 1.—X is the sole shareholder of A, a calendar year S corporation with no accumulated earnings and profits. X's adjusted basis in the stock of A on January 1, 1992, is $1,000 and X holds no debt of A. During the taxable year, A makes a distribution to X of $600, recognizes a capital gain of $200 and sustains an operating loss of $900. Under the bill, X's adjusted basis in the A stock is increased to $1,200 ($1,000 plus $200 capital gain recognized) pursuant to section 1368(d) to determine the effect of the distribution. X's adjusted basis is then reduced by the amount of the distribution to $600 ($1,200 less $600) to determine the application of the loss limitation of section 1366(d)(1). X is allowed to take into account $600 of A's operating loss, which reduces X's adjusted basis to zero. The remaining $300 loss is carried forward pursuant to section 1366(d)(2).

Example 2.—The facts are the same as in Example 1, except that on January 1, 1992, A has accumulated earnings and profits of $500 and an accumulated adjustments account of $200. Under the bill, because there is a net negative adjustment for the year, no adjustment is made to the accumulated adjustments account before determining the effect of the distribution under section 1368(c).

As to A, $200 of the $600 distribution is a distribution of A's accumulated adjustments account, reducing the accumulated adjustments account to zero. The remaining $400 of the distribution is a distribution of accumulated earnings and profits ("E&P") and reduces A's E&P to $100. A's accumulated adjustments account is then increased by $200 to reflect the recognized capital gain and reduced by $900 to reflect the operating loss, leaving a negative balance in the accumulated adjustment account on January 1, 1993, of $700 (zero plus $200 less $900).

As to X, $200 of the distribution is applied against X's adjusted basis in the A stock of $1,200 ($1,000 plus $200 capital gain recognized), reducing X's adjusted basis to $1,000. The remaining $400 of the distribution is taxable as a dividend and does not reduce X's adjusted basis. Because X's adjusted basis is $1,000, the loss limitation does not apply to X, who may deduct the entire $900 operating loss. X's adjusted basis is then decreased to reflect the $900 operating loss. Accordingly, X's adjusted basis on January 1, 1993, is $100 ($1,000 plus $200 less $200 less $900).

Effective Date

These provisions apply to distributions made in taxable years beginning after December 31, 1991.

4. Treatment of S corporations as shareholders in C corporations (sec. 4504(a) of the bill and sec. 1371 of the Code)

Present Law

Present law contains several provisions relating to the treatment of S corporations as corporations generally for purposes of the Internal Revenue Code.

First, under present law, the taxable income of an S corporation is computed in the same manner as in the case of an individual (sec. 1363(b)). Under this rule, the provisions of the Code governing the computation of taxable income which are applicable only to corporations, such as the dividends received deduction, do not apply to S corporations.

Second, except as otherwise provided by the Internal Revenue Code and except to the extent inconsistent with subchapter S, subchapter C (i.e., the rules relating to corporate distributions and adjustments) applies to an S corporation and its shareholders (sec. 1371(a)(1)). Under this second rule, provisions such as the corporate reorganization provisions apply to S corporations. Thus, a C corporation may merge into an S corporation tax-free.

Finally, an S corporation in its capacity as a shareholder of another corporation is treated as an individual for purposes of subchapter C (sec. 1371(a)(2)). The Internal Revenue Service has taken the position that this rule prevents the tax-free liquidation of a C corporation into an S corporation because a C corporation cannot liquidate tax-free when owned by an individual shareholder.[121] Thus, a C corporation may elect S corporation status tax-free or may merge into an S corporation tax-free, but may not liquidate into an S corporation tax-free.[122] Also, the Service's reasoning would also prevent an S corporation from making an election under section 338 where a C corporation was acquired by an S corporation.

Reasons for Change

The provision promotes simplification by treating similar transactions in a similar manner for tax purposes.

Explanation of Provision

The bill repeals the rule that treats an S corporation in its capacity as a shareholder of another corporation as an individual. Thus, the liquidation of a C corporation into an S corporation will be governed by the generally applicable subchapter C rules, including the provisions of sections 332 and 337 allowing the tax-free liquidation of a corporation into its parent corporation. Following a tax-free liquidation, the built-in gains of the liquidating corporation may later be subject to tax under section 1374 upon a subsequent disposition. An S corporation will also be eligible to make a section 338 election (assuming all the requirements are otherwise met), result-

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[121] *See* PLR 8818049, (Feb. 10, 1988).

[122] A tax is imposed with respect to LIFO inventory held by a C corporation becoming an S corporation.

ing in immediate recognition of all the acquired C corporation's gains and losses (and the resulting imposition of a tax).

The repeal of this rule does not change the general rule governing the computation of income of an S corporation. For example, it does not allow an S corporation, or its shareholders, to claim a dividends received deduction with respect to dividends received by the S corporation, or to treat any item of income or deduction in a manner inconsistent with the treatment accorded to individual taxpayers.

No inference is intended regarding the present-law treatment of these transactions.

Effective Date

The provision applies to taxable years beginning after December 31, 1991.

5. S corporations permitted to hold subsidiaries (sec. 4504(b) of the bill and sec. 1361 of the Code)

Present Law

Under present law, an S corporation may not be a member of an affiliated group of corporations (other than by reason of ownership in certain inactive corporations). The legislative history indicates that this rule was adopted to prevent the filing of consolidated returns by a group which includes an S corporation.[123]

Reasons for Change

The provision promotes simplification by eliminating a barrier to using the S corporation form of entity and providing more appropriate treatment of corporations with subsidiaries, i.e., the prohibition of filing a consolidated return if S corporate status is elected rather than disqualification of the S election.

Explanation of Provision

The bill repeals the rule that an S corporation may not be a member of an affiliated group of corporations. Thus, an S corporation will be allowed to own up to 100 percent of the stock of a C corporation. However, an S corporation cannot be included in a group filing a consolidated return.

Under the bill, if an S corporation holds 100 percent of the stock of a C corporation that, in turn, holds 100 percent of the stock of another C corporation, the two C corporations may elect to file a consolidated return (if otherwise eligible), but the S corporation may not join in the election.

Effective Date

The provision applies to taxable years beginning after December 31, 1991.

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[123] *See* S. Rpt. No. 1983 (85th Cong., 2d Sess., 1958), p. 88.

6. Elimination of pre-1983 earnings and profits of S corporations (sec. 4504(c) of the bill)

Present Law

Under present law, the accumulated earnings and profits of a corporation are not increased for any year in which an election to be treated as an S corporation is in effect. However, under the subchapter S rules in effect before revision in 1982, a corporation electing subchapter S status for a taxable year increased its accumulated earnings and profits if its earnings and profits for the year exceeded both its taxable income for the year and its distributions out of that year's earnings and profits. As a result of this rule, a shareholder may later be required to include in his income the accumulated earnings and profits when it is distributed by the corporation. The 1982 revision to subchapter S repealed this rule for earnings attributable to taxable years beginning after 1982 but did not do so for previously accumulated S corporation earnings and profits.

Reasons for Change

The provision promotes simplification by eliminating the need to keep records of certain generally small amounts of earnings arising before 1983.

Explanation of Provision

The bill provides that if a corporation is an S corporation for its first taxable year beginning after December 31, 1991, the accumulated earnings and profits of the corporation as of the beginning of that year are reduced by the accumulated earnings and profits (if any) accumulated in any taxable year beginning before January 1, 1983, for which the corporation was an electing small business corporation under subchapter S. Thus, such a corporation's accumulated earnings and profits will be solely attributable to taxable years for which an S election was not in effect. This rule is generally consistent with the change adopted in 1982 limiting the S shareholder's taxable income attributable to S corporation earnings to his share of the taxable income of the S corporation.

Effective Date

The provision applies to taxable years beginning after December 31, 1991.

7. Treatment of items of income in respect of a decedent held by an S corporation (sec. 4504(d) of the bill and sec. 1367 of the Code)

Present Law

Income in respect of a decedent (IRD) generally consists of items of gross income that accrued during the decedent's lifetime but were not yet includible in the decedent's income before his death under his method of accounting. IRD is includible in the income of the person acquiring the right to receive such item. A deduction for

the estate tax attributable to an item of IRD is allowed to the person who includes the item in gross income (sec. 691(c)).

The basis of property acquired from a decedent is its fair market value at the date of death (or alternate valuation date if that date is elected for estate tax purposes). This basis often is referred to as a "stepped-up basis". Property that constitutes a right to receive IRD does not receive a stepped-up basis.

The basis of a partnership interest or corporate stock acquired from a decedent generally is stepped-up at death. Under Treasury regulations, the basis of a partnership interest acquired from a decedent is reduced to the extent that its value is attributable to items constituting IRD.[124] Although S corporation income is included in the income of the shareholders in a manner similar to the inclusion of partnership income in the income of the partners, no comparable regulation provides for a reduction in the basis of stock of an S corporation acquired from a decedent where the S corporation holds items of IRD on the date of death of a shareholder. Thus, under present law, the treatment of an item of IRD held by an S corporation is unclear.

Reasons for Change

The provision promotes simplification by eliminating the uncertainty of present law, and by treating items of IRD held by a taxpayer directly, through a partnership, or through an S corporation in a similar manner.

Explanation of Provision

The bill provides that a person acquiring stock in an S corporation from a decedent will treat as IRD his pro rata share of any item of income of the corporation which would have been IRD if that item had been acquired directly from the decedent. Where a item is treated as IRD, a deduction for the estate tax attributable to the item generally will be allowed under the provisions of section 691(c). The stepped-up basis in the stock will be reduced by the extent to which the value of the stock is attributable to items consisting of IRD. This basis rule is comparable to the present-law partnership rule.

No inference is intended regarding the present-law treatment of IRD in the case of S corporations.

Effective Date

The provision applies with respect to decedents dying after date of enactment of the bill.

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[124] Treas. Reg. sec. 1.742-1.

Part II—Accounting Provisions

1. Modifications to the look-back method for long-term contracts (sec. 4511 of the bill and sec. 460 of the Code)

Present Law

Taxpayers engaged in the production of property under a long-term contract generally must compute income from the contract under the percentage of completion method. Under the percentage of completion method, a taxpayer must include in gross income for any taxable year an amount that is based on the product of (1) the gross contract price and (2) the percentage of the contract completed as of the end of the year. The percentage of the contract completed as of the end of the year is determined by comparing costs incurred with respect to the contract as of the end of the year with the estimated total contract costs.

Because the percentage of completion method relies upon estimated, rather than actual, contract price and costs to determine gross income for any taxable year, a "look-back method" is applied in the year a contract is completed in order to compensate the taxpayer (or the Internal Revenue Service) for the acceleration (or deferral) of taxes paid over the contract term. The first step of the look-back method is to reapply the percentage of completion method using actual contract price and costs rather than estimated contract price and costs. The second step generally requires the taxpayer to recompute its tax liability for each year of the contract using gross income as reallocated under the look-back method. If there is any difference between the recomputed tax liability and the tax liability as previously determined for a year, such difference is treated as a hypothetical underpayment or overpayment of tax to which the taxpayer applies a rate of interest equal to the overpayment rate, compounded daily.[125] The taxpayer receives (or pays) interest if the net amount of interest applicable to hypothetical overpayments exceeds (or is less than) the amount of interest applicable to hypothetical underpayments.

The look-back method must be reapplied for any item of income or cost that is properly taken into account after the completion of the contract.

The look-back method does not apply to any contract that is completed within two taxable years of the contract commencement date and if the gross contract price does not exceed the lesser of (1) $1 million or (2) one percent of the average gross receipts of the taxpayer for the preceding three taxable years. In addition, a simplified look-back method is available to certain pass-through entities and, pursuant to Treasury regulations, to certain other taxpayers. Under the simplified look-back method, the hypothetical underpayment or overpayment of tax for a contract year generally is determined by applying the highest rate of tax applicable to such taxpayer to the change in gross income as recomputed under the look-back method.

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[125] The overpayment rate equals the applicable Federal short-term rate plus two percentage points. This rate is adjusted quarterly by the IRS. Thus, in applying the look-back method for a contract year, a taxpayer may be required to use five different interest rates.

Reasons for Change

Present law may require multiple applications of the look-back method with respect to a single contract or may otherwise subject contracts to the look-back method even though the amounts necessitating the look-back computations are de minimis relative to the aggregate contract income. In addition, the use of multiple interest rates complicates the mechanics of the look-back method.

Explanation of Provision

Election not to apply the look-back method for de minimis amounts

The bill provides that a taxpayer may elect not to apply the look-back method with respect to a long-term contract if, for each prior contract year, the cumulative taxable income (or loss) under the contract as determined using estimated contract price and costs is within 10 percent of the cumulative taxable income (or loss) as determined using actual contract price and costs.

Thus, under the election, upon completion of a long-term contract, a taxpayer would be required to apply the first step of the look-back method (the reallocation of gross income using actual, rather than estimated, contract price and costs), but would not be required to apply the additional steps of the look-back method if the application of the first step resulted in de minimis changes to the amount of income previously taken into account for each prior contract year.

The election applies to all long-term contracts completed during the taxable year for which the election is made and to all long-term contracts completed during subsequent taxable years, unless the election is revoked with the consent of the Secretary of the Treasury.

Example 1.—A taxpayer enters into a three-year contract and upon completion of the contract, determines that annual net income under the contract using actual contract price and costs is $100,000, $150,000, and $250,000, respectively, for Years 1, 2, and 3 under the percentage of completion method. An electing taxpayer need not apply the look-back method to the contract if it had reported cumulative net taxable income under the contract using estimated contract price and costs of between $90,000 and $110,000 as of the end of Year 1; and between $225,000 and $275,000 as of the end of Year 2.

Election not to reapply the look-back method

The bill provides that a taxpayer may elect not to reapply the look-back method with respect to a contract if, as of the close of any taxable year after the year the contract is completed, the cumulative taxable income (or loss) under the contract is within 10 percent of the cumulative look-back income (or loss) as of the close of the most recent year in which the look-back method was applied (or would have applied but for the other de minimis exception described above). In applying this rule, amounts that are taken into account after completion of the contract are not discounted.

Thus, an electing taxpayer need not apply or reapply the look-back method if amounts that are taken into account after the completion of the contract are de minimis.

The election applies to all long-term contracts completed during the taxable year for which the election is made and to all long-term contracts completed during subsequent taxable years, unless the election is revoked with the consent of the Secretary of the Treasury.

Example 2.—A taxpayer enters into a three-year contract and reports taxable income of $12,250, $15,000 and $12,750, respectively, for Years 1 through 3 with respect to the contract. Upon completion of the contract, cumulative look-back income with respect to the contract is $40,000, and 10 percent of such amount is $4,000. After the completion of the contract, the taxpayer incurs additional costs of $2,500 in each of the next three succeeding years (Years 4, 5, and 6) with respect to the contract. Under the bill, an electing taxpayer does not reapply the look-back method for Year 4 because the cumulative amount of contract taxable income ($37,500) is within 10 percent of contract look-back income as of the completion of the contract ($40,000). However, the look-back method must be applied for Year 5 because the cumulative amount of contract taxable income ($35,000) is not within 10 percent of contract look-back income as of the completion of the contract ($40,000). Finally, the taxpayer does not reapply the look-back method for Year 6 because the cumulative amount of contract taxable income ($32,500) is within 10 percent of contract look-back income as of the last application of the look-back method ($35,000).

Interest rates used for purposes of the look-back method

The bill provides that, for purposes of the look-back method, only one rate of interest is to apply for each accrual period. An accrual period with respect to a taxable year begins on the day after the return due date (determined without regard to extensions) for the taxable year and ends on such return due date for the following taxable year. The applicable rate of interest is the overpayment rate in effect for the calendar quarter in which the accrual period begins.

Effective Date

The provisions apply to contracts completed in taxable years ending after the date of enactment.

2. Simplified method for applying uniform cost capitalization rules (sec. 4512 of the bill and sec. 263A of the Code)

Present Law

In general, the uniform cost capitalization rules require taxpayers that are engaged in the production of real or tangible personal property or in the purchase and holding of property for resale to capitalize or include in inventory the direct costs of the property and the indirect costs that are allocable to the property. In determining whether indirect costs are allocable to production or resale activities, taxpayers are allowed to use various methods so long as

the method employed reasonably allocates indirect costs to production and resale activities.

Reasons for Change

The uniform cost capitalization rules require taxpayers to determine for each taxable year the costs of each administrative, service, or support function or department that are allocable to production or resale activities. If a taxpayer does not elect any of the simplified methods provided in Treasury regulations, this allocation may be unduly burdensome and costly.

Explanation of Provision

The bill authorizes (but does not require) the Treasury Department to issue regulations that allow taxpayers in appropriate circumstances to determine the costs of any administrative, service, or support function or department that are allocable to production or resale activities by multiplying the total amount of costs of any such function or department by a fraction, the numerator of which is the amount of costs of the function or department that was allocable to production or resale activities for a base period and the denominator of which is the total amount of costs of the function or department for the base period. It is anticipated that the regulations will provide that the base period is to begin no earlier than 4 taxable years prior to the taxable year with respect to which this simplified method applies.

Effective Date

The provision applies to taxable years beginning after the date of enactment of the bill. Thus, the regulations may permit the use of the simplified method for taxable years beginning after this date. The simplified method, however, may not be used for any taxable year that begins prior to the date that the Treasury Department publishes regulations that authorize the use of the simplified method and set forth the requirements that must be satisfied in order for the method to be used.

Part III—Tax-Exempt Bond Provisions

Overview

Interest on State and local government bonds generally is excluded from gross income for purposes of the regular individual and corporate income taxes if the proceeds of the bonds are used to finance direct activities of these governmental units (Code sec. 103).

Unlike the interest on governmental bonds, described above, interest on private activity bonds generally is taxable. A private activity bond is a bond issued by a State or local governmental unit acting as a conduit to provide financing for private parties in a manner violating either (a) a private business use and payment test or (b) a private loan restriction. However, interest on private activity bonds is not taxable if (a) the financed activity is specified in the Code and (b) at least 95 percent of the net proceeds of the bond issue is used to finance the specified activity.

Issuers of State and local government bonds must satisfy numerous other requirements, including arbitrage restrictions (for all such bonds) and annual State volume limitations (for most private activity bonds) for the interest on their bonds to be excluded from gross income.

1. Simplification of arbitrage rebate requirement for governmental bonds (sec. 4521 of the bill and sec. 148 of Code)

Present Law

Subject to limited exceptions, arbitrage profits from investing bond proceeds in investments unrelated to the governmental purpose of the borrowing must be rebated to the Federal Government. No rebate is required if the gross proceeds of an issue are spent for the governmental purpose of the borrowing within six months after issuance.

This six-month exception is deemed to be satisfied by issuers of governmental bonds (other than tax and revenue anticipation notes) and qualified 501(c)(3) bonds if (1) all proceeds other than an amount not exceeding the lesser of five percent or $100,000 are so spent within six months and (2) the remaining proceeds are spent within one year after the bonds are issued.

Reasons for Change

The principal Federal policy concern underlying the arbitrage rebate requirement is to limit the subsidy provided by tax-exempt bonds to amounts that are necessary to finance current governmental purposes by discouraging the earlier or larger than necessary issuance of tax-exempt bonds to profit by investing funds borrowed at low-cost tax-exempt rates in higher yielding taxable investments. The committee believes that if at least 95 percent of the proceeds of an issue are spent within six months, and the remainder within one year, opportunities for such arbitrage profit are significantly limited.

Explanation of Provision

The $100,000 limit on proceeds that may remain unspent after six months for certain governmental and qualified 501(c)(3) bonds otherwise exempt from the rebate requirement is deleted. Thus, if at least 95 percent of the proceeds of these bonds is spent within six months after their issuance, and the remainder is spent within one year, the six-month exception is deemed to be satisfied.

Effective Date

This provision applies to bonds issued after the date of its enactment.

2. Simplification of compliance with 24-month arbitrage rebate exception for construction bonds (sec. 4522 of the bill and sec. 148 of the Code)

Present Law

In general, arbitrage profits from investing bond proceeds in investments unrelated to the governmental purpose of the borrowing must be rebated to the Federal Government. An exception is provided for certain construction bond issues if the bonds are governmental bonds, qualified 501(c)(3) bonds, or exempt-facility private activity bonds for governmentally owned property.

This exception is satisfied only if the available construction proceeds of the issue are spent at least at specified rates during the 24-month period after the bonds are issued. The exception does not apply to bond proceeds invested after the 24-month expenditure period as part of a reasonably required reserve or replacement fund, a bona fide debt service fund, or to certain other investments (e.g., sinking funds). Issuers of these construction bonds also may elect to comply with a penalty regime in lieu of rebating if they fail to satisfy the exception's spending requirements.

Reasons for Change

Bond proceeds invested in a bona fide debt service fund generally must be spent at least annually for current debt service. The short-term nature of investments in such funds results in only limited potential for generating arbitrage profits. If the spending requirements of the 24-month rebate exception are satisfied, the administrative complexity of calculating rebate on these proceeds outweighs the other Federal policy concerns addressed by the rebate requirement.

Explanation of Provision

The bill exempts earnings on bond proceeds invested in bona fide debt service funds from the arbitrage rebate requirement and the penalty requirement of the 24-month exception if the spending requirements of that exception are otherwise satisfied.

Effective Date

This provision applies to bonds issued after the date of its enactment.

3. Automatic extension of initial temporary period for certain construction bonds (sec. 4523 of the bill and sec. 148 of the Code)

Present Law

Issuers of all tax-exempt bonds generally are subject to two sets of arbitrage requirements with respect to investment of their bond proceeds. First, a yield restriction requirement provides that tax-exempt bond proceeds generally may not be invested at a yield materially higher (generally defined as 0.125 percentage points) than the bond yield. Exceptions are provided to this restriction for in-

vestments during any of several "temporary periods" pending use of the proceeds, and throughout the term of the issue, for proceeds invested as part of a reasonably required reserve or replacement fund or a "minor" portion of the issue proceeds.

Second, in general, all arbitrage profits earned on investments unrelated to the governmental purpose (i.e., principally earnings on investments not subject to the yield restriction requirement) of the borrowing must be rebated to the Federal Government. Arbitrage profits include all such earnings (in excess of bond yield) derived from the investment of bond proceeds (and subsequent earnings on any such earnings).

Reasons for Change

Notwithstanding the arbitrage rebate requirement, requiring yield restriction following initial temporary periods may be an important factor in curbing earlier issuance of bonds than otherwise would occur. Provided that issuers substantially comply with a prompt expenditure requirement so that the opportunities for earning tax-motivated arbitrage profits are limited, however, exclusive reliance on the rebate requirement for limited additional periods will allow issuers to continue to pursue more flexible and liquid investments while bond-financed construction activities are being completed. Automatically allowing an additional 12-month period, where substantially all of the proceeds have been spent, also will relieve issuers from the burden of seeking a ruling from the Internal Revenue Service without increasing the opportunity for arbitrage-motivated investments.

Explanation of Provision

The bill provides that the initial temporary period for construction bonds is automatically extended for a period of 12 months if at least 85 percent of the available construction proceeds are spent within the original initial temporary period and the issuer reasonably expects to spend the remaining proceeds within the 12-month extension period. Construction bonds eligible for this automatic extension include only those bonds currently eligible for the 24-month arbitrage rebate expenditure exception, described above. Thus, these bond proceeds may be invested without yield restriction during this additional period; however, the arbitrage rebate or alternative penalty requirements for certain construction bonds will continue to apply during the extension period.

Effective Date

This provision applies to bonds issued after the date of its enactment.

4. Simultaneous issuance of certain discrete issues not aggregated (sec. 4524 of the bill and sec. 148 of the Code)

Present Law

In certain cases, the Treasury Department treats multiple issues of tax-exempt bonds paid from substantially the same source of

funds as a single issue in applying the Code's tax-exempt bond restrictions when the bonds are issued within a relatively short period of time (31 days).

Reasons for Change

Requiring issuers that simultaneously issue discrete issues of tax and revenue anticipation notes ("TRANs") and other governmental bonds to separate issuance of these bonds by 31 days adds administrative complexity and increases their costs of issuance.

Explanation of Provision

The bill provides that discrete issues of governmental bonds issued simultaneously will not be treated as a single issue in cases where one of the issues is a TRAN reasonably expected to satisfy the arbitrage rebate safe harbor of section 148(f)(4)(B)(iii).

Effective Date

This provision applies to bonds issued after the date of its enactment.

No inference is intended by this effective date as to the proper treatment of any bonds issued before the date of the provision's enactment.

5. Expand exception to pro rata disallowance of bank interest expense related to investment in tax-exempt bonds (sec. 4525 of the bill and sec. 265 of the Code)

Present Law

Banks and other financial institutions generally are denied a deduction for the portion of their interest expense (e.g., interest paid to depositors) that is attributable to investment in tax-exempt bonds acquired after August 7, 1986. This disallowance is computed using a pro-rata formula that compares the institution's average adjusted basis in tax-exempt bonds acquired after that date with the average adjusted basis of all assets of the institution.

An exception to this pro-rata disallowance rule is permitted for governmental bonds and qualified 501(c)(3) bonds issued by or on behalf of governmental units that issue no more than $10 million of such bonds during a calendar year (the "small-issuer exception").

Reasons for Change

Bonds issued by smaller governmental units are exempt from the general restrictions on banks and other financial institutions deducting costs of acquiring and carrying tax-exempt investments because banks are sometimes the only potential purchasers for bonds of these smaller governmental units. The committee believes that increasing the current $10 million annual issuance limit for eligible governments is appropriate. Further, expanding the exception to bonds of pools lending exclusively to qualified borrowers will expand the demand for the bonds of these smaller governments.

Explanation of Provision

The bill increases from $10 million to $25 million the amount of governmental and qualified 501(c)(3) bonds that an entity may issue annually while qualifying those bonds for the small-issuer exception to the general bank interest disallowance rule.

The bill also provides that pooled financing tax-exempt bonds (other than private activity bonds) may qualify for the small-issuer exception if—

(a) all of the proceeds of the pooled financing bonds (net of issuance costs associated with the bonds) are used exclusively to acquire from the issuer thereof bonds ("acquired bonds") eligible for the small-issuer exception,

(b) the acquired bonds are not designated under section 265(b)(3)(B)(i)(III) as "bank qualified" for purposes of the small-issuer exception; [126]

(c) the weighted average maturity of the pooled financing bonds does not exceed the weighted average maturity of the acquired bonds; and

(d) the issuer of the pooled financing bonds designates those bonds as "bank qualified" under section 265(b)(3)(i)(B)(III).

Effective Date

The provision is effective for bonds issued and acquired in calendar years beginning after December 31, 1992.

6. Modification of rules governing qualified 501(c)(3) bonds (sec. 4526 of the bill and secs. 141-150, 265, and 56 of the Code)

Present Law

Interest on State and local government bonds generally is excluded from income if the bonds are issued to finance direct activities of these governments (sec. 103). Interest on bonds issued by these governments to finance activities of other persons, e.g., private activity bonds, is taxable unless a specific exception is included in the Code. One such exception is for private activity bonds issued to finance activities of private, charitable organizations described in Code section 501(c)(3) ("section 501(c)(3) organizations") when the activities do not constitute an unrelated trade or business (sec. 141(e)(1)(G)).

Classification of section 501(c)(3) organization bonds as private activity bonds

Before enactment of the Tax Reform Act of 1986, States and local governments and section 501(c)(3) organizations both were defined as "exempt persons," under the Code bond provisions, and their bonds generally were subject to the same requirements. As exempt persons, section 501(c)(3) organizations were not treated as "private" persons, and their bonds were not "industrial development

[126] The acquired bonds are taken into account in determining how many bonds are reasonably expected to be issued by the borrowers from the pool in the calendar year in which they are issued.

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bonds" or "private loan bonds" (the predecessor categories to current private activity bonds).

Under present law, a bond is a private activity bond if its proceeds are used in a manner violating either (a) a private business test or (b) a private loan test. The private business test is a conjunctive two-pronged test. First, the test limits private business use of governmental bonds to no more than 10 percent of the proceeds.[127] Second, no more than 10 percent of the debt service on the bonds may be derived from private business users of the proceeds. The private loan test limits to the lesser of five percent or $5 million the amount of governmental bond proceeds that may be used to finance loans to persons other than governmental units.

Special restrictions on tax-exemption for section 501(c)(3) organization bonds

As stated above, present law treats section 501(c)(3) organizations as private persons; thus, bonds for their use may only be issued as private activity "qualified 501(1)(3) bonds," subject to the restrictions of Code section 145. The most significant of these restrictions limits the amount of outstanding bonds from which a section 501(c)(3) organization may benefit to $150 million. In applying this "$150 million limit," all section 501(c)(3) organizations under common management or control are treated as a single organization. The limit does not apply to bonds for hospital facilities, defined to include only acute care, primarily inpatient, organizations. A second restriction limits to no more than five percent the amount of the net proceeds of a bond issue that may be used to finance any activities (including all costs of issuing the bonds) other than the exempt purposes of the section 501(c)(3) organization.

Legislation enacted in 1988 imposed low-income tenant occupancy restrictions on existing residential rental property that is acquired by section 501(c)(3) organizations in tax-exempt-bond-financed transactions. These restrictions require that a minimum number of the housing units comprising the property be continuously occupied by tenants having family incomes of 50 percent (60 percent in certain cases) of area median income for periods of up to 15 years. These same low-income tenant occupancy requirements apply to for-profit developers receiving tax-exempt private activity bond financing.

Other restrictions

Several restrictions are imposed on private activity bonds generally that do not apply to bonds used to finance State and local government activities. Many of these restrictions also apply to qualified 501(c)(3) bonds.

No more than two percent of the net proceeds of a bond issue may be used to finance the costs of issuing the bonds, and these monies are not counted in determining whether the bonds satisfy

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[127] No more than 5 percent of bond proceeds may be used in a private business use that is unrelated to the governmental purpose of the bond issue. The 10-percent debt service test, described below, likewise is reduced to 5 percent in the case of such "disproportionate" private business use.

the requirement that at least 95 percent of the net proceeds of each bond issue be used for the exempt activities qualifying the bonds for tax-exemption.

The weighted average maturity of a bond issue may not exceed 120 percent of the average economic life of the property financed with the proceeds.

A public hearing must be held and an elected public official must approve the bonds before they are issued (or the bonds must be approved by voter referendum).

If property financed with private activity bonds is converted to a use not qualifying for net-exempt financing, certain loan interest penalties are imposed.

Both governmental and private activity bonds are subject to numerous other Code restrictions, including the following:

(a) The amount of arbitrage profits that may be earned on tax-exempt bonds is strictly limited, and most such profits must be rebated to the Federal Government.

(b) Banks may not deduct interest they pay to the extent of their investments in most tax-exempt bonds.

(c) Finally, interest on private activity bonds, other than qualified 501(c)(3) bonds, is a preference item in calculating the alternative minimum tax.

Reasons for Change

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

Explanation of Provision

The bill would amend the tax-exempt bond provisions of the Code to conform generally the treatment of bonds for section 501(c)(3) organizations to that provided for bonds issued to finance direct State or local government activities. Certain restrictions, described below, that have been imposed on qualified 501(c)(3) bonds (but not on governmental bonds) since 1986, and that address specialized policy concerns, are retained.

Repeal of private activity bond classification for bonds for section 501(c)(3) organizations

The concept of an "exempt person" that existed under the Code bond provisions before 1986, is reenacted. An exempt person is defined as (a) a State or local governmental unit or (b) a section 501(c)(3) organization, when carrying out its exempt activities under Code section 501(a). Thus, bonds for section 501(c)(3) organizations will no longer be classified as private activity bonds. Financing for unrelated business activities of such organizations will continue to be treated as a private activity for which tax-exempt financing is not authorized.

As exempt persons, section 501(c)(3) organizations will be subject to the same limits as States and local governments on using their bond proceeds to finance private business activities or to make private loans. Thus, no more than 10 percent of the bond proceeds [128] may be used in a business use of a person other than an exempt person if the Code security interest test is satisfied, and no more than five percent ($5 million if less) may be used to make loans to such "nonexempt" persons. By classifying governmental units and section 501(c)(3) organizations into a single category, the bill eliminates present-law impediments to common financings by eliminating the present-law need for separate bond issues—even when the activities of the parties are closely affiliated.

Repeal of most additional special restrictions on section 501(c)(3) organization bonds

Present Code section 145, which establishes additional restrictions on qualified 501(c)(3) bonds, is repealed, along with the restriction on bond-financed costs of issuance for section 501(c)(3) organization bonds (sec. 147(h)). This eliminates the $150-million-per-organization limit on nonhospital bonds for section 501(c)(3) organizations.

Retention of certain specialized requirements for section 501(c)(3) organization bonds

As stated above, the bill retains certain specialized restrictions on bonds for section 501(c)(3) organizations. First, the bill retains the requirement that existing residential rental property acquired by a section 501(c)(3) organization in a tax-exempt-bond-financed transaction satisfy the same low-income tenant requirements as similar housing financing for for-profit developers. Second, the bill retains the present-law maturity limitations applicable to bonds for section 501(c)(3) organizations, and the public approval requirements applicable generally to private activity bonds. Third, the bill continues to apply the penalties on changes in use of tax-exempt-bond-financed section 501(c)(3) organization property to a use not qualified for such financing.

Finally, the bill makes no amendments, other than technical conforming amendments, to the tax-exempt arbitrage restrictions, the alternative minimum tax tax-exempt bond preference, or the provi-

[128] This limit would be reduced to five percent in the case of disproportionate private use as under the present-law governmental bond disproportionate private use limit.

sions generally disallowing interest paid by banks on monies used to acquire or carry tax-exempt bonds.

Effective Date

The bill applies to bonds issued after December 31, 1992.

7. Authority for Treasury Department to exempt certain taxpayers from tax-exempt interest reporting requirement (sec. 4527 of the bill and sec. 6012 of the Code)

Present Law

Present law requires all individuals to report on their income tax returns the amount of interest on State and local government bonds they receive.

Reasons for Change

The Treasury Department should be authorized to exempt taxpayers from requirements to compile and report information on income tax returns if the Secretary determines that such information is not useful to the administration of the tax laws.

Explanation of Provision

The bill authorizes the Treasury Department to provide exceptions from the requirement that taxpayers report interest on State and local government bonds on their Federal income tax returns in cases where the Secretary determines that such information is not useful to the administration of the tax laws.

Effective Date

This provision is effective for taxable years beginning after the date of enactment.

8. Repeal of expired provisions (sec. 4528 of the bill and sec. 148 of the Code)

Present Law

Present law includes two special exceptions to the arbitrage rebate and pooled financing temporary period rules for certain qualified student loan bonds. This exception applied only to bonds issued before January 1, 1989.

Explanation of Provision

These special exceptions are deleted as "deadwood."

Effective Date

This provision is effective on the date of enactment.

Part IV—Taxable Year Election for Partnerships, S Corporations, and Personal Service Corporations (secs. 4531-4534 of the bill and secs. 280H, 444, and 7519 of the Code)

Present Law

In general

A partnership is generally required for Federal income tax purposes to use the taxable year that is used by a majority of its partners. An S corporation is generally required for Federal income tax purposes to use the calendar year as its taxable year. A personal service corporation also is generally required for Federal income tax purposes to use the calendar year as its taxable year.[129]

A partnership, S corporation, or personal service corporation, however, may elect to use a taxable year other than the required taxable year. In the case of a partnership, S corporation, or personal service corporation that is adopting a taxable year or changing a taxable year, the taxable year that may be elected generally may not result in a deferral period of more than three months. For this purpose, the deferral period generally is the number of months between (1) the beginning of the taxable year of the partnership, S corporation, or personal service corporation, and (2) the close of the first required taxable year that ends within such year.

A partnership, S corporation, or personal service corporation is required to obtain the approval of the Internal Revenue Service in order to change to a taxable year other than the required taxable year. A partnership, S corporation, or personal service corporation that terminates an election to use a taxable year other than the required taxable year may not make an election for any subsequent taxable year.

An election may not be made by a partnership, S corporation, or personal service corporation that is part of a tiered structure other than a tiered structure that is comprised of one or more partnerships or S corporations, all of which have the same taxable year. An electing partnership, S corporation, or personal service corporation that becomes part of a proscribed tiered structure is considered to have terminated its election.

Required payment for electing partnerships and S corporations

A partnership or S corporation that elects a taxable year other than the required taxable year is required to make a payment to the Internal Revenue Service (a "required payment") that is designed to compensate the Federal government for the deferral of tax that results from the use of a taxable year other than the required taxable year. The amount of the required payment for any taxable year for which an election is in effect (an "applicable election year") equals the excess (if any) of (1) the highest rate of tax in effect under section 1 of the Code plus 1 percentage point multiplied by the net base year income of the partnership or S corpora-

[129] For this purpose, a personal service corporation is defined as a C corporation the principal activity of which is the performance of services if (1) the services are substantially performed by employee-owners, and (2) more than 10 percent of the stock of the corporation is owned by employee-owners.

tion, over (2) the net required payment balance. The net required payment balance is the aggregate amount of required payments less refunds of required payments for all preceding taxable years for which an election was in effect.

The required payment is due on May 15 of the calendar year that follows the calendar year in which the applicable election year began. The required payment is required to be refunded by the Internal Revenue Service if certain conditions are satisfied. No interest is to be paid by the Internal Revenue Service with respect to a refund of a required payment.

Minimum distribution requirement for electing personal service corporations

A personal service corporation that elects a taxable year other than the required taxable year is required to satisfy a minimum distribution requirement that applies to applicable amounts paid by the personal service corporation.[130] If the minimum distribution requirement is not satisfied for any taxable year for which a taxable year election is in effect, the deduction otherwise allowed for applicable amounts paid or incurred during such taxable year is limited to the applicable amounts paid during the deferral period of the taxable year multiplied by a ratio, the numerator of which is the number of months in the taxable year and the denominator of which is the number of months in the deferral period of the taxable year.

The minimum distribution requirement is satisfied with respect to a taxable year only if the applicable amounts paid or incurred during the deferral period of the taxable year equal or exceed the lesser of (1) the applicable amounts paid during the preceding taxable year multiplied by a ratio, the numerator of which is the number of months in the deferral period of the taxable year and the denominator of which is the number of months in the taxable year, or (2) the applicable percentage of the adjusted taxable income for the deferral period of the taxable year.

A net operating loss carryback is not allowed to or from a taxable year of a personal service corporation for which a taxable year election is in effect.

Reasons for Change

The committee believes that the limitations on the taxable years that may be elected by partnerships, S corporations, and personal service corporations have resulted in an excessive burden on tax return preparers due to the concentration of workload during a limited portion of the year. In order to more evenly spread this workload throughout the year, the committee believes that a partnership, S corporation, or personal service corporation should be allowed to elect any taxable year, provided that the tax benefit from the deferral of income that is available through the use of a tax-

[130] The term "applicable amount" generally is defined as any amount paid to an employee-owner that is includible in the gross income of the employee-owner other than any dividend paid by the personal service corporation or any gain from the sale or exchange of property by the employee-owner to the personal service corporation.

able year other than the required taxable year is eliminated through other means.

Explanation of Provision

In general

The bill allows a partnership, S corporation, or personal service corporation to elect any taxable year without regard to the length of the deferral period of the taxable year elected. If a partnership, S corporation, or personal service corporation, however, has annual reports or statements that (1) ascertain the income, profit, or loss of the entity, and (2) are used for credit purposes or are provided to the partners, shareholders, or other proprietors of the entity, then the entity may only elect a taxable year that covers the same period as such annual reports or statements.

The bill also repeals the provision of present law that prohibits a partnership, S corporation, or personal service corporation from electing a taxable year other than the required taxable year if an earlier taxable year election has been terminated. The bill continues to require a partnership, S corporation, or personal service corporation to obtain the approval of the Internal Revenue Service in order to change a taxable year (including, unlike present law, a change to the required taxable year).

The committee anticipates that the Internal Revenue Service will provide a procedure by which a partnership, S corporation, or personal service corporation may expeditiously obtain the approval of the Internal Revenue Service in order to change a taxable year (for example, by timely filing a form with the Internal Revenue Service). The committee anticipates that this "automatic consent" procedure will only apply to a partnership, S corporation, or personal service corporation that has not changed its taxable year within the past 6 calendar years, except that the 6-year limitation will not apply to any partnership, S corporation, or personal service corporation that has changed its taxable year in order to comply with the taxable year requirements contained in the Tax Reform Act of 1986.

The committee also anticipates that the "automatic consent" procedure will require any net operating loss of a personal service corporation that arises in a short period required to effect a change in taxable year to be deducted ratably over a 6-year period beginning with the first taxable year after the short period. In addition, the committee anticipates that the "automatic consent" procedure will require any excess of deductions over income of a partnership or S corporation that arises in a short period required to effect a change in taxable year to be taken into account by the partners or shareholders over a 6-year period beginning with the taxable year of the partners or shareholders that includes the last day of the first taxable year of the partnership or S corporation that occurs after the short period.

The bill also provides that a taxable year election is to remain in effect until the partnership, S corporation, or personal service corporation terminates its election and changes to the required tax-

able year.[131] A change from a taxable year that is not a required taxable year to another taxable year that is not a required taxable year is not treated as a termination of the taxable year election unless the taxable year is allowable by reason of a business purpose.

The bill provides that a partnership, S corporation, or personal service corporation is not to be considered part of a tiered structure solely because a trust the beneficiaries of which use the calendar year owns an interest in the partnership, S corporation, or personal service corporation. Consequently, an election of a taxable year other than the required taxable year may be made by a partnership, S corporation, or personal service corporation with respect to which a trust owns an interest if all of the beneficiaries of the trust use the calendar year and the partnership, S corporation, or personal service corporation is not otherwise considered to be part of a proscribed tiered structure.

Required payment for electing partnerships and S corporations

The bill increases the amount of the required payment that must be made by a partnership or S corporation that elects a taxable year other than the required taxable year (including any partnership or S corporation that has an election in effect on the date of enactment of the bill). Under the bill, the amount of the required payment for any applicable election year equals the excess (if any) of (1) the highest rate of tax in effect under section 1 of the Code as of the close of the first required taxable year ending within the applicable election year plus 2 percentage points, multiplied by the net base year income of the partnership or S corporation, over (2) the net required payment balance.

In addition, the bill requires an additional required payment for any new applicable election year of a partnership or S corporation. For this purpose, a new applicable election year is defined as any applicable election year that either (1) immediately follows a taxable year for which a taxable year election was not in effect, or (2) covers a different period than the preceding taxable year by reason of a change in the taxable year elected. If, however, the applicable election year described in the preceding sentence is a short taxable year that does not include the last day of a required taxable year, then the new applicable election year is the taxable year immediately following the short taxable year.

In the case of a new applicable election year that does not result from a change in the taxable year elected, the amount of the additional required payment equals 75 percent of the amount of the required payment for such applicable election year (determined without regard to the additional required payment). In the case of a new applicable election year that results from a change in the taxable year elected, the amount of the additional required payment equals 75 percent of the excess (if any) of (1) the amount of the re-

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[131] As under present law, a taxable year election is also terminated if: (1) the entity becomes part of a proscribed tiered structure; or (2) a partnership or S corporation willfully fails to comply with the required payment rules described below. In addition, the bill authorizes the Treasury Department to issue regulations which provide for the termination of a taxable year election if the entity does not comply with the annual financial statement requirement described above.

quired payment for such applicable election year (determined without regard to the additional required payment), over (2) the amount of the required payment for such applicable election year (determined without regard to the additional required payment) determined by using the deferral ratio and the deferral period that applied to the taxable year that was used prior to the change.[132]

The additional required payment is required to be made on or before September 15 of the calendar year in which the new applicable election year begins. A partnership or S corporation that fails to make the additional required payment by the due date of such payment is treated as having terminated the taxable year election and changed to the required taxable year.

In determining the net base year income of a partnership or S corporation for purposes of the required payment (including the additional required payment), the base year is defined as the first taxable year of 12 months (or 52-53 weeks) of the partnership or S corporation that precedes the applicable election year.[133] In addition, in the case of a new applicable election year, the net income for the base year is to be increased by the excess (if any) of (1) the applicable payments taken into account in determining net income for the base year, over (2) 120 percent of the average amount of applicable payments made during the 3 taxable years immediately preceding the base year.[134]

The bill also requires interest to be paid by the Internal Revenue Service with respect to a refund of a required payment but only for the period that begins on the date that the refund is payable and that ends on the date of the payment of the refund.

Minimum distribution requirement for electing personal service corporations

The bill modifies the minimum distribution requirement that must be satisfied by a personal service corporation that elects a taxable year other than the required taxable year (including a personal service corporation that has an election in effect on the date of enactment of the bill). The minimum distribution requirement is satisfied with respect to a taxable year only if the applicable amounts paid during the deferral period of the taxable year equal or exceed the lesser of (1) 110 percent of the applicable amounts paid during the first preceding taxable year of 12 months (or 52-53 weeks)[135] multiplied by a ratio, the numerator of which is the

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[132] In the case of a new applicable election year that results from a change in the taxable year elected, an additional required payment is required only if the deferral period of the new applicable election year exceeds the deferral period of the former applicable election year.

[133] The Treasury Department is authorized to promulgate regulations that provide for the application of the required payment rules if there is no taxable year of 12 months (or 52-53 weeks) of the partnership or S corporation that precedes the applicable election year. The committee anticipates that these regulations will annualize the results of any short taxable year that is used as the base year.

[134] In the event that there are not 3 taxable years immediately preceding the base year, the provision is to apply based on the number of taxable years immediately preceding the base year.

[135] The Treasury Department is authorized to promulgate regulations that provide for the application of the minimum distribution requirement if there is no preceding taxable year of 12 months (or 52-53 weeks) of the personal service corporation. The committee anticipates that these regulations will annualize the results of any short year that is taken into account for purposes of these rules.

number of months in the deferral period of the taxable year and the denominator of which is 12, or (2) 110 percent of the applicable percentage of the adjusted taxable income for the deferral period of the taxable year.

The bill also permits a personal service corporation to carry back a net operating loss from a taxable year for which a taxable year election was not in effect to a taxable year for which a taxable year election was in effect.

Effective Date

The provision applies to taxable years beginning after December 31, 1991.

Part V—Cooperatives

1. Discharge of Indebtedness Income from Prepayment of REA Loans at a Discount (sec. 4541 of the bill and sec. 501(c)(12) of the Code)

Present Law

Internal Revenue Code

Section 501(c)(12) of the Internal Revenue Code provides an income tax exemption for rural electric cooperatives if at least 85% of the cooperative's income is derived from member sources. Income from cancellation of indebtedness generally is not derived from member sources. Nonetheless, section 501(c)(12)((b)(iv) provides that the 85% test is determined without regard to any discharge of indebtedness income arising from prepayment of loans of the Rural Electrification Administration pursuant to sections 306A, 306B, or 311 of the Rural Electrification Act.[136]

1990 Farm Act

The Food, Agriculture, Conservation, and Trade Act of 1990 ("1990 Farm Act") provided that rural electric cooperatives that merge with another rural electric cooperative that previously had prepaid REA loans under the 1988 or 1989 Reconciliation Acts also could prepay REA loans at a discount.

Reasons for Change

The committee believes that it is appropriate to disregard certain discharge of indebtedness income in determining whether rural electric cooperatives satisfy the 85-percent of income test under present law.

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[136] The 1988 and 1989 Budget Reconciliation Acts provided that rural electric cooperatives could prepay loans made by the Rural Electrification Administration (REA) at a discount in 1988 and 1989 as part of the Agriculture Committee's revenue raising obligation under the budget reconciliation process. The 1989 and 1990 Technical Correction Acts which made technical corrections to the 1988 and 1989 Budget Reconciliation Acts provided the exclusion of present law. [The amendments were treated as technical because it was believed that the tax writing committees of Congress were responsible, as parties to the Budget Reconciliation Acts, for the budget reconciliation acts reaching their revenue targets and the amendments were necessary for those Budget Reconciliation Acts to reach their revenue targets.]

Explanation of Provision

The bill provides that the income from discharge of indebtedness from the prepayment of loans of the Rural Electrification Administration under section 2387 of the 1990 Farm Act is disregarded for purposes of determining whether a rural electric cooperative satisfies the 85-percent test of section 501(c)(12).

Effective Date

The provision is effective for taxable years beginning before, on, or after the date of enactment.

2. Private Foundation Common Investment Fund (sec. 4542 of the bill and new section 501(n) of the Code)

Present Law

Section 501(c)(3) requires that an organization be organized and operated exclusively for an exempt purpose in order to qualify for tax-exempt status under that section.

Section 501(f) provides that an organization is treated as organized and operated exclusively for charitable purposes if it is comprised solely of members that are educational institutions and is organized and operated solely to hold, commingle, and collectively invest (including arranging for investment services by independent contractors) in stocks and securities, the moneys contributed thereto by the members, and to collect income therefrom and turn over the entire amount thereof, less expenses, to such members.

Reasons for Change

The committee believes it is appropriate to extend to private foundations and community foundations present-law rules that permit educational institutions to form tax-exempt cooperative service organizations to provide for collective investment of their assets.

Explanation of Provision

The bill provides that a cooperative service organization comprised solely of members that are tax-exempt private foundations and community foundations [137] shall be treated as organized and operated exclusively for charitable purposes if: (1) it has at least 20 members; (2) no one member holds (after the organization's second taxable year) more than 10 percent (by value) of the interests in the organization; (3) no one member controls the organization or any other member; (4) the members are permitted to dismiss any of the organization's investment advisors (following reasonable notice)

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[137] For purposes of the provision, "community foundations" are a form of charitable trust or fund (which generally are established to attract large contributions of a capital or endowment nature for the benefit of a particular community or area) as to which section 170(b)(1)(A)(vi) applies. See Treas. Reg. sec. 1.170A-9(e)(10).

The committee expects that members will present the organization with verification of their status as tax-exempt private foundations or community foundations at the time they become members (i.e., when they make an initial investment). The committee intends that a reasonable time period should be allowed for withdrawal by a member that subsequently ceases to qualify as a tax-exempt private foundation or community foundation.

upon a vote of members holding a majority of interest in the account managed by such advisor; (5) the organization is organized and operated solely to hold, commingle, and collectively invest (including arranging for investment services by independent contractors) in stocks and securities, the monies contributed by the members, and to collect income therefrom and turn over the entire amount thereof, less expenses, to such members.[138]

A cooperative service organization meeting the criteria of the proposed modification would be subject to the present-law excise tax provisions applicable to private foundations (e.g., sec. 4941 rules governing self-dealing arrangements), other than sections 4940 and 4942. In addition, each member's allocable share (whether or not distributed) of the capital gain net income and gross investment income of the organization for any taxable year of the organization is treated, for purposes of the excise tax imposed under present-law section 4940, as capital gain net income and gross investment income of the member for the taxable year of such member in which the taxable year of the organization ends.

Effective Date

The provision applies to taxable years ending after the date of enactment.

3. Treatment of amounts received by telephone cooperatives (sec. 4543 of the bill and secs. 501(c)(12) and 512 of the Code)

Present Law

Mutual or cooperative telephone companies ("telephone cooperatives") are exempt from Federal income tax if 85 percent or more of their income consists of amounts collected from members for the sole purpose of meeting losses and expenses (sec. 501(c)(12)(A)). In applying this 85-percent test, certain income received by a telephone cooperative is disregarded, including income received from a nonmember telephone company for the performance of communication services which involve members of the telephone cooperative, certain pole rental income, and income from the sale of display listings in a telephone directory sold to members of the telephone cooperative (sec. 501(c)(12)(B)).

Tax-exempt organizations generally are subject to the unrelated business income tax (UBIT) on income from a trade or business that is not substantially related to the organization's tax-exempt purposes. Under special rules, certain investment income (e.g., interest, dividends, royalties, and certain rents) generally is exempt from UBIT, although some tax-exempt organizations, such as social clubs described in section 501(c)(7) and certain mutual benefit organizations, are subject to UBIT on their investment income.

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[138] The committee intends that an organization will be deemed to be organized and operated solely to collectively invest in stocks and securities if its income is derived solely from investing in stocks and securities, and ordinary and routine investments in connection with a stock and securities portfolio.

A cooperative service organization described in the provision qualifies for tax-exempt status under section 501(c)(3) only if the other applicable requirements of that section (e.g., prohibition of private inurement, political activities, and substantial lobbying) are satisfied.

Reasons for Change

In view of regulatory changes in the telecommunications industry affecting the division of revenues between long-distance carriers and local phone companies, the committee believes that it is appropriate to modify the tax treatment for purposes of sections 501(c)(12) and 512 of certain revenues received by telephone cooperatives.

In general, the committee believes that income received indirectly from members through a nonmember telephone company for communication services indirectly provided to members should qualify as member-source income for purposes of the 85-percent test of section 501(c)(12). Consistent with the present-law exclusion of directory income, the committee believes that certain income from services related to telecommunications (e.g., billing and collection services provided to long-distance telephone companies) should be excluded from the computation of the 85-percent test. Finally, the committee believes that a telephone cooperative should not lose its tax-exempt status where it derives more interest income on replacement reserves than the de minimis amount allowed under the 85-percent test, so long as the excess is subject to tax and such income does not become the predominant source of income of the cooperative.

Explanation of Provision

The bill amends section 501(c)(12) to provide that 50 percent of the income received by a telephone cooperative from a nonmember telephone company—e.g., fees received for originating (or terminating) a long-distance call placed by (or to) a member—are treated as collected from members of the telephone cooperative for the sole purpose of meeting the losses and expenses of the telephone cooperative.[139] The remaining 50 percent of income received by a telephone cooperative from a nonmember telephone company is, as under present law, excluded from the 85-percent test under section 501(c)(12)(B)(i).

The bill also excludes from the 85-percent test under section 501(c)(12) amounts received by a telephone cooperative from billing and collection services performed for another telephone company.[140]

In addition, the bill provides that telephone cooperatives will not lose their tax-exempt status under section 501(c)(12) if they earn certain investment "reserve income" in excess of 15 percent of

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[139] Amounts received by a telephone cooperative from a nonmember telephone company (e.g., long-distance carrier) often are referred to as "access charges." Thus, under the bill, 50 percent of such access charges received by a telephone cooperative from another telecommunications company are treated as member-source income for purposes of the 85-percent test of section 501(c)(12).

[140] Telephone cooperatives (and other local telephone companies) often serve as billing and collection agents for other telecommunications companies. (That is, a telephone cooperative bills, and collects from, its members not only charges for local phone service provided by the cooperative but also charges for amounts owed to a long-distance carrier for the member's long-distance calls.) Telephone cooperatives are compensated for performing billing and collection services, generally by retaining a portion of the long-distance charges collected from members. Similar to the present-law treatment of certain pole rental income and directory listing (e.g., "yellow pages") revenue, the bill treats such billing and collection revenues as excluded from the 85-percent test under section 501(c)(12).

their total income, but only if such reserve income (when added to other income not collected from members) does not exceed 35 percent of the cooperative's total income. For purposes of this provision, "reserve income" is defined as income that otherwise would be excluded from UBIT under section 512(b) (e.g., interest and dividends) and that is set aside for the repair or replacement of telephone facilities of the cooperative. Under the provision, tax-exempt telephone cooperatives are subject to the UBIT on such reserve income between the 15-percent and 35-percent range.

Effective Date

The provision is effective for taxable years beginning before, on, or after the date of enactment.

4. Treatment of housing cooperatives (sec. 4544 of the bill and secs. 277 and 1388 of the Code)

Present Law

Treatment of cooperatives generally

A cooperative association is an organization, usually a corporation, which benefits its members and patrons by selling goods to them and purchasing products from them and returning to them any income in excess of costs. Unlike other corporations, a cooperative association may exclude from its taxable income patronage dividends paid to its members or patrons. For a nonexempt cooperative, a patronage dividend must be determined by reference to the net earnings of the organization from business done with or for its patrons and cannot include any earnings other than from such business.

Deductions by membership organizations

A membership organization operated primarily to furnish services or goods to its members may deduct costs attributable to such operation only to the extent of income derived from the members (sec. 277). The Internal Revenue Service has ruled that section 277 applies to housing cooperatives.[141] Two courts have refused to apply section 277 to nonexempt cooperatives.[142]

Reasons for Change

The committee was concerned about the uncertainty created by the conflicting authorities over the application of section 277 to housing cooperatives. Accordingly, the committee decided to clarify the rules governing the deduction of nonpatronage losses. The committee also believed it appropriate to specify the character of certain common transactions.

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[141] *See* Rev. Rul. 90-36, 1990-1 C.B. 59.

[142] *See* Landmark v. United States, 92-1 Tax Cas. (CCH) para. 50,058 (Cl. Ct. 1992); Farm Service Cooperative v. Commissioner, 70 T.C. 145, 155-57 (1978), *rev'd on other grounds*, 611 F.2d 1270 (9th Cir. 1980).

Explanation of Provision

The bill provides that section 277 does not apply to a cooperative housing corporation [143] and that patronage losses of the corporation cannot offset earnings that are not patronage earnings.

Patronage earnings and losses generally include earnings and losses derived from business done with or for patrons of the corporation. In addition, the bill treats the following as patronage sourced: (1) interest on reasonable reserves established in connection with the corporation, including reserves required by a government agency or lender, (2) rents from laundry and parking to the extent attributable to use of the facilities by tenants-stockholders [144] and their guests, and (3) (in the case of a limited equity cooperative housing corporation [145]) rental income attributable to a housing project operated by the corporation.

The committee intends that no inference be drawn from the provision regarding the deductibility of patronage losses under present law.

Effective Date

The provision applies to taxable years beginning after date of enactment.

5. Treatment of safe harbor leases of membership organizations (sec. 4545 of the bill and sec. 277 of the Code)

Present Law

Deductions of membership organizations

A membership organization operated primarily to furnish services or goods to its members may deduct costs attributable to such operations only to the extent of income derived from the members (sec. 277). In essence, section 277 prohibits using losses incurred from transactions with members to offset income derived from transactions with nonmembers.

Safe harbor leases

The Economic Recovery Tax Act of 1981 ("ERTA") contained rules designed to permit full utilization of tax benefits. Under these so-called "safe harbor lease rules," a lease meeting certain requirements was respected for Federal income tax purposes notwithstanding other legal principles: the lessor in the agreement was treated as the property owner, entitled to cost recovery deductions and investment credits. A person complying with these rules

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[143] A cooperative housing corporation generally is a corporation (1) that has one class of stock, (2) each of the stockholders of which is entitled, solely by reason of ownership of stock, to occupy a dwelling owned or leased by the cooperative, (3) no stockholder of which is entitled to receive any distribution not out of earnings and profits of the cooperative, and (4) 80 percent or more of the gross income for the taxable year of which is derived from tenant-stockholders.

[144] A tenant-stockholder generally is a person owning fully paid-up stock in the cooperative corporation, the purchase price of which bore a reasonable relationship to the value of the cooperative's equity in land and buildings attributable to the dwelling unit occupied by such person.

[145] Generally, a cooperative housing corporation is a limited equity cooperative housing corporation if the amount paid by a tenant-stockholder for stock in the corporation cannot exceed the sum of (1) the consideration paid by the first tenant-stockholder, adjusted for cost of living, (2) payments for improvements to the dwelling unit and (3) payments to amortize corporate indebtedness arising from the acquisition or development of real property.

could, by entering into a nominal sale and safe-harbor leaseback, effectively sell tax benefits associated with property while retaining all the benefits and burdens of ownership. The safe harbor lease rules were repealed by the Tax Equity and Fiscal Responsibility Act of 1982.

Reasons for Change

The committee understands that a number of electricity generating cooperatives subject to section 277 engaged in safe harbor leases in reliance upon ERTA. In a typical safe harbor lease transaction, the cooperative first sold property to a corporation on an installment sale basis in exchange for cash equal to the value of tax benefits from the property and an interest bearing installment sale note and then leased the property back from that corporation for an amount equal to the payments on the note. Thus, the transaction created both interest income (from the installment sales note) and rental expense (from the lease back) for the cooperative.

The committee understands that the Internal Revenue Service has asserted that the interest income is not derived from transactions with members but that the rental expense must be allocated between income derived from members and nonmembers. Under this assertion, a cooperative can offset only the relatively small amount of rental expense allocable to nonmember business against its interest income, resulting in significant additional tax liability. The additional liability largely nullifies the benefit of safe harbor leasing.

The committee believes that the safe harbor lease rules were intended to benefit cooperatives notwithstanding section 277. The committee believes, however, that the safe harbor lease should not result in a cooperative avoiding tax on nonmember income. Accordingly, the net interest income and rental expense arising from safe-harbor leases should be allocated between members and nonmember income.

Explanation of Provision

The bill provides that the interest income and rental expense from the sale and leaseback of the property under a safe harbor lease are to be first netted and the difference allocated between members and nonmembers in proportion to the business done with each group.

Effective Date

The provision applies to taxable years beginning before, on, or after the date of enactment.

Part VI—Employment

1. Employer Tax Credit for FICA Paid on Tip Income (sec. 4551 of the bill and sec. 38 of the Code)

Present Law

Under present law, all employee tip income is treated as employer-provided wages for purposes of the Federal Unemployment Tax

Act (FUTA) and the Federal Insurance Contributions Act (FICA). For purposes of the minimum wage provisions of the Fair Labor Standards Act (FLSA), reported tips are treated as employer-provided wages to the extent they do not exceed one-half of such minimum wage.

Reasons for Change

The committee believes that it is appropriate to ease the payroll tax burden of employers in tipped industries.

Explanation of Provision

The bill provides a business tax credit (sec. 38) in an amount equal to the employer's FICA tax obligation (7.65 percent) attributable to reported tips in excess of those treated as wages for purposes of satisfying the minimum wage provisions of the FLSA. To prevent double dipping, no deduction is allowed for any amount taken into account in determining the credit. The bill prohibits carryback of unused FICA credits (sec. 39) to a taxable year ending before the date of enactment.

Effective Date

The provision is effective for tips received and wages paid after the date of enactment.

2. Deny Deduction for Club Dues (sec. 4552 of the bill and sec. 162 of the Code)

Present Law

No deduction is permitted for club dues unless the taxpayer establishes that his or her use of the club was primarily for the furtherance of the taxpayer's trade or business and the specific expense was directly related to the active conduct of that trade or business. Luncheon club dues are deductible to the same extent and subject to the same rules as business meals in a restaurant and are not subject to these special rules for club dues. No deduction is permitted for an initiation or similar fee that is payable only upon joining a club if the useful life of the fee extends over more than one year. Such initiation fees are nondeductible capital expenditures.[146]

Reasons for Change

Under present law, taxpayers can obtain a tax deduction for dues for a club (such as a country club) with respect to which a significant element of personal pleasure and enjoyment is present. The committee believes that it is inappropriate to permit a deduction for such expenditures. Denying all deductions for club dues also simplifies present law, in that a strict nondeductibility rule is easier to comply with than the present-law rule requiring an assessment of the primary purpose of the use of the club.

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[146] *Kenneth D. Smith*, 24 TCM 899 (1965).

Explanation of Provision

Under the bill, no deduction is permitted for club dues. This rule applies to all types of clubs: business, social, athletic, luncheon, or sporting clubs. Specific business expenses (e.g. meals) incurred at a club would be deductible only to the extent they otherwise satisfy present-law standards for deductibility.

Effective Date

The provision is effective for club dues paid on or after the date of enactment.

3. Employment tax status of fishermen (sec. 4553 of the bill and sec. 3121(b)(20) of the Code)

Present Law

Under present law, service as a crew member on a fishing vessel is generally excluded from the definition of employment for purposes of income tax withholding on wages and for purposes of FICA and FUTA taxes if the operating crew of the boat normally consists of fewer than 10 individuals, the individual receives a share of the catch based on the total catch, and the individual does not receive cash remuneration other than proceeds from the sale of the individual's share of the catch.

Reasons for Change

The committee believes that providing a statutory definition for determining whether the crew of a fishing boat normally consists of 10 or fewer individuals would make the provision easier to apply and administer. Providing that the exemption continues to apply if an individual receives a small amount of cash in addition to a share of the catch would recognize long-standing industry tradition.

Explanation of Provision

The operating crew of a boat is to be treated as normally made up of fewer than 10 individuals if the average size of the operating crew on trips made during the preceding 4 calendar quarters consisted of 10 or fewer individuals. In addition, the exemption applies if the crew member receives, in addition to the cash remuneration permitted under present law, cash remuneration which does not exceed $100 per trip, is contingent on a minimum catch, and is paid solely for additional duties (e.g., mate, engineer, or cook) for which additional cash remuneration is traditional.

Effective Date

The provision applies to remuneration paid on or after January 1, 1992. In addition, the provision applies to remuneration paid after December 31, 1984, and before January 1, 1993, unless the payor treated such remuneration when paid as being subject to wage withholding and employment taxes.

Part VII—Other Provisions

1. Close partnership taxable year with respect to deceased partner (sec. 4561 of the bill and sec. 706(c) of the Code)

Present Law

The partnership taxable year closes with respect to a partner whose entire interest is sold, exchanged, or liquidated. Such year, however, generally does not close upon the death of a partner. Thus, a decedent's entire share of items of income, gain, loss, deduction and credit for the partnership year in which death occurs is taxed to the estate or successor in interest rather than to the decedent on his or her final income tax return. See *Estate of Hesse v. Commissioner*, 74 T.C. 1307, 1311 (1980).

Reasons for Change

The rule leaving open the partnership taxable year with respect to a deceased partner was adopted in 1954 to prevent the bunching of income that could occur with respect to a partnership reporting on a fiscal year other than the calendar year. Without this rule, as many as 23 months of income might have been reported on the partner's final return. Legislative changes occurring since 1954 have required most partnerships to adopt a calendar year, reducing the possibility of bunching. Consequently, income and deductions are better matched if the partnership taxable year closes upon a partner's death and partnership items are reported on the decedent's last return.

Present law closes the partnership taxable year with respect to a deceased partner only if the partner's entire interest is sold or exchanged pursuant to an agreement existing at the time of death. By closing the taxable year automatically upon death, the provision reduces the need for such agreements.

Explanation of Provision

The bill provides that the taxable year of a partnership closes with respect to a partner whose entire interest in the partnership terminates, whether by death, liquidation or otherwise.

Effective Date

The provision applies to partnership taxable years beginning after December 31, 1991.

2. Treatment of built-in losses for purposes of the corporate alternative minimum tax (sec. 4562 of the bill and sec. 56(g) of the Code)

Present Law

For purposes of the regular corporate tax, if at the time of an ownership change, a corporation has a net operating loss or a net unrealized built-in loss, the use of such losses in post-change periods is limited. A corporation has a net unrealized built-in loss if the aggregate adjusted bases of the assets of the corporation exceed the

fair market value of the assets immediately before the change of ownership (sec. 382).

For purposes of the adjusted current earnings ("ACE") component of the corporate alternative minimum tax ("AMT"), if a corporation with a net unrealized built-in loss undergoes an ownership change in a taxable year beginning after 1989, the adjusted basis of each asset of such corporation generally is adjusted to each asset's fair market value (sec. 56(g)(4)(G)). This rule essentially eliminates, rather than limits, the use of built-in losses for ACE purposes. The net operating loss of a corporation, on the other hand, is not eliminated for AMT purposes after a change of ownership.

Reasons for Change

Present law complicates the treatment of built-in losses of a corporation after a change of ownership by providing different rules for regular and alternative minimum tax and by providing rules different than those applicable to net operating losses. The present-law alternative minimum tax rules applicable to built-in losses require a significant amount of additional recordkeeping.

Explanation of Provision

The bill repeals the ACE rule relating to the treatment of built-in losses after a change of ownership. Thus, for ACE purposes, the treatment of built-in losses would be similar to the treatment of net operating loss carryovers (in the same way that the treatment of built-in losses is similar to the treatment of net operating losses for regular tax purposes).

Effective Date

The provision is effective for changes of ownership occuring after December 31, 1991.

3. Authorization for Bureau of Land Management to Use Proceeds of Reforestation Trust Fund (sec. 4563 of the bill)

Present Law

The United States Treasury contains a Reforestation Trust Fund the proceeds of which are used by the Department of Agriculture for reforestation and timber stand improvement of lands in the national forest system and for related administrative costs. The amount transferred to the Reforestation Trust Fund for any fiscal year equals the amount collected during such year from custom tariffs on certain wood products, except that the maximum amount transferred for any fiscal year may not exceed $30 million.

Reasons for Change

The committee believes that additional funds should be made available to the Department of the Interior for the purpose of financing the reforestation and forest conservation of public lands administered by the Bureau of Land Management.

Explanation of Provision

The bill increases from $30 million to $45 million the maximum amount that may be transferred to the Reforestation Trust Fund for any fiscal year. The additional $15 million that is transferred to the Reforestation Trust Fund for any fiscal year is to be allocated and made available to the Department of the Interior for the reforestation, forest development, and forest conservation activities of the Bureau of Land Management and for related administrative costs.

Of the additional $15 million that is transferred to the Reforestation Trust Fund for any fiscal year, $14 million is to be allocated for Oregon and California Railroad and Coos Bay Wagon Road grant lands in Oregon. The remaining $1 million is to be allocated for public domain lands located in any State based on (in order of priority): (1) the level of timber sales (measured in board feet) during the previous calendar year from public domain lands located within the State; (2) the amount of reforestation backlog in the State; (3) the need for planting as part of the reforestation program; and (4) the need forest development as part of the reforestation program.

The bill also provides that if the wood product tariffs are insufficient to provide an additional $15 million for any fiscal year, the Treasury Department is required to transfer to the Reforestation Trust Fund an amount equal to the shortfall in the wood product tariffs. In the case of any such shortfall in the wood product tariffs, 93⅓ percent of the amount of the shortfall is to be taken from the Federal portion of the Bureau of Land Management timber receipt payments from the Coos Bay Wagon Road grant lands in Oregon and the remainder of the shortfall is to be taken from the Federal portion of the Bureau of Land Management timber receipt payments from public domain lands in the States.

Effective Date

The provision is effective on October 1, 1992.

4. Repeal of Investment Restrictions Applicable to Nuclear Decommissioning Funds (sec. 4564 of the bill and sec. 468A of the Code)

Present Law

A taxpayer that is required to decommission a nuclear power plant may elect to deduct certain contributions that are made to a nuclear decommissioning fund. A nuclear decommissioning fund is a segregated fund the assets of which are to be used exclusively to pay nuclear decommissioning costs, taxes on fund income, and certain administrative costs. The assets of a nuclear decommissioning fund that are not currently required for these purposes must be invested in (1) public debt securities of the United States, (2) obligations of a State or local government that are not in default as to principal or interest, or (3) time or demand deposits in a bank or an insured credit union located in the United States. These investment restrictions are the same restrictions which apply to black

lung trusts that are established under section 501(c)(21) of the Code.

Reasons for Change

The committee believes that a nuclear decommissioning fund should be allowed to invest in any asset that is considered appropriate by the applicable public utility commission or other State regulatory body.

Explanation of Provision

The bill repeals the present-law investment restrictions that apply to nuclear decommissioning funds.

Effective Date

The provision applies to taxable years beginning after December 31, 1991.

5. Determinations of gas produced from qualifying sources under the nonconventional fuels production credit (sec. 4565 of the bill and sec. 29 of the Code)

Present Law

Nonconventional fuels are eligible for a production credit ("the section 29 credit") equal to $3 per barrel or Btu oil barrel equivalent [147] (the credit amount generally is adjusted for inflation, except for gas produced from a tight formation). Qualified fuels must be produced domestically from a well drilled, or a facility placed in service, before January 1, 1993. The production credit is available for qualified fuels sold before January 1, 2003.

Qualified fuels include (1) oil produced from shale and tar sands, (2) gas produced from geopressured brine, Devonian shale, coal seams, a tight formation, or biomass (i.e., any organic material other than oil, natural gas, or coal (or any product thereof), and (3) liquid, gaseous, or solid synthetic fuels produced from coal (including lignite), including such fuels when used as feedstocks. The amount of the credit is determined without regard to any production attributable to a property from which gas from Devonian shale, coal seams, geopressured brine, or a tight formation was produced in marketable quantities before 1980.

As a general rule, the determination of whether any gas is produced from geopressured brine, Devonian shale, coal seams, or a tight formation is made in accordance with section 503 of the Natural Gas Policy Act of 1978 (the "NGPA"),[148] The term "gas from a tight formation" means only gas from a tight formation which either, as of April 20, 1977, was committed or dedicated to interstate commerce (as defined in section 2(18) of the NGPA), as in effect on the date of enactment of the Omnibus Budget Reconciliation Act of 1990, or is produced from a well drilled after November 5, 1990.

[147] A barrel-of-oil equivalent generally means that amount of the qualifying fuel which has a Btu content of 5.8 million.

[148] P.L. 95-621, Nov. 9, 1978.

Under section 503 of the NGPA,[149] if any State or Federal agency[150] makes any final determination that a well produces certain "high-cost natural gas," [151] that determination is applicable unless it is reversed by the Federal Energy Regulatory Commission (FERC) under special procedures established by the NGPA.[152]

Under the regulatory authority granted to it by the NGPA, FERC has furnished the following definitions of certain types of high-cost natural gas. Natural gas produced from geopressured brine is natural gas which is dissolved before initial production of the natural gas in subsurface brine aquifers with at least 10,000 parts of dissolved solids per million parts of water and with an initial reservoir geopressure gradient in excess of 0.465 pounds per square inch for each vertical foot of depth.[153]

Occluded natural gas produced from coal seams means naturally occurring natural gas from entrapment from the fractures, pores and bedding planes of coal seams.[154]

Natural gas produced from Devonian shale means natural gas produced from fractures, micropores and bedding planes of shales deposited during the paleozoic Devonian Period. Shales deposited during such period are defined as either (1) the gross Devonian age stratigraphic interval encountered by a well bore, at least 95 percent of which has a gamma ray index of 0.7 or greater; or (2) generally, one continuous interval within the gross Devonian age stratigraphic interval, encountered by a well bore, as long as at least 95 percent of the selected Devonian shale interval has a gamma ray index of 0.7 or greater.[155] When measuring the Devonian age stratigraphic interval, the gamma ray index at any point is calculated by dividing the gamma ray log value at that point by the gamma ray log value at the shale base line established over the entire Devonian age interval penetrated by the well bore.

In general, guidelines for making a determination that a formation is a tight formation are as follows: (1) The estimated average *in situ* gas permeability, throughout the pay section, is expected to be 0.1 millidarcy or less; (2) the stabilized production rate, against atmospheric pressure, of wells completed for production in the formation, without stimulation, is not expected to exceed the production rate set forth by FERC in regulations; [156] and (3) no well drilled into the recommended tight formation is expected to produce, without stimulation, more than 5 barrels of crude oil per day.[157] The FERC regulations establishing a definition of tight for-

[149] 15 U.S.C. sec. 3413 (1988).

[150] Under the NGPA, a State or Federal agency having regulatory jurisdiction with respect to the production of natural gas is authorized to make determinations for qualifying under certain categories of natural gas. Such an agency, however, may waive its authority to make such determinations by entering into an agreement with FERC allowing FERC to be the determination-making body. (15 U.S.C. sec. 3413(c) (1988).)

[151] Under the NGPA, high-cost natural gas includes gas produced from geopressured brine, coal seams, or Devonian shale. In addition, the NGPA grants FERC the authority to treat other types of natural gas as high-cost natural gas if the gas is produced under such other conditions that FERC determines to present extraordinary risks or costs. Under this authority, FERC treats gas produced from a tight formation as high-cost natural gas. (15 U.S.C. sec. 3317(c) (1988).)

[152] 15 U.S.C. sec. 3413(a)(1) (1988).

[153] 18 C.F.R. sec. 272.103(c).

[154] 18 C.F.R. sec. 272.103(d).

[155] 18 C.F.R. sec. 272.103(e).

[156] *See* table in 18 C.F.R. sec. 271.703(c)(1)(B).

[157] 18 C.F.R. sec. 271.703(c).

mation also set forth determination and review requirements similar to those provided by the NGPA for high-cost natural gas.

Any Federal or State agency that makes a determination that a formation is a tight formation or that a well produces high-cost natural gas is required to provide timely notice in writing of such determination to FERC.[158] The notice must include such substantiation and be in such a manner as FERC may, by ruling, require.

The NGPA provides that FERC will reverse any final State or Federal agency determination that a formation is a tight formation or that a well produces high-cost natural gas if (1) FERC finds that such determination is not supported by substantial evidence in the record upon which such determination was made; and (2) the preliminary finding and required notice thereof is made within 45 days after the date on which FERC received notice of the determination by the State or Federal agency and the final finding is made within 120 days after the date of the preliminary finding.[159] If (1) FERC finds that a State or Federal agency determination is not consistent with information contained in FERC's public records, and which is not part of the record upon which the State or Federal agency's determination was made, and (2) the preliminary finding by FERC and required notice thereof is made within 45 days after the date on which FERC received notice of the determination and the final finding is made within 120 days after the date of the preliminary finding, FERC may remand the matter to the State or Federal agency for consideration of such information.[160] If the agency, after consideration of the information transmitted to it by FERC, affirms its previous determination, such determination, as so affirmed, is subject to additional review by FERC. Such findings and remands by FERC may be subject to judicial review.[161]

In general, any final determination by a State or Federal agency (or by FERC) that a formation is a tight formation or that a well produces high-cost natural gas which is no longer subject to FERC or judicial review is thereafter binding with respect to such natural gas.[162]

In 1989, the Natural Gas Wellhead Decontrol Act[163] was enacted. That Act repealed Title I of the NGPA, effective on January 1, 1993. It also repealed FERC's determination review responsibility under section 503 of the NGPA. The legislative history to the 1989 legislation stated that the Senate Committee on Energy and Natural Resources did not intend, by repealing sections of the NGPA referenced in section 29 of the Internal Revenue Code, to reflect an adverse judgment as to the merits of the tax credits for any categories of natural gas production that might be affected by such action.[164] In view of this indication that Congress did not intend the 1989 legislation to limit the availability of the section 29 credit, FERC announced that it will continue to process well determinations until January 1, 1993, in order to allow producers to

[158] 15 U.S.C. sec. 3413(a)(2) (1988).
[159] 15 U.S.C. sec. 3413(b)(1) (1988).
[160] 15 U.S.C. sec. 3413(b)(2) (1988).
[161] 15 U.S.C. sec. 3413(b)(4) (1988).
[162] 15 U.S.C. sec. 3413(d) (1988).
[163] P.L. 101-60, July 26, 1989.
[164] S. Rep. No. 101-39, 101st Cong., 1st Sess. 9 (1989).

obtain tax credits that are dependent upon such determinations even if the gas has been otherwise decontrolled.[165]

Reasons for Change

The committee understands that the Internal Revenue Code requires certain formations and wells to be determined as qualifying for the section 29 credit under relevant provisions of the Natural Gas Policy Act of 1978. The committee further understands that based on the repeal of that statute, effective January 1, 1993, and based on published statements by the Federal Energy Regulatory Commission, it may be that no such determinations will be made by FERC after the end of 1992. In order to ensure that gas production which is qualified for the section 29 credit (and only that production) in fact will receive the credit, the committee believes that it is necessary to continue the well and formation determination process for periods after FERC discontinues its role in this process.

Because the sole purpose for well and formation determinations after 1992 will be for section 29 tax credit qualification, the committee believes it is appropriate to mandate that the Treasury Department be the determination-making body for periods for which FERC does not continue making determinations. Moreover, the committee believes it appropriate to require Treasury to make determinations using guidelines substantially consistent with those presently employed by FERC.

Explanation of Provision

With respect to determinations required under the Internal Revenue Code of whether gas is produced from geopressured brine, Devonian shale, coal seams, or from a tight formation, in the event that such a determination is not made by the Federal Energy Regulatory Commission in accordance with section 503 of the Natural Gas Policy Act of 1978 due to the expiration of that statute, the bill requires the Secretary of Treasury to make such determinations. For this purpose, the bill mandates that any such determination by the Treasury Department be based on the guidelines for making determinations set forth in the Natural Gas Policy Act of 1978 (and in regulations thereunder) prior to its repeal.

In addition, the bill clarifies that for purposes of the section 29 credit, the definitions of gas produced from geopressured brine, Devonian shale, coal seams, or from a tight formation are as established by the Federal Energy Regulatory Commission under the Natural Gas Policy Act of 1978 prior to repeal of provisions of that statute relating to such definitions.

Effective Date

With respect to well and formation determinations required to be made by the Treasury Department, the bill is effective for determinations with respect to which no such determination is made by the Federal Energy Regulatory Commission as a result of the repeal of relevant provisions of the Natural Gas Policy Act of 1978.

[165] F.E.R.C. Order No. 523, 55 Fed. Reg. 17425, April 25, 1990.

Subtitle F—Estate and Gift Tax Provisions

1. Waiver of right of recovery for certain marital deduction property (sec. 4601 of the bill and sec. 2207A of the Code)

Present Law

For estate and gift tax purposes, a marital deduction is allowed for qualified terminable interest property (QTIP). Such property generally is included in the surviving spouse's gross estate. The surviving spouse's estate is entitled to recover the portion of the estate tax attributable to such inclusion from the person receiving the property, unless the spouse directs otherwise by will (sec. 2207A). A will provision specifying that all taxes be paid by the estate may waive the right of recovery.

The gross estate includes the value of previously transferred property in which the decedent retains enjoyment or the right to income (sec. 2036). The estate is entitled to recover from the person receiving the property a portion of the estate tax attributable to the inclusion (sec. 2207B). This right may be waived only by a provision in the will (or revocable trust) specifically referring to section 2207B.

Reasons for Change

The committee understands that persons utilizing standard testamentary language often inadvertently waive the right of recovery with respect to QTIP. The committee believes, however, that allowing the right of recovery to be waived only by specific reference would simplify the drafting of wills by better conforming with the testator's likely intent. The committee also believes that persons waiving a right to contribution are unlikely to refer to the code section granting the right.

Explanation of Provision

The bill provides that the right of recovery with respect to QTIP is waived to the extent that language in the decedent's will or revocable trust specifically so indicates. The bill also provides that the right of contribution for property over which the decedent retained enjoyment or the right to income is waived by such indication.

Effective Date

The provision applies to decedents dying after the date of enactment.

2. Inclusion in gross estate of certain gifts made within three years of death (sec. 4602 of the bill and secs. 2035 and 2038 of the Code)

Present Law

The first $10,000 of gifts of present interests to each donee during any one calendar year are excluded from Federal gift tax.

The value of the gross estate includes the value of any previously transferred property if the decedent retained the power to revoke

the transfer (sec. 2038). The gross estate also includes the value of any property with respect to which such power is relinquished during the three years before death (sec. 2035). This rule has been interpreted to include in the gross estate certain transfers made from a revocable trust within three years of death.[166] Such inclusion subjects gifts that would otherwise qualify under the annual $10,000 exclusion to estate tax.

Reasons for Change

The inclusion of certain property transferred during the three years before death is directed at transfers that would otherwise reduce the amount subject to estate tax by more than the amount subject to gift tax, disregarding appreciation occurring between gift and death. The committee believes, therefore, that inclusion is unnecessary if the transfer subjects the entire property to gift tax and the transferor has retained no power over the property. The committee understands that repeal of such inclusion eliminates a principal tax disadvantage of funded revocable trusts, which are generally used for nontax purposes.

Explanation of Provision

The bill provides that a transfer from a trust over which the grantor held the power to revoke would be treated as if made directly by the grantor. Thus, an annual exclusion gift from such trust is not included in the gross estate. It is intended that no inference be drawn from the provision with respect to the treatment of transfers from revocable trusts under present law.

The bill also revises section 2035 to improve its clarity.

Effective Date

The provision applies to decedents dying after the date of enactment.

3. Definition of qualified terminable interest property (sec. 4603 of the bill and secs. 2044, 2056(b)(7), and 2523(f) of the Code)

Present Law

A marital deduction is allowed for qualified terminable interest property (QTIP). Property is QTIP only if the surviving spouse has a qualifying income interest for life (e.g., the spouse is entitled to all of the income from the property, payable at least annually). QTIP generally is includible in the surviving spouse's gross estate.

Under proposed regulations, an income interest may constitute a qualifying income interest for life even if income accumulating between the last distribution date and the date of the surviving spouse's death (the "accumulated income") is not required to be distributed to the surviving spouse or the surviving spouse's estate. *See* Prop. Reg. secs. 20.2056(b)-7(c)(1), 25.2523(f)-1(b). Contrary to the regulations, the United States Tax Court has held that in order to

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[166] See, e.g., *Jalkut Estate v. Commissioner*, 96 T.C. 675 (1991) (transfers from revocable trust to permissible beneficiaries of the trust includible in the grantor's gross estate); LTR 9117003 (same).

satisfy the QTIP requirements, the accumulated income must be paid to the spouse's estate or be subject to a power of appointment held by the spouse. *See Estate of Howard v. Commissioner*, 91 T.C. 329, 338 (1988), *rev'd*, 910 F.2d 633 (9th Cir. 1990).

Reasons for Change

The Tax Court opinion in *Estate of Howard* has created uncertainty as to when a trust qualifies for the marital deduction. This uncertainty makes planning difficult and necessitates closing agreements designed to prevent the whipsaw that would occur if a deduction is allowed for property that is not subsequently included in the spouse's estate. The committee believes, therefore, that codification of the Treasury Regulations would eliminate uncertainty and simplify the administration of the tax laws.

Explanation of Provision

Under the bill, an income interest does not fail to be a qualified income interest for life solely because the accumulated income is not required to be distributed to the surviving spouse. Such income is includible in the surviving spouse's gross estate.

It is intended that no inference be drawn from the provision with respect to the definition of a qualified income interest for life under present law.

Effective Date

The provision applies to decedents dying, and gifts made, after date of enactment. However, the bill does not include in the surviving spouse's gross estate property transferred before the date of enactment for which no marital deduction was claimed.

4. Inclusion of property qualifying for the marital deduction in the gross estate (sec. 4604 of the bill and secs. 2056(b) and 2523 of the Code)

Present Law

A marital deduction against the estate and gift tax generally is permitted for the value of property passing between spouses. No marital deduction is permitted, however, if, upon termination of the spouse's interest, possession or enjoyment of the property passes to another person (the "terminable interest rule"). Certain exceptions to this rule may apply if the spouse receives a general power of appointment over, or an income interest in, a "specific portion" of property (sec. 2056(b)(5), (6), (7)). The spouse is subject to transfer tax on property over which he or she holds a general power of appointment.

A Treasury regulation defines a "specific portion" to be a fractional or percentile share of a property interest (Treas. Reg. sec. 20.2056(b)-5(c)). Finding this regulation invalid, courts have held that the term "specific portion" includes a fixed dollar amount. *See Northeastern Pennsylvania National Bank & Trust Co. v. United States*, 387 U.S. 213 (1967); *Estate of Alexander v. Commissioner*, 82 T.C. 34 (1984), aff'd, No. 8401600 (4th Cir. April 3, 1985). Under the

court holdings, appreciation in certain marital deduction property may be includible in neither spouse's estate.

Reasons for Change

The marital deduction postpones the imposition of the estate or gift tax until the property is transferred outside the marital unit. The exceptions to the terminable interest rule insure that the present value of property qualifying for the marital deduction is subject to transfer tax in the hands of the recipient spouse. By invalidating the Treasury regulation having this effect, the court holdings create uncertainty. Reversal of the holdings makes the law more certain by unequivocally implementing the policy underlying the marital deduction.

Explanation of Provision

The bill provides that, for purposes of the marital deduction, a "specific portion" only includes a portion determined on a fractional or percentage basis. Thus, a trust does not qualify under the exceptions to the terminable interest rule unless the required income interest and general power of appointment are expressed as a fraction or a percentage of the property. The bill thereby reverses the court holdings and codifies the position of the Treasury Regulations.

It is intended that no inference be drawn from the provision with respect to definition of "specific portion" under present law. The bill does not generally affect the marital deduction allowed for a pecuniary formula marital deduction bequest. *See*, *e.g.*, Rev. Rul. 64-9, 1964-1 C.B. 682.

Effective Date

The provision generally applies to gifts made, and decedents dying, after date of enactment. The provision does not apply to a transfer under a will or revocable trust executed before the date of enactment if either (1) on that date the decedent was under a mental disability to change the disposition of his property and did not regain his competence to dispose of such property before the date of death, or (2) the decedent dies within three years after the date of enactment. The provision applies, however, if the will or trust is amended after the date of enactment in any respect that increases the amount of the transfer qualifying for the marital deduction or alters the terms by which the interest passes.

5. Requirements for qualified domestic trust (sec. 4605 of the bill and sec. 2056A of the Code)

Present Law

A deduction generally is allowed for Federal estate tax purposes for the value of property passing to a spouse. The Technical and Miscellaneous Revenue Act of 1988 ("TAMRA") denied the marital deduction for property passing to a noncitizen spouse outside a qualified domestic trust ("QDT"). An estate tax is imposed on corpus distributions from a QDT.

TAMRA defined a QDT as a trust that, among other things, required all trustees be U.S. citizens or domestic corporations. This provision was modified in the Omnibus Budget Reconciliation Acts of 1989 and 1990 to require that at least one trustee be a U.S. citizen or domestic corporation and that no corpus distribution be made unless such trustee has the right to withhold any estate tax imposed on the distribution (the "withholding requirement").

Reasons for Change

Wills drafted under the TAMRA rules must be revised to conform with the withholding requirement, even though both the TAMRA rule and its successor ensure that a U.S. trustee is personally liable for the estate tax on a QDT. Reinstatement of the TAMRA rule for wills drafted in reliance upon it reduces the number of will revisions necessary to comply with statutory changes, thereby simplifying estate planning.

Explanation of Provision

A trust created before the enactment of the Omnibus Budget Reconciliation Act of 1990 is treated as satisfying the withholding requirement if its governing instrument requires that all trustees be U.S. citizens or domestic corporations.

Effective Date

The provision applies as if included in the Omnibus Budget Reconciliation Act of 1990.

6. Election of special use valuation of farm property for estate tax purposes (sec. 4606 of the bill and sec. 2032A of the Code)

Present Law

For estate tax purposes, an executor may elect to value certain real property used in farming or other closely held business operations at its current use value rather than its highest and best use (sec. 2032A). A written agreement signed by each person with an interest in the property must be filed with the election.

Treasury regulations require that a notice of election and certain information be filed with the Federal estate tax return (Treas. Reg. sec. 20.2032A-8). The administrative policy of the Treasury Department is to disallow current use valuation elections unless the required information is supplied.

Under procedures prescribed by the Secretary of the Treasury, an executor who makes the election and substantially complies with the regulations but fails to provide all required information or the signatures of all persons with an interest in the property may supply the missing information within a reasonable period of time (not exceeding 90 days) after notification by the Secretary.

Reasons for Change

The committee understands that executors commonly fail to include with the filed estate tax return a recapture agreement signed by all persons with an interest in the property or all information

required by Treasury regulations. The committee believes that allowing such signatures or information to be supplied later eases return filing.

Explanation of Provision

The bill extends the procedures allowing subsequent submission of information to any executor who makes the election and submits the recapture agreement, without regard to compliance with the regulations. Thus, the bill allows the current use valuation election if the executor supplies the required information within a reasonable period of time (not exceeding 90 days) after notification by the IRS. During that time period, the bill also allows addition of signatures to a previously filed agreement.

Effective Date

The provision applies to decedents dying after the date of enactment.

7. Income taxation of accumulation trusts (sec. 4607 of the bill and secs. 644 and 665-669 of the Code)

Present Law

In general

A nongrantor trust is treated as a separate taxpayer for Federal income tax purposes. Such trust is generally treated as a conduit with respect to amounts distributed currently and taxed as an individual with respect to undistributed income. The conduit treatment is achieved by allowing the trust a deduction for amounts distributed to beneficiaries during the taxable year to the extent of distributable net income and by including the distributions in the beneficiaries' income.

Distributions of accumulated income

A distribution of previously accumulated income is taxed under the so-called throwback rules, which provide that beneficiaries are taxed on distributions of previously accumulated income from trusts in substantially the same manner as if the income had been distributed when collected.

Distributions of appreciated property

If property is sold within two years of its contribution to a trust, the gain that would have been recognized had the contributor sold the property is taxed at the contributor's marginal tax rates (sec. 644). In effect, section 644 treats such gains as if the contributor had realized the gain and then transferred the net after-tax proceeds from the sale to the trust as corpus.

Treatment of multiple trusts

Effective March 1, 1984, two or more trusts are treated as one trust if (1) the trusts have substantially the same grantor or grantors and substantially the same primary beneficiary or beneficiaries, and (2) a principal purpose for the existence of the trusts is

the avoidance of Federal income tax (sec. 643(f)). For trusts that were irrevocable as of that date, section 643(f) applies only to subsequent contributions to corpus.

Reasons for Change

The throwback rules and section 644 are designed to eliminate the potential tax reduction arising from taxation at the trust, rather than the beneficiary, level. When those provisions were enacted, a taxpayer could reduce substantially overall tax liability by transferring property to one or more trusts, where it would be taxed at lower income tax brackets. In 1984, Congress curtailed the tax avoidance use of multiple trusts, and in 1986, substantially decreased the amount of income taxed at the lower trust income tax brackets.[167] Accordingly, the committee determined that the remaining potential tax reduction available through the transfer of property to trust no longer warranted the complex computations required by the throwback rules and section 644.

Explanation of Provision

The bill exempts amounts accumulated in domestic trusts after December 31, 1992, from "throwback rules." It also provides that precontribution gain on property sold by a domestic trust is no longer taxed at the contributor's marginal tax rates. The provision does not apply to a trust created before March 1, 1984, unless the taxpayer establishes that the trust would not have been aggregated under the standard contained in section 643(f).

Effective Date

The change in the throwback rules applies to taxable years beginning after December 31, 1992. The modification in section 644 applies to sales or exchanges after December 31, 1992.

Subtitle G—Excise Tax Simplification

Part I—Fuel Tax Provisions

1. Consolidate provisions imposing diesel and aviation fuel excise taxes (sec. 4701 of the bill and secs. 4041 and 4091 of the Code)

Present Law

Code section 4091 imposes a tax on the sale of diesel and aviation fuel by a "producer." The term producer generally includes refiners, compounders, blenders, and wholesalers who are registered with the Internal Revenue Service. The term also includes persons to whom diesel or aviation fuel has been sold tax-free.

As a backup, section 4041 imposes a tax on certain sales or uses of diesel and aviation fuel if a taxable sale of such fuel has not occurred under section 4091.

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[167] This reduction is preserved by the rates contained in the bill.

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Reasons for Change

Consolidating the diesel and aviation tax rules into one section of the Code will make the rules easier to find and understand.

Explanation of Provision

The bill combines the diesel and aviation fuel tax provisions currently divided between Code sections 4041 and 4091 into a revised section 4091. The use of diesel and aviation fuel in a taxable use by producers will be taxed under section 4091, and the definition of producer is clarified to include purchasers in tax-reduced sales.

The bill also simplifies the Code by eliminating two unnecessary provisions, sections 4041(b)(1)(B) and (j) of the Code. These provisions are redundant.

Effective Date

The provision is effective for sales or uses on or after January 1, 1993.

2. Permit refund of tax to taxpayer for diesel and aviation fuel resold to certain exempt purchasers (sec. 4702(a) of the bill and sec. 6416(b) of the Code)

Present Law

As a general matter, purchasers who use tax-paid fuels for an exempt use are entitled to a refund or credit. Purchasers of tax-paid fuels generally are not permitted a refund or credit if they resell the fuels to another person who subsequently uses them in an exempt use.

However, persons who buy and then resell (a) fuel subject to the special motor fuel or gasoline taxes and (b) certain other articles are permitted a refund or credit (in place of the ultimate users claiming the credit or refund) if they resell the fuel or article for use in the following exempt uses: (1) export, (2) supplies for aircraft or vessels, (3) use by a State or local government, or (4) use by a nonprofit educational organization for its exclusive use.

Reasons for Change

Diesel and aviation fuel sales are not subject to the special refund or credit procedures. The general rules require users of such fuels for exempt purposes to bear the burden of filing for the refund or credit themselves and, therefore, makes such purchases more difficult compared to purchases of gasoline and special motor fuels.

Explanation of Provision

The bill allows a refund or credit to sellers of diesel and aviation fuel who purchase the fuels tax-paid and re-sell the fuels without payment of tax for any of the exempt uses described above.

Effective Date

The provision is effective for sales on or after January 1, 1993.

3. Consolidate refund provisions for fuel excise taxes (sec. 4702(b) of the bill and secs. 6420, 6421, and 6427 of the Code)

Present Law

As a general matter, purchasers who use fuels for an exempt use are entitled to a refund if the fuels have been purchased tax-paid. The refund provisions for the fuels excise taxes are found in several sections of the Code.

In general, a purchaser entitled to a refund may file a quarterly refund claim for any of the first three quarters of the purchaser's tax year, if the claim exceeds a threshold dollar amount (with the lowest threshold being $750). The threshold amounts differ for different fuels and different exempt uses. A purchaser cannot file a quarterly claim for refund for its fourth quarter, but must file the claim as a credit on that year's income tax return.

There is an expedited procedure for gasohol blenders claiming a refund of part of the excise tax included in the price of the gasoline used for blending into gasohol.

Finally, only an income tax credit, and not a refund, may be claimed for excise taxes on gasoline and special motor fuel used on a farm for farming purposes.

Reasons for Change

Consolidating the credit and refund provisions for fuel excise taxes into one section in the Code will make these provisions easier to find and understand. Standardizing the refund procedures will reduce confusion and allow taxpayers to obtain refunds more quickly.

Explanation of Provision

The bill consolidates the user credit and refund provisions for the fuels excise taxes into one section of the Code. The bill also combines the three refund procedures for fuels taxes into a uniform refund procedure. The new uniform refund procedure permits an exempt user to aggregate its refund claims for all fuels taxes and file for a refund in any calendar quarter in which the amount of the aggregate claim exceeds $750. The uniform refund procedure also permits such a user to file for a refund for its fourth quarter rather than apply for a credit.

The special expedited procedure for gasohol blenders is unchanged.

Effective Date

The provision is effective for sales on or after January 1, 1993.

4. Repeal waiver requirement for fuel tax refunds for cropdusters and other fertilizer applicators (sec. 4702(c) of the bill and sec. 6420 of the Code)

Present Law

In general, farmers who use gasoline and aviation fuel on a farm are entitled to a refund of the tax that has been paid on that fuel.

Cropdusters and other fertilizer applicators that use gasoline and aviation fuel on a farm are entitled to a refund of the tax paid on that fuel in lieu of the farmer, but only if the owner or operator of the farm waives its right to a refund for such fuel.

Reasons for Change

Eliminating the waiver will reduce the paperwork burden of a taxpayer seeking a refund.

Explanation of Provision

The bill eliminates the waiver requirement for fuels tax refunds for cropdusters and other fertilizer applicators.

Effective Date

The provision is effective for fuels purchased on or after January 1, 1993.

5. Authorize exceptions from information reporting for certain sales of diesel and aviation fuel (sec. 4703 of the bill and sec. 4093(c)(4) of the Code)

Present Law

Certain producers and importers and purchasers are required to file information returns for reduced-tax sales of diesel and aviation fuel.

Reasons for Change

Allowing the Internal Revenue Service to exempt certain classes of taxpayers from the mandatory information return requirement will simplify its administration of the registration requirements and eliminate unnecessary paperwork for taxpayers.

Explanation of Provision

The bill permits the IRS by regulation to provide exceptions to the mandatory information return requirement for certain sales of diesel and aviation fuel.

Effective Date

The provision applies to sales on or after January 1, 1993.

Part II—Provisions Relating to Distilled Spirits, Wines, and Beer (secs. 4711-4721 of the bill, secs. 5008(c), 5044, 5053, 5055, 5115, 5175(c), 5207(c), 5222(b), 5384(b) of the Code, and new sec. 5418 of the Code)

Present Law

Return of imported bottled distilled spirits

Present law provides that when tax-paid distilled spirits which have been withdrawn from bonded premises of a distilled spirits plant are returned for destruction or redistilling, the excise taxes are refunded (sec. 5008(c)). This provision does not apply to import-

ed bottled distilled spirits, since they are withdrawn from customs custody and not from bonded premises.

Bond for exported distilled spirits

Bond generally must be furnished to the Department of the Treasury when distilled spirits are removed from bonded premises for exportation without payment of tax. These bonds are cancelled or credited when evidence is submitted to the Department of the Treasury that the distilled spirits have been exported (sec. 5175(c)).

Distilled spirits plant records

Distilled spirits plant proprietors are required to maintain records of their production, storage, denaturation, and other processing activities on the premises where the operations covered by the records are carried on (sec. 5207(c)).

Transfers from breweries to distilled spirits plants

Under present law, beer may be transferred without payment of tax from a brewery to a distilled spirits plant to be used in the production of distilled spirits, but only if the brewery is contiguous to the distilled spirits plant (sec. 5222(b)).

Posting of sign by wholesale liquor dealers

Wholesale liquor dealers (i.e., dealers, other than wholesale dealers in beer alone, who sell distilled spirits, wines, or beer to other persons who re-sell such products) are required to post a sign conspicuously on the outside of their place of business indicating that they are wholesale liquor dealers (sec. 5115).

Refund of tax for wine returned to bond

Under present law, when unmerchantable wine is returned to bonded production premises, tax that has been paid is returned or credited to the proprietor of the bonded wine cellar to which the wine is delivered (sec. 5044). In contrast, when beer is returned to a brewery, tax that has been paid is returned or credited, regardless of whether the beer is unmerchantable (sec. 5056(a)).

Use of ameliorating material in certain wines

The Code contains rules governing the extent to which ameliorating material (e.g., sugar) may be added to wines made from high acid fruits and the product still be labelled as a standard, natural wine. In general, ameliorating material may not exceed 35 percent of the volume of juice and ameliorating material combined (sec. 5383(b)(1)). However, wines made exclusively from loganberries, currants, or gooseberries are permitted a volume of ameliorating material of up to 60 percent (sec. 5384(b)(2)(D)).

Domestically produced beer for use by foreign embassies, etc.

Under present law, domestically produced distilled spirits and wine may be removed from bond, without payment of tax, for transfer to any customs bonded warehouse for storage pending removal for the official or family use of representatives of foreign governments or public international organizations (secs. 5066 and 5362(e)). (A similar rule also applies to imported distilled spirits,

wine, and beer.) No such provision exists under present law for domestically produced beer.

Withdrawal of beer for destruction

Present law does not specifically permit beer to be removed from a brewery for destruction without payment of tax.

Records of exportation of beer

Present law provides that a brewer is allowed a refund of tax paid on exported beer upon submission to Department of the Treasury of certain records indicating that the beer has been exported (sec. 5055).

Transfer to brewery of beer imported in bulk

Imported beer brought into the United States in bulk containers may not be transferred from customs custody to brewery premises without payment of tax. Under certain circumstances, distilled spirits imported into the United States in bulk containers may be transferred from customs custody to bonded premises of a distilled spirits plant without payment of tax (sec. 5232).

Reasons for Change

In addition to imposing taxes, the Internal Revenue Code regulates many aspects of the alcoholic beverage industry. These regulations date in many cases from the Prohibition Era or earlier. In 1980, the method of collecting excise taxes on alcoholic beverages was changed from a system under which Treasury Department inspectors regularly were present at production facilities to a bonded premises system, which more closely tracks the systems used in connection with other Federal excise taxes. Many of the recordkeeping requirements and other regulatory measures imposed in connection with these taxes have not been modified to conform to these collection system changes. In addition, modification of statutory provisions is warranted in view of advances in technology used in the alcoholic beverage industry and environmental protection concerns.

Explanation of Provisions

Return of imported bottled distilled spirits

The procedures for refunds of tax collected on imported bottled distilled spirits returned to bonded premises are conformed to the rules for domestically produced and imported bulk distilled spirits. Thus, refunds are available for all distilled spirits on their return to a bonded distilled spirits plant.

Bond for exported distilled spirits

For purposes of cancelling or crediting bonds furnished when distilled spirits are removed from bonded premises for exportation, the Department of the Treasury is authorized to permit records of exportation to be maintained by the exporter, rather than requiring submission of proof of exportation to Treasury in all cases.

Distilled spirits plant records

Distilled spirits plant proprietors are permitted to maintain records of their activities at locations other than the premises where the operations covered by the records are carried on (e.g., corporate headquarters), provided that the records are available for inspection by the Treasury Department during business hours.

Transfers from breweries to distilled spirits plants

The bill allows beer to be transferred without payment of tax from a brewery to a distilled spirits plant to be used in the production of distilled spirits, regardless of whether the brewery is contiguous to the distilled spirits plant. The bill also allows brewers to receive credit or refund for tax paid on beer that is transferred to a distilled spirits plant for use in the production of distilled spirits after having been removed from a brewery without such beer first being required to be returned to a brewery for such transfer.

Posting of sign by wholesale liquor dealers

The requirement that wholesale liquor dealers post a sign outside their place of business indicating that they are wholesale liquor dealers is repealed.

Refund of tax for wine returned to bond

The bill deletes the requirement that wine returned to bonded premises be "unmerchantable" in order for tax to be refunded to the proprietor of the bonded wine cellar to which the wine is delivered.

Use of ameliorating material in certain wines

The wine labelling restrictions are modified to allow any wine made exclusively from a fruit or berry with a natural fixed acid of 20 parts per thousand or more (before any correction of such fruit or berry) to contain a volume of ameliorating material not in excess of 60 percent.

Domestically produced beer for use by foreign embassies, etc.

The bill extends to domestically produced beer the present-law rule applicable to domestically produced distilled spirits and wine (and imported distilled spirits, wine, and beer) which permits these products to be withdrawn from the place of production without payment of tax for the official or family use of representatives of foreign governments or public international organizations.

Withdrawal of beer for destruction

The bill allows beer to be removed from a brewery without payment of tax for purposes of destruction, subject to Treasury Department regulations.

Records of exportation of beer

The bill repeals the requirement that proof of exportation be submitted to the Treasury Department in all cases as a condition of receiving a refund of tax. This proof will continue to be required to be maintained at the exporter's place of business.

Transfer to brewery of beer imported in bulk

The bill extends the present-law rule applicable to distilled spirits imported into the United States in bulk containers to beer imported into the United States in bulk containers, so that imported beer may, subject to Treasury regulations, be withdrawn from customs custody for transfer to a brewery without payment of tax.

Effective Date

These provisions of the bill generally are effective beginning 180 days after date of the bill's enactment. The provision deleting the requirement that wholesale liquor dealers post a sign outside their place of business is effective on the date of the bill's enactment.

Part III—Other Excise Tax Provisions

1. Authority for IRS to grant exemptions from registration requirements (sec. 4731 of the bill and sec. 4222 of the Code)

Present Law

Under section 4222, certain sales of articles subject to Federal excise taxes may not be made without payment of tax unless the manufacturer, the first purchaser, and the second purchaser (if any) are all registered under regulations prescribed by the Secretary.

Reasons for Change

Allowing the Internal Revenue Service to exempt certain classes of taxpayers from the registration requirements will simplify the IRS's administration of the registration provisions. Also, the provision will reduce unnecessary paperwork for affected taxpayers.

Explanation of Provision

This will allow the IRS to provide exemption from generally applicable excise tax registration requirements for certain classes of taxpayers.

Effective Date

The provision applies to sales after the 180th day after the date of enactment.

2. Firearms excise tax exemption for small manufacturers (sec. 4732 of the bill and sec. 4282 of the Code)

Present Law

Present law imposes an 11-percent excise tax on the manufacture or importation of rifles and shotguns and on ammunition (shells and cartridges). Present law also imposes a 10-percent excise tax on the manufacture or importation of pistols and revolvers (sec. 4181).

Revenues from these taxes are appropriated, in the fiscal year following receipt, to the Federal Aid to Wildlife Program for support of State wildlife programs.

Reasons for Change

Exempting small manufacturers and importers of firearms from the excise tax on firearms and ammunition will reduce the tax paperwork burden on small businesses that produce or import fewer than 50 such items per year.

Explanation of Provision

The bill exempts small manufacturers and importers from the 11-percent excise tax on firearms (rifles and shotguns) and ammunition and the 10-percent excise tax on pistols and revolvers, if the manufacturer or importer manufactures or imports fewer than 50 such articles per year.

Effective Date

The provision is effective for articles sold after September 30, 1983. In the case of any taxable year ending before the date of enactment, the period for claiming a credit or refund of any overpayment of tax resulting from the proposed exemption from tax will not expire before one year after the date of enactment.

3. Repeal temporary reduction in tax on piggyback trailers (sec. 4733(a) of the bill and sec. 4051(d) of the Code)

Present Law

Piggyback trailers and semitrailers sold within the 1-year period beginning on July 18, 1984 were permitted a temporary reduction in the retail excise tax on trailers.

Explanation of Provision

The bill repeals the temporary reduction in tax on piggyback trailers as "deadwood."

Effective Date

The provision is effective on the date of enactment.

4. Expiration of excise tax on deep seabed minerals (sec. 4733(b) of the bill and secs. 4495-4498 of the Code)

Present Law

Background

The Deep Seabed Mineral Resources Act (the "Resources Act," P.L. 96-283), imposed an excise tax on certain hard minerals mined on the deep seabed. The tax revenues were intended to fund obligations of the United States under a contemplated Law of the Sea Convention.

The tax was scheduled to terminate on the earlier of the date on which a U.N. international deep seabed treaty took effect with respect to the United States, or June 28, 1990 (10 years after the date of enactment of the tax). Since the United States did not sign the treaty, the excise tax provisions expired on June 28, 1990.

Explanation of Provision

The bill deletes the deep seabed hard minerals excise tax provisions as "deadwood."

Effective Date

The provision is effective on the date of enactment.

Subtitle H—Administrative Provisions

Part I—General Provisions

1. Simplify payroll tax deposit requirements (sec. 4801 of the bill and sec. 6302 of the Code)

Present Law

The Code provides that the Secretary of the Treasury ("Secretary") may establish the mode or time for collecting any tax if the mode or time is not specified in the Code (sec. 6302(a)). In general, Treasury regulations have established the system under which employers deposit income taxes withheld from employees' wages and FICA taxes. The frequency with which these taxes must be deposited increases as the amount required to be deposited increases.

Employers are required to deposit these taxes as frequently as eight times per month, provided that the amount to be deposited equals or exceeds $3,000. These deposits must be made within three banking days after the end of each eighth-monthly period. Monthly or quarterly deposits are required for smaller amounts.

In addition, the Code requires employers who are on this eighth-monthly system to deposit income taxes withheld from employees' wages and FICA taxes by the close of the next banking day (instead of by the close of the third banking day) after any day on which the business cumulates an amount to be deposited equal to or greater than $100,000 (regardless of whether that day is the last day of an eighth-monthly period).

Reasons for Change

Many employers find the present-law deposit requirements extremely confusing and complex. A large number of employers have difficulty dealing with the eighth-monthly system, in part because the day of the week on which the last day of each eighth-monthly period falls varies from month to month. In addition, a number of employers have difficulty in determining with certainty and with sufficient lead time which of the four deposit schemes of present law they are required to utilize.

The bill's simplified payroll tax deposit system will be significantly easier to understand and to administer for both businesses and the IRS. This should reduce materially the number of businesses who are subject to the penalty for failure to make timely deposits (sec. 6656) due to inadvertent errors.

Explanation of Provision

In general

The bill replaces the entire payroll tax deposit system with a new system that is clearer and easier to understand. In general, the new system consists of three basic deposit timetables. The first, which replaces the eighth-monthly system, requires deposits twice a week, on Tuesdays and Fridays. The second, which applies to large depositors, retains the requirement of present law that cumulations of an amount to be deposited of $100,000 or more must be deposited on or before the next day. The third, which applies to many small depositors, provides generally that if the amount required to be deposited was $12,000 or less per quarter for a previous one-year base period, deposits must be made only once a month, on or before the fifteenth day of the following month.

Tuesday, Friday deposit rule

The Tuesday/Friday rule operates in the following manner. Amounts attributable to wage payments made on Wednesday, Thursday, or Friday are to be deposited on or before the following Tuesday. Amounts attributable to wage payments made on Saturday, Sunday, Monday, or Tuesday are to be deposited on or before the following Friday. Utilizing Tuesday and Friday as both the final days of the portion of the week with respect to which amounts to be deposited are cumulated as well as the days on which deposits must be made will provide a simple, easily remembered rule that will simplify the administration of these deposit requirements for both employers and the IRS.

Small depositor rules

The small depositor rules operate as follows. If an employer is a small depositor, deposits of employment taxes attributable to wage payments during a month must be made on or before the fifteenth day of the following month.

A person is a small depositor for a calendar quarter if, for each calendar quarter in the base period, the amount of employment taxes attributable to payments in each of those calendar quarters was $12,000 or less. The base period is defined to be the four calendar quarters ending with the second preceding calendar quarter before the quarter with respect to which the deposit requirements are being determined. For example, the base period for the calendar quarter of April through June 1993 is January 1992 through December 1992. If with respect to each of the calendar quarters in that one-year base period, the amount of employment taxes was $12,000 or less, then the employer is a small depositor for the April through June 1993 calendar quarter and is required to make monthly deposits of employment taxes for that quarter. This is true regardless of the amount of employment taxes for the April through June 1993 quarter. The only exception to this is that the $100,000 rule applies to all depositors, including small depositors. This application of the $100,000 rule should have no impact on small employers; it is designed to prevent very large new companies from making deposits only once a month.

New companies will initially be treated as small depositors. For purposes of performing the base period determination, a company is considered to have employment taxes of zero for any calendar quarter in which a company did not exist. Consequently, new companies will, for at least the first two calendar quarters of their existence, be required to deposit only once a month (unless they fall within the $100,000 rule).

The small depositor rule is designed to provide certainty to small employers with respect to their current deposit requirements. Most employers will be able to examine their quarterly employment tax returns (Form 941) for the one year in the base period and readily determine on that basis whether they are small depositors or must deposit on the Tuesday/Friday system. The "second preceding quarter" provision is designed to provide employers with ample lead time to make this determination prior to the start of a calendar quarter.

Safe harbor

The bill provides a statutory safe harbor with respect to certain shortfalls in deposits. An employer will be treated as having deposited the required amount of employment taxes in any deposit if the shortfall does not exceed the greater of $100 or two percent of the amount of employment taxes otherwise required to be deposited. A shortfall is the excess of the amount required to be deposited (without regard to this rule) over the amount actually deposited on or before the last day on which that deposit is required. Any shortfall is to be deposited as required by Treasury regulations.

Definitions and other rules

The bill provides that deposits are required only on banking days. (This rule is also contained in present law.) If a deposit is required to be made on or before a day that is not a banking day, the deposit is considered to have been made on a timely basis if it is made on or before the close of the next banking day. It is anticipated that the substance of Treasury regulations defining the term "banking day" will not be changed. For example, if a deposit is required to be made on a Friday which is also the July 4 holiday, that deposit would be considered to be made on a timely basis if it is made on or before the following Monday.

The bill defines "employment taxes" to mean FICA taxes (both the employer and employee portions), Railroad Retirement Tax Act taxes, and withheld income taxes (as well as similar withheld taxes under chapter 24 of the Code).

These provisions generally do not apply to employment taxes that are not required to be deposited pursuant to Treasury regulations issued pursuant to section 6302. Under present law, employers with less than $500 of employment taxes for a calendar quarter are not required to deposit those taxes. They are instead permitted to remit those taxes with the quarterly employment tax return (Form 941). It is anticipated that a similar system permitting remittance (rather than requiring deposit) of these small amounts will be continued.

Treasury regulations

The bill provides that the Secretary may prescribe regulations relating to specific issues (in addition to the general authority to issue regulations with respect to collecting tax in sec. 6302 or generally in sec. 7805). First, the regulations may specify alternate employment tax requirements for employers who fail to comply with the requirements of this provision. This would enable the IRS to continue its practice (currently authorized by regulations issued pursuant to sec. 6302(a)) of specifying more frequent deposit requirements or alternate payment mechanisms for employers who have seriously violated the established deposit requirements.

The bill also permits the Secretary to issue regulations specifying the additional circumstances (beyond those provided in the bill) under which an employer may be treated as a small depositor. This in effect permits the Treasury to expand (but not contract) the definition of small depositors.

In addition, the bill permits the Secretary to issue regulations modifying these provisions for end-of-quarter periods. This is designed to permit the IRS to require appropriate treatment of amounts that overlap two quarters. For example, assume that a quarter ends on Wednesday. The deposit normally required to be made on or before the following Tuesday could include amounts attributable to the previous quarter (with respect to Wednesday) as well as amounts attributable to the current quarter (with respect to Thursday and Friday). Treasury regulations can specify an alternate rule to distinguish amounts relating to the two quarters.

Finally, the bill permits the Secretary to issue regulations establishing different deposit requirements for amounts withheld pursuant to the backup withholding requirements of section 3406. Under present law, these amounts are treated the same as amounts withheld from income taxes. Because amounts withheld pursuant to the backup withholding requirements are often relatively small and are not generally handled by payroll offices, it is appropriate for Treasury to provide alternate deposit rules with respect to these amounts.

Effective Date

The provision is effective for amounts attributable to payments made after December 31, 1992.

2. Simplify employment tax reporting for household employees (sec. 4802 of the bill and secs. 3102, 3121, 3306 and 6654 of the Code)

Present Law

An employer who pays a household employee wages of $50 or more in a calendar quarter for household work must withhold social security taxes (including medicare taxes) from wages paid to the employee during the quarter. The employer must also pay an amount of tax that matches the tax withheld from the employee's wages. The employer must file an Employer's Quarterly Tax Return (Form 942) each quarter and a Wage and Tax Statement (Form W-2) at the end of the year.

In addition, an employer must pay Federal unemployment taxes if he or she paid cash wages to household employees totalling $1,000 or more in a calendar quarter in the current or preceding year. The employer must file an Employer's Annual Federal Unemployment Tax Return (Form 940 or Form 940-EZ) at the end of the year.

Reasons for Change

Employer return requirements are confusing and burdensome for many individuals, who may be employers only because they employ a domestic employee on an intermittent basis. Streamlining the return requirements would reduce the filing burden for individuals employing domestic employees.

Explanation of Provision

The bill changes the threshold for withholding and paying social security taxes with respect to domestic service employment from $50 a quarter to $300 a year. The bill requires an individual who employs only household employees (regardless of the amount of the remuneration) to report any social security or Federal unemployment tax obligation for wages paid to such employees on his or her income tax return for the year. The bill includes a household employer's social security and unemployment taxes in the estimated tax provisions. The bill also authorizes the Secretary to enter into agreements with States to collect State unemployment taxes in the same manner.

Effective Date

The provision is effective for remuneration paid in calendar years beginning after December 31, 1992.

3. Clarify that reproductions from digital images are reproductions for recordkeeping purposes (sec. 4803 of the bill and sec. 6103(p) of the Code)

Present Law

Reproductions of a return, document, and certain other matters have the same legal status as the original for purposes of judicial and administrative proceedings. It is unclear whether reproductions made from digital images are also accorded the same legal status as originals.

Reasons for Change

Reducing the IRS' need to maintain hard-copy originals of documents would simplify the administration of the tax laws. As part of its systems modernization plan, the IRS intends to store returns, documents, and other materials in digital image format. This plan will permit the IRS to respond much more quickly to taxpayers' inquiries about the status of their accounts. It will facilitate implementation of this plan to clarify that reproductions made from such images would be accorded the same legal status as other reproductions.

Explanation of Provision

The bill provides that the term reproduction includes a reproduction from a digital image. The bill also requires the Comptroller General to conduct a study of available digital image technology for the purpose of determining the extent to which reproductions of documents stored using that technology accurately reflect the data on the original document and the appropriate period for retaining the original document.

Effective Date

The provision is effective on the date of enactment.

4. Repeal of authority to disclose whether a prospective juror has been audited (sec. 4804 of the bill and sec. 6103(h)(5) of the Code)

Present Law

In connection with a civil or criminal tax proceeding to which the United States is a party, the Secretary must disclose, upon the written request of either party to the lawsuit, whether an individual who is a prospective juror has or has not been the subject of an audit or other tax investigation by the Internal Revenue Service (sec. 6103(h)(5)).

Reasons for Change

This disclosure requirement, as it has been interpreted by several recent court decisions, has created significant difficulties in the civil and criminal tax litigation process. First, the litigation process can be substantially slowed. It can take the Secretary a considerable period of time to compile the information necessary for a response (some courts have required searches going back as far as 25 years). Second, providing early release of the list of potential jurors to defendants (which several recent court decisions have required to permit defendants to obtain disclosure of the information from the Secretary) can provide an opportunity for harassment and intimidation of potential jurors in organized crime, drug, and some tax protester cases. Third, significant judicial resources have been expended in interpreting this procedural requirement that might better be spent resolving substantive disputes. Fourth, differing judicial interpretations of the nature of this provision have caused confusion. In some instances, defendants convicted of criminal tax offenses have obtained reversals of those convictions because of failures to comply fully with this provision.

Explanation of Provision

The bill repeals the requirement that the Secretary disclose, upon the written request of either party to the lawsuit, whether an individual who is a prospective juror has or has not been the subject of an audit or other tax investigation by the Internal Revenue Service.

Effective Date

The provision is effective for judicial proceedings pending on, or commenced after, the date of enactment.

5. Repeal TEFRA audit rules for S corporations (sec. 4805 of the bill and secs. 6037, 6241, 6242, 6243, 6244, and 6245 of the Code)

Present Law

An S corporation generally is not subject to income tax on its taxable income. Instead, it files an information return and the shareholders report their pro rata share of the S corporation's income and deductions on their own tax returns.

The Subchapter S Revision Act of 1982 generally made the TEFRA partnership audit and litigation rules applicable to S corporations. These rules require the determination of all "Subchapter S items" at the corporate, rather than the shareholder, level. These rules also require a shareholder to report all Subchapter S items consistently with the corporation's information return or to notify the IRS of any inconsistency. Temporary regulations contain an exception from these rules for "small S corporations," i.e., those with five or fewer shareholders, each of whom is a natural person or an estate.

Reasons for Change

An S corporation generally is limited to 35 investors. In addition, the vast majority of both existing and newly formed S corporations are expected to qualify for the small S corporation exception from the unified audit and litigation provisions. Consequently, a unified audit procedure is an unnecessary requirement for S corporations.

Explanation of Provision

The bill repeals the unified audit procedures for S corporations. The bill retains, however, the requirement that shareholders report items in a manner consistent with the corporation's return.

Effective Date

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

6. Clarify statute of limitations for items from passthrough entities (sec. 4806 of the bill and sec. 6501(a) of the Code)

Present Law

Passthrough entities (such as S corporations, partnerships, and certain trusts) generally are not subject to income tax on their taxable income. Instead, these entities file information returns and the entities' shareholders (or beneficial owners) report their pro rata share of the gross income and are liable for any taxes due.

Some believe that present law may be unclear as to whether the statute of limitations for adjustments that arise from distributions from passthrough entities should be applied at the entity or indi-

vidual level (i.e., whether the 3-year statute of limitations for assessments runs from the time that the entity files its information return or from the time that a shareholder timely files his or her income tax return). (Compare *Fehlhaber v. Comm.*, 94 TC 863 (1990) with *Kelly v. Comm.*, 877 F.2d 7567 (9th Cir. 1989)).

Reasons for Change

Uncertainty regarding the correct statute of limitations hinders the resolution of factual and legal issues and creates needless litigation over collateral matters.

Explanation of Provision

The bill clarifies that the return that starts the running of the statute of limitations for a taxpayer is the return of the taxpayer and not the return of another person from whom the taxpayer has received an item of income, gain, loss, deduction, or credit. The provision is not intended to create any inference as to the proper interpretation of present law.

Effective Date

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

Part II—Tax Court Provisions

1. Clarify jurisdiction of Tax Court with respect to overpayment determinations (sec. 4811 of the bill and sec. 6512(b) of the Code)

Present Law

The Tax Court may order the refund of an overpayment determined by the Court, plus interest, if the IRS fails to refund such overpayment and interest within 120 days after the Court's decision becomes final. Whether such an order is appealable is uncertain.

In addition, it is unclear whether the Tax Court has jurisdiction over the validity or merits of certain credits or offsets (e.g., providing for collection of student loans, child support, etc.) made by the IRS that reduce or eliminate the refund to which the taxpayer was otherwise entitled.

Reasons for Change

Clarification of the jurisdiction of the Tax Court and the appealability of orders of the Tax Court would provide for greater certainty for taxpayers and the Government in conducting cases before the Tax Court. Clarification will also reduce litigation.

Explanation of Provision

The bill clarifies that an order to refund an overpayment is appealable in the same manner as a decision of the Tax Court. The bill also clarifies that the Tax Court does not have jurisdiction over

the validity or merits of the credits or offsets that reduce or eliminate the refund to which the taxpayer was otherwise entitled.

Effective Date

The provision is effective on the date of enactment.

2. Clarify procedures for administrative cost awards (sec. 4812 of the bill and sec. 7430 of the Code)

Present Law

Any person who substantially prevails in any action brought by or against the United States in connection with the determination, collection, or refund of any tax, interest, or penalty may be awarded reasonable administrative costs incurred before the IRS and reasonable litigation costs incurred in connection with any court proceeding.

No time limit is specified for the taxpayer to apply to the IRS for an award of administrative costs. In addition, no time limit is specified for a taxpayer to appeal to the Tax Court an IRS decision denying an award of administrative costs. Finally, the procedural rules for adjudicating a denial of administrative costs are unclear.

Reasons for Change

The proper procedures for applying for a cost award are uncertain in some instances. Clarifying these procedures will decrease litigation over these procedural issues and will provide for expedited settlement of these claims.

Explanation of Provision

The bill provides that a taxpayer who seeks an award of administrative costs must apply for such costs within 90 days of the date on which the taxpayer was determined to be a prevailing party. The bill also provides that a taxpayer who seeks to appeal an IRS denial of an administrative cost award must petition the Tax Court within 90 days after the date that the IRS mails the denial notice.

The bill clarifies that dispositions by the Tax Court of petitions relating only to administrative costs are to be reviewed in the same manner as other decisions of the Tax Court.

Effective Date

The provision is effective on the date of enactment.

3. Clarify Tax Court jurisdiction over interest determinations (sec. 4813 of the bill and sec. 7481(c) of the Code)

Present Law

A taxpayer may seek a redetermination of interest after certain decisions of the Tax Court have become final by filing a petition with the Tax Court.

Reasons for Change

It would be beneficial to taxpayers if a proceeding for a redetermination of interest supplemented the original deficiency action brought by the taxpayer to redetermine the deficiency determination of the IRS. A motion, rather than a petition, is a more appropriate pleading for relief in these cases.

Explanation of Provision

The bill provides that a taxpayer must file a "motion" (rather than a "petition") to seek a redetermination of interest in the Tax Court.

Effective Date

The provision is effective on the date of enactment.

4. Clarify net worth requirements for awards of administrative or litigation costs (sec. 4814 of the bill and sec. 7430 of the Code)

Present Law

Any person who substantially prevails in any action brought by or against the United States in connection with the determination, collection, or refund of any tax, interest, or penalty may be awarded reasonable administrative costs incurred before the IRS and reasonable litigation costs incurred in connection with any court proceeding.

A person who substantially prevails must meet certain net worth requirements to be eligible for an award of administrative or litigation costs. In general, only an individual whose net worth does not exceed $2,000,000 is eligible for an award, and only a corporation or partnership whose net worth does not exceed $7,000,000 is eligible for an award. (The net worth determination with respect to a partnership or S corporation applies to all actions that are in substance partnership actions or S corporation actions, including unified entity-level proceedings under sections 6226 or 6228, that are nominally brought in the name of a partner or a shareholder.)

Reasons for Change

Although the net worth requirements are explicit for individuals, corporations, and partnerships, it is not clear which net worth requirement is to apply to other potential litigants. It is also unclear how the individual net worth rules are to apply to individuals filing a joint tax return. Clarifying these rules will provide certainty for potential claimants and will decrease needless litigation over procedural issues.

Explanation of Provision

The bill provides that the net worth limitations currently applicable to individuals also apply to estates and trusts. The bill also provides that individuals who file a joint tax return shall be treated as one individual for purposes of computing the net worth limitations. Consequently, the net worths of both spouses are aggregat-

ed for purposes of this computation. An exception to this rule is provided in the case of a spouse otherwise qualifying for innocent spouse relief.

Effective Date

The provision applies to proceedings commenced after the date of enactment.

Part III—Permit IRS to Enter Into Cooperative Agreements With State Tax Authorities (sec. 4821 of the bill and new sec. 7524 of the Code)

Present Law

The IRS is generally not authorized to provide services to non-Federal agencies even if the cost is reimbursed (62 Comp. Gen. 323,335 (1983)).

Reasons for Change

Most taxpayers reside in States with an income tax and, therefore, must file both Federal and State income tax returns each year. Each return is separately prepared, with the State return often requiring information taken directly from the Federal return. Permitting the IRS to enter into agreements that are designed to promote efficiency through joint tax administration programs with States would reduce the burden on taxpayers because much of the same information could be used by both Governments.

For example, the burden on taxpayers could be significantly reduced through joint electronic filing of tax returns, whereby a taxpayer electronically transmits both Federal and State returns to one location. Joint Federal and State electronic filing could simplify and shorten return preparation time for taxpayers. Also, State governments could benefit from reduced processing costs, while the IRS could benefit from the potential increase in taxpayers who would elect to file electronically because they would be able to fulfill both their Federal and State obligations simultaneously.

Explanation of Provision

The bill provides that the Secretary is authorized to enter into cooperative agreements with State tax authorities to enhance joint tax administration. These agreements may include (1) joint filing of Federal and State income tax returns, (2) single processing of these returns, and (3) joint collection of taxes (other than Federal income taxes).

The bill provides that these agreements may require reimbursement for services provided by either party to the agreement. Any funds appropriated for tax administration may be used to carry out the responsibilities of the IRS under these agreements, and any reimbursement received under an agreement shall be credited to the amount appropriated.

No agreement may be entered into that does not provide for the protection of confidentiality of taxpayer information that is required by section 6103.

Effective Date

This provision is effective on the date of enactment.

TITLE V—TAXPAYER BILL OF RIGHTS 2

Subtitle A—Taxpayer Advocate

1. Establishment of Position of Taxpayer Advocate Within Internal Revenue Service (sec. 5001 of the bill and sec. 7802 of the Code)

Present Law

The Office of the Taxpayer Ombudsman was created by the IRS in 1979. The Taxpayer Ombudsman's duties are to serve as the primary advocate, within the IRS, for taxpayers. As the taxpayers' advocate, the Taxpayer Ombudsman participates in an ongoing review of IRS policies and procedures to determine their impact on taxpayers, receives ideas from the public concerning tax administration, identifies areas of the tax law that confuse or create an inequity for taxpayers, and supervises cases handled under the Problem Resolution Program. Under current procedures, the Taxpayer Ombudsman is selected by the Commissioner of the IRS and serves at his discretion.

Reasons for Change

In order to ensure that the Taxpayer Ombudsman has the necessary stature within the IRS to represent fully the interests of taxpayers, the committee believes that it is appropriate that the position be elevated to a position comparable to that of the Chief Counsel. In addition, in order to ensure that the Congress is systematically made aware of recurring and unresolved problems and difficulties taxpayers encounter in dealing with the IRS, the Taxpayer Ombudsman should have the authority and responsibility to make independent reports to the Congress in order to advise the tax-writing Committees of those areas.

Explanation of Provision

The bill establishes a new position, Taxpayer Advocate, within the IRS. This replaces the position of Taxpayer Ombudsman. The Advocate is appointed by the IRS Commissioner and reports directly to the Commissioner. Compensation of the Advocate is at a level equal to that of the IRS Chief Counsel.

The bill also establishes the Office of Taxpayer Advocate within the IRS. All problem resolution officers are part of that office, and are under the supervision and direction of the Taxpayer Advocate. The functions of the office are (1) to assist taxpayers in resolving problems with the IRS, (2) to identify areas in which taxpayers have problems in dealing with the IRS, (3) to propose changes (to the extent possible) in the administrative practices of the IRS that will mitigate those problems, and (4) to identify potential legislative changes that may mitigate those problems.

The Taxpayer Advocate is required to make two annual reports to the tax-writing Committees. The first report is to contain the ob-

jectives of the Taxpayer Advocate for the next calendar year. This report is to contain full and substantive analysis, in addition to statistical information. This report is due not later than October 31 of each year. The second report is on the activities of the Taxpayer Advocate during the previous fiscal year. The report must identify the initiatives the Taxpayer Advocate has taken to improve taxpayer services and IRS responsiveness, contain recommendations received from individuals who have the authority to issue a TAO, contain a summary of at least 20 of the most serious problems which taxpayers have in dealing with the IRS, describe in detail the progress made in implementing these recommendations, include recommendations for such administrative and legislative action as may be appropriate to resolve such problems, and to include other such information as the Taxpayer Advocate may deem advisable. The Commissioner is required to establish internal procedures that will ensure a formal IRS response to all recommendations submitted to the Commissioner by the Taxpayer Advocate.

Effective Date

The provision is effective on the date of enactment. The first annual reports of the Taxpayer Advocate are due in 1992.

2. Expansion of Authority to Issue Taxpayer Assistance Orders (sec. 5002 of the bill and sec. 7811 of the Code)

Present Law

Section 7811(a) authorizes the Taxpayer Ombudsman to issue a Taxpayer Assistance Order (TAO). TAOs may order the release of taxpayer property levied upon by the IRS and may require the IRS to cease any action, or refrain from taking any action if, in the determination of the Taxpayer Ombudsman, the taxpayer is suffering or about to suffer a significant hardship as a result of the manner in which the internal revenue laws are being administered.

Reasons for Change

The requirement that the significant hardship be as a result of the manner in which the internal revenue laws are being administered has resulted in confusion as to the circumstances which justify the issuance of a TAO. The most frequent situation where a TAO may be needed, but may not be authorized under present law, involves income tax refunds that are needed to relieve severe hardship of taxpayers. Another example involves the re-issuance of refund checks which have been sent by the IRS to an address at which the taxpayer no longer resides. While the mailing of the check to the incorrect address might in no way be due to the fault of the IRS, the normal delays in reissuing such a check may cause great hardship for the taxpayer. Also, the IRS Collection Division may take an enforcement action when the taxpayer has had no actual notice of the deficiency and is not afforded any opportunity to obtain an administrative review of the validity of the tax deficiency. In cases like these, it may be appropriate for the Taxpayer Advocate to issue a TAO to temporarily stay the IRS collection

action in order to allow for a review of the appropriateness of the proposed action.

Explanation of Provision

The bill eliminates the requirement that the hardship experienced by the taxpayer be significant as a condition for the issuance of a TAO. The bill also provides the Taxpayer Advocate with broader authority to affirmatively take any action with respect to taxpayers who would otherwise suffer a hardship as a result of the manner in which the IRS is administering the tax laws. The bill provides that a TAO may specify a time period within which the TAO must be followed. Finally, the bill provides that only the Taxpayer Advocate, the Commissioner of the IRS, or a superior of those two positions, as well as a delegate of the Taxpayer Advocate, may modify or rescind a TAO.

Effective Date

The provision is effective on the date of enactment.

Subtitle B—Modifications to Installment Agreement Provisions

1. Notification of Reasons for Termination or Denial of Installment Agreements (sec. 5101 of the bill and sec. 6159 of the Code)

Present Law

Section 6159 authorizes the IRS to enter into written installment agreements with taxpayers to facilitate the collection of tax liabilities. In general, the IRS has the right to terminate (or in some instances, alter or modify) such agreements if the taxpayer provided inaccurate or incomplete information before the agreement was entered into, if the taxpayer fails to make a timely payment of an installment or another tax liability, if the taxpayer fails to provide the IRS with a requested update of financial condition, if the IRS determines that the financial condition of the taxpayer has changed significantly, or if the IRS believes collection of the tax liability is in jeopardy. If the IRS determines that the financial condition of a taxpayer that has entered into an installment agreement has changed significantly, the IRS must provide the taxpayer with a written notice that explains the IRS determination at least 30 days before altering, modifying or terminating the installment agreement. No notice is statutorily required if the installment agreement is altered, modified, or terminated for other reasons.

Reasons for Change

The committee believes that the IRS generally should notify taxpayers if an installment agreement is denied, altered, modified, or terminated.

Explanation of Provision

The bill requires the IRS to notify taxpayers 30 days before denying, altering, modifying, or terminating any installment agreement

for any reason other than that the collection of tax is determined to be in jeopardy. The IRS must include in the notification an explanation of why the IRS intends to take this action.

Effective Date

The provision is effective six months after the date of enactment.

2. Administrative Review of Denial of Requests For, or Termination of, Installment Agreements (sec. 5102 of the bill and sec. 6159 of the Code)

Present Law

A taxpayer whose request for an installment agreement is denied can appeal to successively higher levels of Collection Division management, including the District Director. The IRS is currently testing an appeals process for various collection actions, including installment agreements, that will permit taxpayers to appeal these collection actions to Appeals Division personnel.

Reasons for Change

The committee believes that taxpayers should be able to obtain an independent administrative review of denials of requests for, or terminations of, installment agreements.

Explanation of Provision

The bill requires the IRS to establish procedures for an independent administrative review of denials of requests for, or terminations of, installment agreements.

Effective Date

The provision is effective on the date of enactment.

Subtitle C—Interest

1. Expansion of Authority to Abate Interest (sec. 5201 of the bill and sec. 6404 of the Code)

Present Law

Any assessment of interest on any deficiency attributable in whole or in part to any error or delay by an officer or employee of the IRS (acting in his official capacity) in performing a ministerial act may be abated.

Reasons for Change

The committee believes that the IRS should be required to abate interest in situations where there was an unreasonable and excessive IRS error or delay.

Explanation of Provision

The bill requires the IRS to abate interest in any case in which the taxpayer establishes that there was an unreasonable and exces-

sive IRS error or delay and the taxpayer has fully cooperated in resolving outstanding issues. To allow the taxpayer to develop the facts of the error or delay, the IRS is required to provide to the taxpayer, within 30 days of the taxpayer's written request (which is to be made in the form the Secretary prescribes), all information and copies of relevant records in the possession of the IRS with respect to the taxpayer's case.

Effective Date

The provision applies to interest accruing with respect to deficiencies or payments for taxable years beginning after the date of enactment.

2. Extension of Interest-Free Period For Payment of Tax After Notice and Demand (sec. 5202 of the bill and sec. 6601 of the Code)

Present Law

In general, a taxpayer must pay interest on late payments of tax. An interest-free period of ten days is provided to taxpayers who pay the tax due within ten days of notice and demand.

Reasons for Change

The ten-day interest-free period was designed to give taxpayers time to receive the notice and pay the amount due. Because it may be very difficult for some taxpayers to remit payment within the ten-day period, particularly if the mail has delayed delivery of the notice, the IRS often must recompute interest and send another notice to taxpayers.

Explanation of Provision

The bill extends the interest-free period provided to taxpayers for the payment of the tax liability reflected in the notice from 10 days to 21 days, provided that the total tax liability shown on the notice of deficiency is less than $100,000.

Effective Date

The provision applies in the case of any notice and demand given after the date six months after the date of enactment.

Subtitle D—Joint Returns

1. Requirement of Separate Deficiency Notices in Certain Cases (sec. 5301 of the bill and sec. 6212 of the Code)

Present Law

The IRS may send a single notice of deficiency with respect to a joint return unless a spouse has notified the IRS that separate residences have been established, in which case the IRS must send a copy of the notice to each spouse at his or her last known address.

Reasons for Change

The committee believes that, if the spouses have not filed a joint return, each spouse is entitled to receive a copy of the notice of deficiency.

Explanation of Provision

The bill requires the IRS to send each spouse a copy of the notice of deficiency if the spouses have not filed a joint return for the most recent taxable year for which the IRS's master files have been updated or if the IRS has been notified by either spouse that separate residences have been established.

Effective Date

The provision is effective on the date six months after the date of enactment.

2. Disclosure of Collection Activities (sec. 5302 of the bill and sec. 6103(e) of the Code)

Present Law

The IRS does not disclose collection information to spouses that have filed a joint return.

Reasons for Change

The committee believes that it is appropriate to permit the IRS to discuss with one spouse the efforts it has made to collect the joint return tax liability from the other spouse.

Explanation of Provision

If a tax deficiency with respect to a joint return is assessed, and the individuals filing the return are no longer married or no longer reside in the same household, the bill requires the IRS to disclose in writing (in response to a written request by one of the individuals) to that individual whether the IRS has attempted to collect the deficiency from the other individual, the general nature of the collection activities, and the amount (if any) collected.

Effective Date

The provision is effective on the date of enactment.

3. Joint Return May Be Made After Separate Returns Without Full Payment of Tax (sec. 5303 of the bill and sec. 6013 of the Code)

Present Law

Taxpayers who file separate returns and subsequently determine that their tax liability would have been less if they had filed a joint return are precluded by statute from reducing their tax liability by filing jointly if they are unable to pay the entire amount of the joint return liability before the expiration of the three-year period for making the election to file jointly.

Reasons for Change

Not all taxpayers are able to pay the full amount owed on their returns by the filing deadline. In such circumstances, the IRS encourages the taxpayer to pay the tax as soon as possible or enter into an installment agreement. However, taxpayers who file separate returns and subsequently determine that their tax liability would have been less if they had filed a joint return are precluded from reducing their tax liability by filing jointly if they are unable to pay the entire amount of the joint return liability. This rule may be unfair to taxpayers experiencing financial difficulties.

Explanation of Provision

The bill repeals the requirement of full payment of tax liability as a precondition to switching from married filing separate status to married filing jointly status.

Effective Date

The provision applies to taxable years beginning after the date of the enactment.

4. Representation of Absent, Divorced or Separated Spouse by Other Spouse (sec. 5304 of the bill and sec. 7605 of the Code)

Present Law

A taxpayer that has joined in the filing of a joint return may represent the taxpayer's spouse with respect to a deficiency assessed for the taxable year to which the return applies. Current IRS procedures allow each spouse to separately appeal the statutory notice of deficiency.

Reasons for Change

The committee believes that it is appropriate to obtain written authorization from the absent spouse.

Explanation of Provision

The bill provides that an individual who had filed a joint return with a spouse but who is no longer married to that spouse (or no longer resides in the same household) and that spouse is absent from the examination of that return may not represent that absent spouse at the examination unless the absent spouse permits it in writing.

Effective Date

The provision is effective on the date of enactment.

Subtitle E—Collection Activities

1. Notice of Proposed Deficiency (sec. 5401 of the bill and new sec. 6211A of the Code)

Present Law

The IRS generally issues a notice of proposed deficiency prior to issuing a notice of deficiency. The notice of proposed deficiency, commonly referred to as the "30-day letter," offers a taxpayer the opportunity for review of the case by the IRS Appeals Office. The IRS is not required to issue a 30-day letter, but generally does unless the statute of limitations on assessment will expire within six months. If a 30-day letter is not issued and the taxpayer files a petition in the Tax Court, the taxpayer is permitted to have the case reviewed by Appeals after it is docketed.

Reasons for Change

The committee believes that requiring the IRS to issue a notice of proposed deficiency will help protect the rights of taxpayers.

Explanation of Provision

The IRS is required to issue a notice of proposed deficiency in every case (other than jeopardy assessment cases). The mailing of the notice of proposed deficiency must precede the mailing of the notice of deficiency by at least 60 days. If the statute of limitations would expire within six months, the IRS may ask the taxpayer to extend the statute of limitations so that the IRS may issue a notice of proposed deficiency. Failure to issue a notice of proposed deficiency would invalidate the notice of deficiency.

Effective Date

The provision is effective with respect to deficiencies determined on or after 1 year after the date of enactment.

2. Modifications to Lien and Levy Provisions (sec. 5402 of the bill and secs. 6323 and 6343 of the Code)

(a) *Withdrawal of Public Notice of Lien*

Present Law

The IRS must file a notice of lien in the public record, in order to protect the priority of a tax lien. A notice of tax lien provides public notice that a taxpayer owes the Government money.

Reasons for Change

The IRS has discretion in filing such a notice, but may withdraw a filed notice only if the notice (and the underlying lien) was erroneously filed or if the underlying lien has been paid, bonded, or become unenforceable. The committee believes that it is appropriate to give the IRS discretion to withdraw a notice of lien in other situations as well.

Explanation of Provision

The bill allows the IRS to withdraw a public notice of tax lien prior to payment in full by the indebted taxpayer if the Secretary determines that (1) the filing of the notice was premature or otherwise not in accordance with the administrative procedures of the IRS, (2) the taxpayer has entered into an installment agreement to satisfy the tax liability, (3) the withdrawal of the lien will facilitate collection of the tax liability, or (4) the withdrawal of the lien would be in the best interests of the taxpayer and the Government (with the consent of the taxpayer or the Taxpayer Advocate). The bill also requires that, at the written request of the taxpayer, the IRS make reasonable efforts to give notice of the withdrawal of a lien to credit reporting agencies or financial institutions specified by the taxpayer.

Effective Date

The provisions are effective on the date of enactment.

(b) *Return of Levied Property*

Present Law

The IRS is authorized to return levied property to a taxpayer only when the taxpayer has overpaid its liability for tax, interest, and penalties.

Reasons for Change

There are several situations where the IRS cannot return levied-upon amounts even when it believes doing so would be equitable and in the best interests of the taxpayer and the Government. For example, if the IRS enters into an installment agreement and, in contradiction to the terms of the installment agreement, the IRS levies on the taxpayer's property, the IRS is prohibited from returning the property to the taxpayer.

Explanation of Provision

The bill allows the IRS to return property (including money deposited in the Treasury) that has been levied upon if the Secretary determines that (1) the levy was premature or otherwise not in accordance with the administrative procedures of the IRS, (2) the taxpayer has entered into an installment agreement to satisfy the tax liability, (3) the return of the property will facilitate collection of the tax liability, or (4) the return of the property would be in the best interests of the taxpayer and the United States (with the consent of the taxpayer or the Taxpayer Advocate).

Effective Date

The provisions are effective on the date of enactment.

(c) *Modifications in Certain Levy Exemption Amounts*

Present Law

Property exempt from levy includes personal property with a value of up to $1,650 and books and tools necessary for the taxpayer's trade, business, or profession with a value of up to $1,100.

Reasons for Change

The committee believes that these amounts should be increased and indexed for inflation.

Explanation of Provision

The exemption amounts would be increased to $1,700 for personal property and $1,200 for books and tools. Both these amounts would be indexed for inflation commencing with calendar year 1994.

Effective Date

The provisions are effective on the date of enactment.

3. Offers-In-Compromise (sec. 5403 of the bill and sec. 7122 of the Code)

Present Law

The IRS has the authority to settle a tax debt pursuant to an offer-in-compromise. IRS regulations provide that such offers can be accepted if: the taxpayer is unable to pay the full amount of the tax liability and it is doubtful that the tax, interest, and penalties can be collected or there is doubt as to the validity of the actual tax liability. Amounts over $500 can only be accepted if the reasons for the acceptance are documented in detail and supported by an opinion of the IRS Chief Counsel.

Reasons for Change

Because of the requirements for accepting offers-in-compromise, IRS employees may classify accounts as currently-not-collectable, rather than accept part payment through an offer-in-compromise. The committee believes that an expanded offer-in-compromise program would benefit taxpayers by making it possible to liquidate a debt with the Government more rapidly.

Explanation of Provision

The bill allows acceptance of an offer-in-compromise where the compromise would be in the best interests of the Government. The bill also increases from $500 to $50,000 the amount requiring a written opinion from the Office of Chief Counsel. Compromises below that threshold must be subject to continuing quality review by the IRS.

Effective Date

The provision is effective on the date of enactment.

4. Notification of Examination (sec. 5404 of the bill and sec. 7605 of the Code)

Present Law

In general, the IRS notifies taxpayers in writing prior to commencing an examination and encloses a copy of Publication 1, "Your Rights as a Taxpayer," with the notice. Sometimes, however, the IRS uses the telephone to schedule an examination.

Reasons for Change

The committee believes that taxpayers should always receive written notice of an examination.

Explanation of Provision

The bill requires the IRS to notify a taxpayer in writing prior to commencing an examination and to provide the taxpayer with an explanation of the examination process prior to commencing the examination.

Effective Date

The provision is effective on the date of enactment.

5. Modification of Certain Limits on Recovery of Civil Damages for Unauthorized Collection Activities (sec. 5405 of the bill and sec. 7433 of the Code)

Present Law

A taxpayer may sue the United States for up to $100,000 of damages caused by an officer or employee of the IRS who recklessly or intentionally disregards provisions of the Internal Revenue Code or the Treasury regulations promulgated thereunder.

Reasons for Change

The committee believes that it should be easier for taxpayers to sue the IRS for damages caused by IRS employees.

Explanation of Provision

The bill increases the cap to $1 million with respect to reckless or intentional acts. In addition, it permits a taxpayer to sue the United States for damages caused by an IRS employee who negligently disregards the provisions of the Code or regulations, subject to a cap of $100,000 in damages.

Effective Date

The provision applies to actions by IRS employees that occur after the date of enactment.

6. Designated summons (sec. 5406 of the bill and sec. 6503(k) of the Code)

Present Law

The period for assessment of additional tax with respect to most tax returns, corporate or otherwise, is three years. The IRS and the taxpayer can together agree to extend the period, either for a specified period of time or indefinitely. The taxpayer may terminate an indefinite agreement to extend the period by providing notice to the IRS.

During an audit, the IRS may informally request that the taxpayer provide additional information necessary to arrive at a fair and accurate audit adjustment, if any adjustment is warranted. Not all taxpayers cooperate by providing the requested information on a timely basis. In some cases the IRS seeks information by issuing an administrative summons. Such a summons will not be judicially enforced unless the Government (as a practical matter, the Department of Justice) seeks and obtains an order for enforcement in Federal court. In addition, a taxpayer may petition the court to quash an administrative summons where this is permitted by statute.[168]

In certain cases the running of the assessment period is suspended during the period when the parties are in court to obtain or avoid judicial enforcement of an administrative summons. Such a suspension is provided in the case of litigation over a third-party summons (sec. 7609(e)) or litigation over a summons regarding the examination of a related party transaction. Such a suspension can also occur with respect to a corporate tax return if a summons is issued at least 60 days before the day on which the assessment period (as extended) is scheduled to expire. In this case, suspension is only permitted if the summons clearly states that it is a "designated summons" for this purpose. Only one summons may be treated as a designated summons for purposes of any one tax return. The limitations period is suspended during the judicial enforcement period of the designated summons and of any other summons relating to the same tax return that is issued within 30 days after the designated summons is issued.

Under current internal procedures of the IRS, no designated summons is issued unless first reviewed by the Office of Chief Counsel to the IRS, including review by an IRS Deputy Regional Counsel for the Region in which the audit occurs.

Reasons for Change

The committee recognizes that issuance of a designated summons is a serious step in the examination of a tax return, given the fact that litigation over the summons would suspend the running of the period for assessing additional tax against the taxpayer under audit. The committee is informed that, in recognition of the seriousness of such a step, the IRS has adopted procedures to ensure

[168] Petitions to quash are permitted, for example, in connection with the examination of certain related party transactions under section 6038A(e)(4), and in the case of certain third-party summonses under section 7609(b)(2).

high-level IRS review before any such summons is issued. The committee believes that the Code should, however, mandate review in order to assure that careful consideration is given before issuing such a summons.

Under the designated summons rules, summons enforcement litigation can suspend the running of the period for assessing additional tax on a corporation, even though the summons is issued to a person other than that corporation. The committee believes that the corporation should receive prompt written notice of the issuance of such a summons.

Explanation of Provision

The provision requires that issuance of any designated summons with respect to a corporation's tax return must be preceded by review of such issuance by the Regional Counsel, Office of Chief Counsel to the IRS, for the Region in which the examination of the corporation's return is being conducted.

In addition, the provision requires that the corporation whose return is in issue be promptly notified in writing in any case where the Secretary issues a designated summons (or another summons, the litigation over which suspends the running of the assessment period under the designated summons procedure) to a third party. The committee expects that the IRS will meet this requirement by issuing such notice generally on the same day that it issues such summons, and by transmitting such notice to the corporation in a manner reasonably designed to bring it to the prompt attention of an agent of the corporation responsible for communicating with the IRS in connection with the examination.

Effective Date

The provision applies to summonses issued after date of enactment.

Subtitle F—Information Returns

1. Phone Numbers of Person Providing Payee Statement Required to be Shown on such Statement (sec. 5501 of the bill and secs. 6041, 6041A, 6042, 6044, 6045, 6049, 6050B, 6050H, 6050I, 6050J, 6050K, and 6050N of the Code)

Present Law

Information returns must contain the name and address of the payor.

Reasons for Change

Taxpayers often need to contact payors issuing information returns in order to resolve questions about the accuracy of the information provided to the IRS. Currently, payors are only required to provide their names and addresses on information returns. As a result, taxpayers may have difficulty in contacting the payor and resolving questions quickly.

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Explanation of Provision

The bill requires that information returns contain the name, address, and phone number of the payor's information contact.

Effective Date

The provision applies to statements required to be furnished after December 31, 1992 (determined without regard to any extension).

2. Civil Damages For Fraudulent Filing of Information Returns (sec. 5502 of the bill and new sec. 7434 of the Code)

Present Law

Federal law provides no private cause of action to a taxpayer who is injured because a false or fraudulent information return has been filed with the IRS asserting that payments have been made to the taxpayer.

Reasons for Change

Some taxpayers may suffer significant personal loss and inconvenience as the result of the IRS receiving fraudulent information returns, which have been filed by persons intent on either defrauding the IRS or harassing taxpayers.

Explanation of Provision

The bill provides that, if any person willfully files a false or fraudulent information return with respect to payments purported to have been made to another person, the other person may bring a civil action for damages against the person filing that return. Recoverable damages are the greater of $5,000 or the amount of actual damages (including the costs of the action). An action seeking damages under this provision must be brought within six years after the filing of the false or fraudulent information return.

Effective Date

The provision applies to false or fraudulent information returns filed after the date of enactment.

3. Requirement to Verify Accuracy of Information Returns (sec. 5503 of the bill and sec. 6201 of the Code)

Present Law

Deficiencies determined by the IRS are generally afforded a presumption of correctness.

Reasons for Change

Taxpayers may encounter difficulties when a payor issues an erroneous information return and refuses to correct the information and report the change to the IRS.

Explanation of Provision

The bill provides that, in any court proceeding, if a taxpayer asserts a reasonable dispute with respect to any item of income reported on an information return filed by a third party and the taxpayer has fully cooperated with the IRS, the Government must, in presenting evidence of the deficiency based on the information return, present reasonable evidence of the deficiency (in addition to the information return itself). One way in which the taxpayer must cooperate with the IRS is to bring the reasonable dispute over the item of income to the attention of the IRS at the earliest possible time.

Effective Date

The provision is effective on the date of enactment.

Subtitle G—Modification To Penalty For Failure To Collect and Pay Over Tax

1. Trust Fund Taxes (sec. 5601 of the bill and sec. 6672 of the Code)

Present Law

A "responsible person" is subject to a penalty equal to the amount of trust fund taxes that are not collected or paid to the government on a timely basis. An individual the IRS has identified as a responsible person is permitted an administrative appeal on the question of responsibility.

Reasons for Change

The committee believes that taxpayers should receive more effective notice of their liability for these penalties.

Explanation of Provision

The IRS is required to issue a notice to an individual the IRS had determined to be a responsible person with respect to unpaid trust fund taxes at least 60 days prior to issuing a notice and demand for the penalty. After exhausting the administrative remedies available within the IRS, the recipient could seek a declaratory judgment from the Tax Court prior to assessment. The statute of limitations for the collection of the penalty is suspended during the periods that these rules preclude the IRS from collecting the penalty. The provision does not apply to jeopardy collections.

Effective Date

The provision applies to failures occurring after the date of enactment.

2. Disclosure of Certain Information Where More Than One Person Subject To Penalty (sec. 5602 of the bill and sec. 6103(e) of the Code)

Present Law

The IRS may not disclose to a responsible person the IRS's efforts to collect unpaid trust fund taxes from other responsible persons, who may also be liable for the same tax liability.

Reasons for Change

The committee believes that it is appropriate to permit the IRS to disclose to a responsible person whether the IRS is imposing the penalty on any other responsible person, and whether the IRS has been successful in collecting the penalty against such a person.

Explanation of Provision

The bill requires the IRS, if requested in writing by a person considered by the IRS to be a responsible person, to disclose in writing to that person the name of any other person the IRS has determined to be a responsible person with respect to the tax liability. The IRS would be required to disclose in writing whether it has attempted to collect this penalty from other responsible persons, the general nature of those collection activities, and the amount (if any) collected.

Effective Date

The provision is effective on the date of enactment.

3. Penalties Relating to Failure to Collect and Pay Over Tax (sec. 5603 of the bill)

(a) *Public Information Requirements*

Present Law

Under section 6672, a "responsible person" is subject to a penalty equal to the amount of trust fund taxes that are not collected and paid to the Government on a timely basis.

Reasons for Change

Some employees may not be fully aware of their personal liability under section 6672 for the failure to pay over trust fund taxes. The committee believes that IRS could take additional efforts to assist the public in understanding its responsibilities.

Explanation of Provision

The bill requires the IRS to print warnings on payroll tax deposit coupon books and appropriate tax returns indicating that certain employees may be liable for this penalty, and to develop a special information packet relating to this penalty.

Effective Date

The provision is effective on the date of enactment.

(b) *Board Members of Tax-exempt Organizations*

Present Law

Under section 6672, "responsible persons" of tax-exempt organizations are subject to a penalty equal to the amount of trust fund taxes that are not collected and paid to the Government on a timely basis.

Reasons for Change

Individuals who serve on the boards of tax-exempt organizations, on a voluntary or honorary basis, are often concerned that they will be held liable for unpaid taxes of the organization as a responsible person, even though their service may be strictly voluntary in nature, and they may not be involved in the day-to-day operations and financial decisions of the organization. The committee believes that the IRS has not made adequate efforts to clarify the rules applicable to tax-exempt organizations.

Explanation of Provision

The bill clarifies that the section 6672 responsible person penalty is not to be imposed on unpaid, volunteer members of any board of trustees or directors of a tax-exempt organization to the extent such members do not participate in the day-to-day or financial activities of the organization. The bill requires the IRS to develop materials to better inform board members of tax-exempt organizations (including voluntary members) that they may be treated as responsible persons. The IRS must make such materials routinely available to tax-exempt organizations. The bill also requires the IRS to clarify its instructions to IRS employees on application of the responsible person penalty with regard to volunteer members of boards of trustees or directors of tax-exempt organizations.

Effective Date

The provision is effective on the date of enactment.

(c) *Prompt Notification*

Present Law

The IRS is not required to notify promptly taxpayers who fall behind in depositing trust fund taxes.

Reasons for Change

The IRS may take from six months to two years before making an initial contact with taxpayers who have fallen behind in their trust fund tax deposits, and additional months or years before the IRS takes direct enforcement action. During this period, the tax liabilities and related interest and penalties can increase significantly and collection becomes more difficult. Individuals often find out

many years later, when the amount of tax due is large, that the IRS has determined that they are liable for the entire tax liability as a responsible person. Early notice of such failures could permit more rapid correction of the failure to make correct deposits.

Explanation of Provision

The bill requires the IRS, to the maximum extent practicable, to notify all taxpayers with delinquent trust fund deposits within 30 days of the first indication that there has been a failure to make a timely and complete deposit.

Effective Date

The provision is effective on the date of enactment.

Subtitle H—Awarding of Costs and Certain Fees

1. Commencement Date of Reasonable Administrative Costs (sec. 5701 of the bill and sec. 7430 of the Code)

Present Law

A taxpayer that successfully challenges a determination of deficiency by the IRS may recover attorneys' fees and other administrative and litigation costs if the taxpayer qualifies as a "prevailing party." These costs are recoverable to the extent incurred on or after the earlier of (i) the date of the receipt by the taxpayer of the notice of decision of the IRS Office of Appeals, or (ii) the date of the notice of deficiency.

Reasons for Change

The committee believes that taxpayers should be able to receive attorney's fees for costs incurred at an earlier stage of the IRS administrative process.

Explanation of Provision

Attorney's fees and other administrative costs are recoverable to the extent incurred after the earlier of the date of the notice of proposed deficiency or the date of the notice of deficiency.

Effective Date

The provision is effective for notices made and proceedings commenced after the date of enactment.

2. Interim Notice Requirement (sec. 5702 of the bill and sec. 7430 of the Code)

Present Law

A taxpayer that successfully challenges a determination of deficiency by the IRS may recover attorneys' fees and other administrative and litigation costs if the taxpayer qualifies as a "prevailing party." A taxpayer qualifies as a prevailing party if it (i) establishes that the position of the United States was not substantially justified; (ii) substantially prevails with respect to the amount in

controversy or with respect to the most significant issue or set of issues presented; and (iii) meets certain net worth and (if the taxpayer is a business) size requirements.

Reasons for Change

The committee believes that taxpayers should receive assistance from the IRS in determining whether the position of the IRS was substantially justified.

Explanation of Provision

Once a taxpayer has substantially prevailed, the IRS must provide to the taxpayer all information and copies of relevant records in the possession of the IRS with respect to the taxpayer's case and the substantial justification for the position taken by the IRS. Disclosure under this provision is subject to the confidentiality restrictions of section 6103.

Effective Date

The provision is effective for notices made and proceedings commenced after the date of enactment.

3. Increased Limit on Attorney Fees (sec. 5703 of the bill and sec. 7430 of the Code)

Present Law

Attorneys' fees recoverable by prevailing parties as litigation or administrative costs are limited to a maximum of $75 per hour.

Reasons for Change

The committee believes that these amounts should be indexed for inflation.

Explanation of Provision

The maximum recoverable rate for attorneys' fees is indexed for inflation occurring since 1981.

Effective Date

The provision applies to notices made and proceedings commenced after the date of enactment.

4. Failure To Agree To Extension Not Taken Into Account (sec. 5704 of the bill and sec. 7430 of the Code)

Present Law

To qualify for an award of attorney's fees, the taxpayer must have exhausted the administrative remedies available within the IRS.

Reasons for Change

The IRS has taken the position in regulations that attorney's fees cannot be awarded if the taxpayer has not agreed to extend

the statute of limitations. In *Minahan v. Commissioner*, 88 T.C. 492 (1987), the Tax Court held that regulation invalid insofar as it provides that a taxpayer's refusal to consent to extend the statute of limitations is to be taken into account in determining whether the taxpayer has exhausted administrative remedies available to the taxpayer.

Explanation of Provision

The bill provides that any failure to agree to an extension of the statute of limitations cannot be taken into account for purposes of determining whether a taxpayer has exhausted the administrative remedies for purposes of determining eligibility for an award of attorney's fees.

Effective Date

The provision applies to proceedings commenced after the date of enactment.

Subtitle I—Other Provisions

1. Required Content Of Certain Notices (sec. 5801 of the bill and sec. 7522 of the Code)

Present Law

The Code requires the IRS to describe the basis for and identify the amounts of tax due, interest, penalties, and any other additional amounts owed in the notice of deficiency sent to taxpayers.

Reasons for Change

The IRS is currently not required to set forth separately in its deficiency notices the components of and explanation for each adjustment. As a result, taxpayers frequently have difficulty understanding what portion of the total adjustment is attributable to any particular tax issue. This confusion leads to additional correspondence with the IRS, delay in taxpayers complying with the tax law, and additional interest being charged to taxpayers.

Explanation of Provision

The bill requires that the IRS set forth the components of and explanation for each specific adjustment that is the basis for the total tax deficiency. An inadequate description does not invalidate the notice.

Effective Date

The provision applies to notices sent after the date six months after the date of enactment.

2. Relief from Retroactive Application of Treasury Department Regulations (sec. 5802 of the bill and sec. 7805 of the Code)

Present Law

Treasury may prescribe the extent (if any) to which regulations shall be applied without retroactive effect.

Reasons for Change

The committee believes that it is inappropriate for Treasury to issue retroactive regulations.

Explanation of Provision

Temporary and proposed regulations are required to have an effective date no earlier than the date of publication in the Federal Register. This provision may be superseded by a specific legislative grant authorizing the Treasury to prescribe the effective date with respect to a statutory provision. In addition, the Treasury may provide that taxpayers may elect to apply a temporary or proposed regulation retroactively from the date of publication of the regulation. Final regulations may take effect from the date of publication of the temporary or proposed regulation to which they relate.

Effective Date

The provision applies with respect to any temporary or proposed regulation published on or after February 20, 1992, and any temporary or proposed regulation published before February 20, 1992, and published as a final regulation after that date.

3. Required Notice to Taxpayers of Certain Payments (sec. 5803 of the bill)

Present Law

If the IRS receives a payment without sufficient information to properly credit it to a taxpayer's account, the IRS may attempt to contact the taxpayer. If contact cannot be made, the IRS places the payment in an unidentified remittance file.

Reasons for Change

If the IRS cannot associate a taxpayer's payment with a balance due, the IRS generally deposits the money and may not inform the taxpayer of the overpayment. For example, a check that is separated from a balance-due income tax return, which is subsequently lost, may not get credited to that taxpayer's account.

Explanation of Provision

The bill requires the IRS to make reasonable efforts to notify, within 60 days, those taxpayers who have made payments which the IRS cannot associate with any outstanding tax liability.

Effective Date

The provision is effective on the date of enactment.

4. Unauthorized Enticement of Information Disclosure (sec. 5804 of the bill and new sec. 7217 of the Code)

Present Law

There is no criminal penalty for enticing a tax professional to disclose information about clients in exchange for forgiving the taxes of the professional.

Reasons for Change

The committee believes that enticement of this nature is inappropriate.

Explanation of Provision

The bill provides that a Government employee who defers or offers to defer (or forgives or offers to forgive) the determination or collection of any tax due to a tax professional in exchange for information concerning the professional's clients shall (upon conviction) be guilty of a felony.

Effective Date

The provision applies to actions taken after the date of enactment.

III. BUDGET EFFECTS OF THE BILL

In compliance with paragraph 11(a) of Rule XXVI of the Standing Rules of the Senate, the following statement is made relative to the estimated budget effects of H.R. 4210, as amended and reported by the committee.

The following table shows the estimated budget effects of H.R. 4210 as amended for fiscal years 1992–1996.

Estimated Budget Effects of Senate Finance Committee Amendment to H.R. 4210

Fiscal Years 1992–1996

[Billions of dollars]

Item	Effective	1992	1993	1994	1995	1996	1992–96
Provide Fair Treatment of Working Families:							
1. Provide $300 tax credit for dependents under 16 years; phased out for AGI between $50,000–$70,000.	1/1/92	−0.8	−8.2	−7.6	−7.5	−7.2	−31.4
2. Earned income tax credit (EITC): (1)							
a. Repeal young child credit	1/1/92	(2)	0.3	0.3	0.3	0.3	1.1
b. EITC expansion and simplification	1/1/92	(3)	−0.5	−0.5	−0.5	−0.5	−2.1
3. Extend targeted jobs tax credit (18 months)	7/1/92	(3)	−0.1	−0.2	−0.1	(3)	−0.5
Promote Long-Term Economic Growth Through:							
1. Increased savings—Restoration of the fully-deductible IRAs and creation of Special IRAs.	(4)	(3)	1.9	−1.1	−1.9	−3.9	−5.0
2 Improved educational opportunities:							
a. Self-reliance loans (5)		(3)	−0.1	−0.1	−0.1	−0.1	−0.2
b. Permit deduction/credit for student loan interest.	1/1/92	(3)	−0.1	−0.2	−0.2	−0.2	−0.7
c. Youth training program (LEAP)	2/1/92	(3)	(3)	(3)	−0.1	−0.1	−0.2
d. Penalty-free withdrawals for education (includes interaction with withdrawals for first-time homebuyers.	1/1/92	−0.1	−0.1	−0.1	−0.1	−0.1	−0.6
e. Extend employer-provided educational assistance (18 months).	7/1/92	−0.1	−0.2	−0.2			−0.5
f. Expand exclusion for education savings bonds.	1/1/92	(3)	(3)	(3)	(3)	(3)	(2)

g. Extend access to tax information by the Department of Veterans Affairs (9/30/98) (5).		....	(2)	0.1	0.1	0.1	0.2
3. Better access to affordable health care:							
a. Extend 100% deduction for health insurance premiums of self-employed (25% in 1992; 100% in 1993 and 1994).	7/1/92	−0.1	−0.6	−1.7	−1.2	....	−3.6
b. Adopt small-employer health insurance market reforms; eliminate loss of health insurance resulting from pre-existing condition exclusions.	(6)	....	(7)	(7)	(7)	(7)	(7)
c. Medicare prevention benefits (5)	1/1/93	....	−0.1	−0.1	−0.1	−0.1	−0.3
d. Penalty-free IRA withdrawals for serious medical expenses.	1/1/92	(3)	(3)	(3)	(3)	(3)	(2)
e. Increase excise tax on ozone-depleting (8)	7/1/92	(2)	(2)	0.4	0.6	0.3	1.4
f. Extend orphan drug tax credit (18 months)......	7/1/92	(3)	(3)	(3)	....	....	(2)
4. Investment in real estate:							
a. Penalty-fee withdrawals for first-home purchase (9).	1/1/92	−0.2	−0.4	−0.4	−0.3	−0.2	−1.7
b. UBIT changes to promote increased pension investment in real estate (9).	1/1/92	−0.1	−0.1	−0.1	−0.1	−0.1	−0.4
c. $5,000 credit for first-home purchase (through 12/31/93, new homes only) (9).	2/1/92	−0.1	−0.7	−0.6	−0.1	(3)	−1.5
d. Allow passive losses for active real estate developers (existing properties) (9).	1/1/92	−0.1	−0.4	−0.4	−0.4	−0.5	−1.9
e. Extend depreciation period for nonresidential real estate from 31.5 to 40 years.	2/12/92	(2)	0.1	0.3	0.6	0.9	1.9
f. Extend and modify low-income housing tax credit (18 months).	7/1/92	(3)	−0.1	−0.2	−0.3	−0.3	−0.9
g. Extend mortgage revenue bonds and mortgage credit certificates (18 months).	7/1/92	(3)	(3)	−0.1	−0.1	−0.1	−0.3

Estimated Budget Effects of Senate Finance Committee Amendment to H.R. 4210—Continued

Fiscal Years 1992–1996

[Billions of dollars]

Item	Effective	1992	1993	1994	1995	1996	1992–96
5. Other incentives to promote long-term investment and improve competitiveness:							
a. 10% investment tax allowance (through 12/31/92 (9).	2/1/92	−4.3	−2.4	1.8	1.3	0.9	−2.7
b. Alternative minimum tax relief:							
(1) Gifts of appreciated property to charitable organizations (18 months).	7/1/92	(3)	(3)	−0.1	(2)	(3)	−0.1
(2) Modify treatment of IDCs in minimum tax.	tyba 12/31/91	−0.1	−0.2	−0.2	−0.1	−0.1	−0.8
(3) Repeal ACE depreciation adjustment (9)..	2/1/92	−0.2	−0.3	−0.3	−0.3	−0.2	−1.4
c. Extend research and experimentation tax credit (18 months).	7/1/92	−0.2	−0.8	−0.5	−0.1	−0.1	−1.7
d. Progressive capital gains relief; 2-year holding period; depreciation recapture at 31%; and 50% exclusion for gains from venture capital investments (9).	2/1/92	−0.1	−1.3	−3.2	−2.1	−0.9	−7.7
e. Extend small-issue bonds (18 months)...............	7192	(3)	(3)	−0.1	−0.1	−0.1	−0.3
f. Extend business energy credits (solar and geothermal) (18 months).	7/1/92	(3)	(3)	(3)	(3)	(3)	−0.1
g. Modify import category for certain vehicles (5).	4/1/92	0.1	0.2	0.2	0.2	0.2	1.0

h. Cap deduction for regular tax and AMT purposes for executive compensation at $1 million.	1/1/92	0.1	0.3	0.4	0.4	0.4	1.5
i. Expand exclusion for transit passes to $60 per month; extend exclusion to vanpooling and park-and-ride benefits; limit exclusion for employer-provided parking to $160 per month.	(10)	(2)	(2)	(2)	(3)	(3)	(2)
j. Repeal luxury tax on boats, airplanes, jewelry, and furs; index threshold for automobiles; and impose diesel excise tax on motor boats.	(11)	(3)	(3)	−0.1	−0.1	−0.1	−0.3
k. Extension of other expiring provisions (12)		....	....	....	....	....	....
6. Simplification of the Internal Revenue Code		0.4	−0.1	−0.6	−0.6	0.3	−0.6
7. Taxpayer Bill of Rights	(13)	(3)	−0.1	−0.1	−0.1	−0.1	−0.3
Subtotals		−6.1	−14.4	−15.3	−13.2	−11.6	−60.5
CBO Revenue Surplus		3.0	....	....	....	....	3.5
Totals: Fairness and Long-Term Economic Growth.		−3.1	−14.4	−15.3	−13.2	−11.6	−57.0
Proposals to Ensure High-Income Taxpayers Pay Their Fair Share:							
1. Add fourth individual rate bracket of 36% beginning at taxable income of $150,000 (single), $175,000 (joint), and $162,500 (head of household).	tyba 12/31/91	3.4	10.2	9.5	10.0	9.9	43.0
2. Impose 10% surtax on tax attributable to taxable income in excess of $1 million.	tyba 12/31/91	0.6	1.9	1.9	2.0	2.1	8.5
3. Extend permanently the personal exemption phaseout and the itemized deduction limitation.	tyba 12/31/95	....	....	....	....	3.7	3.7
4. Conform book and tax accounting for securities inventories.	tyeo/a 12/31/93	....	0.1	0.4	0.5	0.5	1.5

Estimated Budget Effects of Senate Finance Committee Amendment to H.R. 4210—Continued

Fiscal Years 1992–1996

[Billions of dollars]

Item	Effective	1992	1993	1994	1995	1996	1992–96
5. Make corporate and individual estimated tax changes permanent.		....	....	....	....	....	....
6. Extend 45-day processing rule to all taxes and refunds.[5]	7/1/92	....	0.1	0.1	0.1	0.1	0.2
Subtotals		**4.1**	**12.3**	**11.8**	**12.6**	**16.3**	**57.0**
Action Taken in Committee:							
1. Health insurance for coalminers:							
a. Net revenue from labor and coal import taxes.	4/1/92	0.1	0.2	0.2	0.2	0.2	0.9
b. Net outlays (health benefits less mandatory contributions).	4/1/92	(3)	−0.2	−0.2	−0.2	−0.2	−0.9
2. Credit equal to FICA paid on cash tips	4/1/92	−0.1	−0.3	−0.3	−0.3	−0.3	−1.5
3. Deny deductibility for club dues	4/1/92	0.1	0.3	0.3	0.3	0.3	1.5
Grand Totals		**1.1**	**−2.1**	**−3.6**	**−0.6**	**4.7**	**0.0**

[1] Changes to the earned income credit will increase outlays by less than $50 million in FY 1992, and by approximately $0.2 billion in FY 1993 and in each fiscal year thereafter.

[2] Gain of less than $50 million.

[3] Loss of less than $50 million.

[4] Generally effective 1/1/93; provision for transfer to special IRAs effective 1/1/92.

[5] Estimate for this provision provided by the Congressional Budget Office (CBO).

[6] Effective dates: Small market reform = plans offered, issued, or renewed on or after 1/1/94; pre-existing conditions = plan years beginning after 12/31/92.

[7] Gain or loss of less than $50 million.

[8] Tax is $1.85 in 1992 (effective 7/1/92), $2.75 in 1993, $3.65 in 1994, $4.55 in 1995, and (as scheduled under present law) increased by $0.45 per year thereafter.

[9] A similar or related proposal was included in the President's 7-point plan.

[10] Effective dates: Transit passes = 1/1/92; Parking cap = DoE.

[11] Net of income tax offsets. Effective dates: Luxury tax = 1/1/92; Diesel tax = 7/1/92.

[12] Other expiring provisions to be extended: excise tax on certain vaccines for the Vaccine Injury Compensation Fund for two years and Railroad Retirement Tier II transfers. (NOTE: Extension of the vaccine excise taxes is assumed in the CBO baseline; therefore, an extension of the Vaccine Injury Compensation Fund has no revenue effect.)

[13] Effective dates: For sections 201, 204, 501, 703, 704, 802, 803, and 902 = date of enactment; for sections 202 and 401 = six months after the date of enactment; for sections 303, 502, and 905 = taxable years beginning after 12/31/92.

Note: Details may not add to totals due to rounding. Legend for Effective column: DoE = Date of enactment, tyba = taxable years beginning after, tyeo/a = taxable years ending on or after.

Source: Joint Committee on Taxation, March 6, 1992.

IV. REGULATORY IMPACT AND OTHER MATTERS TO BE DISCUSSED UNDER SENATE RULES

A. Regulatory Impact

Pursuant to paragraph 11(b) of Rule XXVI of the Standing Rules of the Senate, the committee makes the following statement concerning the regulatory impact that might be incurred in carrying out the bill (H.R. 4210) as reported.

Impact on Individuals and Businesses

Title I of the bill provides tax relief for working families with a tax credit for children under age 16, an expansion and simplification of the earned income tax credit, and an extension of the targeted jobs tax credit.

Title II of the bill provides various incentives to promote savings, educational opportunities, and better access to health care. Title II also provides other incentives for long-term economic growth, including real estate investment, business investment tax allowance for 1992, capital gains progressive tax rates and exclusion for gains from venture capital investments, repeal of the luxury excise tax on boats, airplanes, jewelry and furs, and temporary extensions of the research tax credit and other expiring tax provisions.

Title III of the bill includes revenue increases from higher income taxpayers to pay for the family tax relief and economic growth incentives included in the bill. The committee bill provides a fourth individual income tax bracket of 36 percent, a 10-percent surtax on taxable income in excess of $1 million, and an extension of the personal exemption phaseout and itemized deduction limitation for higher-income taxpayers. Title III also conforms book and tax accounting rules for securities inventories, and makes corporate and individual estimated tax changes. Further, Title III extends the 45-day interest rule on income tax refunds to all taxes and refunds.

Title IV of the bill provides needed simplification of various pension and other tax code provisions. This should improve taxpayer compliance.

Title V includes various improvements to the Taxpayer Bill of Rights.

Impact on Personal Privacy

The provisions of Title V (Taxpayer Bill of Rights) includes administrative changes to improve taxpayer rights and relationships with the IRS in the audit, enforcement, and collection process.

Impact on Paperwork

The bill will reduce paperwork for certain taxpayers by simplifying numerous Code provisions, including simplification of the

earned income tax credit and various income, excise, and estate and gift tax provisions. The bill modifies various business tax provisions to provide incentives for certain business investments, which may involve new calculations and information for tax returns.

B. Other Matters

Vote of the Committee

In compliance with paragraph 7(c) of Rule XXVI of the Standing Rules of the Senate, the following statement is made with respect to the vote of the committee on the motion to report the bill. The bill (H.R. 4210), as amended by the committee substitute, was ordered favorably reported by a roll call vote of 11 ayes and 9 noes.

Tax Expenditures

In compliance with section 308(a)(2) of the Budget Act, the committee states that the income tax provisions of the bill with revenue decreases involve increases in tax expenditures and that the income tax provisions with revenue increases (other than rate increases and the personal exemption phaseout) involve decreases in tax expenditures. (See revenue table in Part III.) Revenue changes from excise, employment, and estate and gift tax provisions are not currently classified as tax expenditures under the Budget Act.

Congressional Budget Office Estimates

In accordance with Section 403 of the Budget Act, the committee advises that the Congressional Budget Office has reviewed the committee budget estimates and agrees with the estimates as presented in Part III. The Congressional Budget Office submitted the following cost estimate with respect to the bill as reported.

U.S. CONGRESS,
CONGRESSIONAL BUDGET OFFICE,
Washington, DC, March 6, 1992.

Hon. LLOYD BENTSEN,
Chairman, Committee on Finance,
U.S. Senate, Washington, DC.

DEAR MR. CHAIRMAN: The Congressional Budget Office has reviewed the Senate amendment to H.R. 4210, the Family Tax Fairness, Economic Growth, and Health Care Access Act of 1992, as ordered reported by the Senate Committee on Finance on March 3, 1992. CBO concurs with the estimates of revenue provisions provided by the Joint Committee on Taxation (JCT) on March 6, 1992. CBO estimated the mandatory outlay effects of following provisions; create self-reliance loans, expand the exclusion for education savings bonds, extend access to tax information by the Department of Veterans' Affairs, modify Medicare benefits, provide health insurance benefits to retired coal miners, and extend the 45-day processing rules to all taxes and refunds. The details of the CBO estimates including the basis of the estimates are enclosed. CBO and JCT estimate that enactment of the bill would increase the deficit by $1.8 billion in fiscal year 1992 and by $3.3 billion over the 1992–1996 period. The budget effects of the bill are shown below.

BUDGET EFFECTS

[By fiscal year, in millions of dollars]

	1992	1993	1994	1995	1996
Estimated mandatory outlays	128	506	528	553	581
Net revenues	−1,700	−1,500	−3,100	−0	5,300
Net deficit effect	1,828	2,006	3,628	553	−4,719

The bill would affect direct spending and receipts and thus would be subject to pay-as-you-go considerations under section 252 of the Balanced Budget and Emergency Deficit Control Act of 1985. All of the revenue provisions of the bill would be scored for pay-as-you-go purposes, but only the mandatory outlays would be scored. The pay-as-you-go impact is summarized below.

PAY-AS-YOU-GO CONSIDERATIONS

[By fiscal year, in millions of dollars]

	1992	1993	1994	1995
Change in outlays	128	506	528	553
Change in receipts	−1,700	−1,500	−3,100	−0

If you wish further details, please feel free to contact me or your staff may wish to contact John Stell at 226-2720, or Chuck Seagrave at 226-2820.

Sincerely,

JAMES L. BLUM
(For Robert D. Reischauer, Director).

Enclosures.

SECTION 2101-2102: INCOME DEPENDENT EDUCATION ASSISTANCE

Estimated cost to the Federal Government:

[By fiscal year, in millions of dollars]

	1993	1994	1995	1996
Estimated budget authority	40	50	50	55
Estimated outlays	30	45	50	55

The costs of these sections would fall within function 500

Basis of estimate: The Income Dependent Education Assistance (IDEA) provision would create a direct student loan program in which borrowers' repayments would be tied to their future incomes. Repayments would be collected by the Internal Revenue Service as part of the borrowers' income taxes. Borrowers would make payments on their loans of 3, 5, or 7 percent of their adjusted gross income, depending on the level of their indebtedness. The IDEA program would be a supplement to all current federal student loan programs. Students would be eligible to receive loans under the IDEA program without regard to financial need. For

each fiscal year 1994 through 1997, this provision specifies the maximum amount of borrowing that would be allowed under the IDEA program. Borrowing could not exceed $450 million, $550 million, $650 million, and $900 million, respectively, in fiscal years 1994, 1995, 1996, and 1997. CBO has estimated that loans under this program would have an average subsidy rate of 5 percent. Therefore, supplying loans under the IDEA program would increase federal outlays by about $15 million in fiscal year 1994 and $40 million by fiscal year 1997. In addition, mandatory administrative expenses to be specified in the final legislative language would increase federal outlays by about $30 million in both fiscal year 1993 and fiscal year 1994, and $25 million in each fiscal year through 1997. These estimates assume that changes that were discussed with staff members are included in the final legislative language.

SECTION 2122: EDUCATION SAVINGS BONDS

Estimated cost to the Federal Government:

[By fiscal year, in millions of dollars]

	1992	1993	1994	1995	1996
Estimated budget authority	([1])	−1	−1	−1	−2
Estimated outlays	([1])	−1	−1	−1	−2

[1] Less than $500 thousand.

The savings would occur in function 900 (net interest).

Basis of estimate: This section would expand eligibility for the exclusion of interest from U.S. savings bonds redeemed to any higher education expenses. This exclusion was first permitted under a 1988 tax act. Currently, only taxpayers who redeem the bonds to pay their own, a spouse's, or a dependent's tuition are eligible. The bill would make it possible for other taxpayers to use the exclusion as well. It would also make the exclusion available to taxpayers at any adjusted gross income (AGI) level; currently, the exclusion is phased out for individual taxpayers with AGI over $40,000 (or joint filers with AGI over $60,000).

The provision would lead to small outlay savings. Savings bonds carry interest rates slightly lower than rates on regular, marketable Treasury securities; so that greater demand for such bonds would reduce interest costs modestly. (The provision also would involve a revenue loss of $1 million to $3 million annually for the next six years, as estimated by the Joint Committee on Taxation.)

The Joint Committee on Taxation estimates that the provision would spur additional sales of savings bonds of about $40 million to $60 million a year. These additional sales would take place at an interest rate slightly lower than that on marketable securities (about 6 percent, versus 6.8 percent, in CBO's baseline), generating small interest savings.

SECTION 2124: DISCLOSURES OF INFORMATION FOR VETERANS BENEFITS

Estimated cost to the Federal Government:

[By fiscal years, in millions of dollars]

	1993	1994	1995	1996
VA benefit savings				
Budget authority	−51	−66	−82	−98
Outlays	−47	−70	−82	−90
Adminjistrative costs				
Budget authority	20	15	10	10
Outlays	20	15	10	10
Net budgetary impact				
Budget authority	−31	−51	−72	−88
Outlays	−27	−55	−72	−80

Basis of estimate: This estimate is based on data from two General Accounting Office (GAO) reports, "Veterans' Pensions: Verifying Income with Tax Data Can Identify Significant Payment Problems" (GAO/HRD-88-24, March, 1988) and "Improving the Integrity of VA's Unemployability Compensation Program" (GAO/HRD-87-62, September, 1987). The GAO estimate that approximately $160 million was overpaid in compensation and pension benefits in 1984 that could have been identified through a match of income reports to the IRS from employers, financial institutions, and other organizations.

CBO assumes that the first match of income reports, currently underway, will result in approximately $200 million in savings in each year. The initial match should enable VA to identify current pensioners whose benefits are based on erroneously reported income and to correct their benefit levels or remove them from the rolls. Should pensioners whose benefits were eliminated by this match reapply for pension after the sunset date has passed, VA has authority to require any additional documentation necessary to verify their income. Therefore, the savings from the initial match are assumed to continue regardless of whether future matches are performed or not. The savings attributable to future matches, shown in the table above, results from the correction of new cases of erroneously reported income.

SECTIONS 2261 THROUGH 2265

Estimated cost to the Federal Government:

[By fiscal years, in millions of dollars]

	1993	1994	1995	1996
Medicare prevention benefits:				
Medicare coverage of influenza immunization:				
Estimated budget authority	80	90	100	110
Estimated outlays	80	90	100	110
Medicare coverage of tetanus-diphtheria booster:				
Estimated budget authority	4	6	6	7
Estimated outlays	3	5	6	6

[By fiscal years, in millions of dollars]

	1993	1994	1995	1996
Medicare coverage of well-child care:				
Estimated budget authority	1	1	1	2
Estimated outlays	1	1	1	2
Add-on Medicare premium:				
Estimated budget authority	−30	−40	−40	−45
Estimated outlays	−30	−40	−40	−45
Medicaid costs:				
Estimated budget authority	2	3	3	3
Estimated outlays	2	3	3	3
Total Medicare prevention benefits:				
Estimated budget authority	57	60	71	77
Estimated outlays	56	60	71	77

Basis of estimate: This bill contains several preventive benefits for Medicare enrollees. The preventive services that would be added include influenza immunizations, tetanus-diphtheria booster shots, and well-child care for End-Stage Renal Disease (ESRD) children. Under current law, Medicare will not pay for these preventive services. In addition, the bill includes a add-on to the Supplementary Medicare insurance (SMI) monthly premium to partially finance the costs of these benefits. These provisions would be subject to pay-as-you go requirements of the Budget Enforcement Act of 1990.

Coverage of Certain Immunizations.—Section 2261 would provide for coverage of annual influenza vaccinations for Medicare enrollees. Costs to the federal government are projected to be $80 million in fiscal year 1993 and would increase to $110 million by fiscal year 1996. The estimate assumes that half of the Medicare population would participate the first year the benefit was offered. This participation assumption would increase to 60 percent by the end of the projection period. The price of the vaccine was estimated using recent price data from the Medicare influenza immunization demonstration project. Because the immunization would prevent more serious illness in some beneficiaries, savings from reduced hospital and ambulatory care are included in this estimate. This benefit would have an effective date of October 1, 1992.

The bill would provide for tetanus-diphtheria booster shots every ten years for Medicare beneficiaries as a preventive benefit. Current utilization for this booster shot is about five percent for people over 65. The estimate assumes that ten percent of the Medicare population would participate when this benefit is offered. The current Medicare price for the tetanus-diphtheria booster was used for the estimate. (Medicare currently will pay for this booster when medically necessary.) The estimated federal costs for this benefit are $3 million in fiscal year 1993 and $20 million over the four-year projection period.

Well-Child Care.—Section 2262 would provide for the coverage of well-child care for the approximately 350 children on the Medicare program. These children are entitled to Medicare through the ESRD program. Well-child services would include routine office visits, routine immunizations, routine laboratory tests, and preventive dental care for these children up to age seven. Costs were esti-

mated by using the Medicaid per capita costs for infants and children and adjusting these rates to reflect Medicare fee schedules. This provision is estimated to cost $1 million in fiscal year 1993 and $5 million over the four-year projection period.

Financing of Additional Benefits.— As partial financing of the pay-as-you-go provisions, section 2265 would increase the SMI monthly premium by $0.10 in each year 1993 to 1997. Table 1 shows the revised monthly premium that would be charged to Medicare beneficiaries upon enactment of this bill. The premium receipts from this proposal would be $30 million in fiscal year 1993 and would increase to $45 million by fiscal year 1996.

TABLE 1.—PREMIUM SUMMARY

[By calendar year, in dollars]

	1993	1994	1995	1996
Add-On premium	0.10	0.10	0.10	0.10
Current law premium	36.60	41.10	46.10	47.80
Total monthly premium	36.70	41.20	46.20	47.90

The Medicaid costs shown in the Estimated Costs to the Federal Government table reflects the federal share of the increased premium associated with this bill. The Medicaid program pays SMI premium for approximately 15 percent of Medicare beneficiaries. The Medicaid program is funded jointly from federal, state, and local sources; the federal share of the program is approximately 57 percent.

SECTION 2281

Estimated cost to the Federal Government:

[By fiscal years, in millions of dollars]

	1992	1993	1994	1995	1996
Outlays: Retire health benefits for coal miners	106	274	298	323	349
Receipts:					
Per beneficiary premiums	35	89	97	105	114
Gross labor tax import [1]	77	186	203	230	253
Indirect tax effects [1]	−4	−14	−19	−24	−28
Payment from pension fund	50	0	0	0	0
Subtotal receipts	158	261	281	311	339
Net effect on the deficit (outlays—receipts)	−52	13	17	12	10

[1] Estimated by the Joint Committee on Taxation.

Basis of estimate: CBO does not have final or draft language for this provision. Therefore, the estimates below are based on discussions with committee staff. The estimates could change if the language is substantially different from the information provided by the staff.

Section 2281 would revise the manner in which the provision of health care to retirees in the coal industry is funded and maintained. Currently, two retiree health benefit funds for coal industry

employees exist. The 1950 Benefit Trust Fund provides benefits to those who retired prior to 1976 while the 1974 Benefit Trust Fund provides benefits to those who have retired since 1976. These funds are financed by contributions from the companies that are signatories to the National Bituminous Coal Wage Agreements.

This bill would replace the 1950 and 1974 Benefit funds with two new funds. The first would be a government entity called the Coal Retiree Health Benefit Corporation (the Corporation) and would provide benefits to orphans. Orphans are those beneficiaries whose companies have gone out of business or ceased contributing to the 1950 or 1974 Benefit funds when they were no longer signatories to the coal wage agreements. The second new fund would be an employee welfare benefit plan within the meaning of section 3(l) of the Employee Retirement Income Security Act of 1974 called the United Mine Workers of America 1991 Benefit Fund. The 1991 Fund would provide retiree health benefits to retirees whose companies are still in business and signatories to the coal wage agreements.

The benefits paid by the two new funds would be financed by three different taxes. The first is a tax on labor employed by domestic coal producers. Producers of lignite and sub-bituminous coal would be exempt from this tax. The tax rate on labor are $1.99 per hour in fiscal year 1992, $1.09 per hour in 1993, $1.20 per hour in 1994, $1.32 per hour in 1995, and $1.45 per hour in 1996 as estimated by the Joint Committee on Taxation. The second is a tax on imported coal that would be set equivalent to the tax on labor employed by domestic coal producers. The third is a per beneficiary premium to cover medical costs. Employers that are current signatories to the coal wage agreements would be required to pay this premium for each of their eligible retired employees. In addition, the companies that were formerly signatories to the coal wage agreements and that as of January 1, 1992, were engaged in the production, sale, distribution, transfer, or use of bituminous or sub-bituminous coal would be required to pay this premium for each eligible retired employee. The bill specifies that the premium would be calculated by dividing the total benefit costs including administrative expenses by the number of eligible retirees for each employer.

CBO estimates that the amount paid from both the Corporation and the 1991 Benefit Fund including administrative expenses would be $108 million in fiscal year 1992 and would grow to $349 million in fiscal year 1996. Based on information in the United Mine Workers of America Health and Retirement Funds 1991 Annual Report, CBO estimates an average benefit of approximately $2,000 in 1992 growing to approximately $4,000 in 1996. These estimates include administrative expenses of roughly 10 percent of total benefits and assume health expenditures would grow at an annual rate of 15 percent. The average number of beneficiaries is estimated to be 118,000 declining to 95,000 in 1966. The estimates of beneficiaries were provided by the current administrators of the 1950 and 1974 Benefit Funds and are based on attrition experience from 1982 through 1991.

Based on information provided by the United Mine Workers association, approximately 30 percent of all current beneficiaries are

associated with employers who would be required to pay the premium. CBO estimates the beneficiary premiums collected would be $440 million over the five-year period.

In addition, this provision would require the transfer of $50 million to the Corporation from the 1950 Pension Fund. According to actuarial analysis, the 1950 Pension Fund is overfunded. Nevertheless if the analyst is incorrect and the Pension Fund should be unable to meet its future obligations, the Pension Benefit Guaranty Corporation would be liable for the remaining obligations. CBO in unable to determine if there is a surplus in the Pension Fund and if the obligations of the fund would become the responsibility of federal government.

SECTION 3108

Estimated cost to the Federal Government:

[By fiscal year, in millions of dollars]

	1992	1993	1994	1995	1996
Disallowance of interest on certain overpayments of tax:					
Estimated Budget Authority	0	−50	−50	−50	−50
Estimated Outlays	0	−50	−50	−50	−50

The costs of this section of the bill fall within budget function 900.

Basis of Estimate: This section of the bill: first, applies the 45-day interest-free processing window on original returns currently in effect for corporate and individual income taxes to other types of taxes (i.e., excise, estate, gift, and other small categories). Second, it allows the IRS a 45-day interest-free processing window for claims for credits or refunds, beginning from the date the claim is filed. Third, it allows the IRS a 45-day interest-free processing window for all credits or refunds arising from any adjustment initiated by the IRS (such as an audit) by subtracting 45 days from the period over which interest would otherwise be due the taxpayer.

The estimates were prepared using 1990 and 1991 IRS data on net tax refunds. The data revealed that applying the interest-free window to the minor tax categories accounted for relatively little savings. The bulk of the savings comes from allowing an interest-free window for refunds and credits arising from amended and audited returns, which account for most of the approximately $2 billion in interest per year. Nevertheless, the IRS now typically pays interest on these refunds for a period ranging from one to eight years, and 45 days will generally be a small fraction of this time period.

V. CHANGES IN EXISTING LAW MADE BY THE BILL

In the opinion of the committee, it is necessary in order to expedite the business of the Senate, to dispense with the requirements of paragraph 12 of Rule XXVI of the Standing Rules of the Senate (relating to the showing of changes in existing law made by the bill as reported by the committee).

VI. MINORITY VIEWS

U.S. SENATE,
COMMITTEE FINANCE,
Washington, DC, March 3, 1992.

Hon. LLOYD BENTSEN,
Chairman, Committee on Finance,
U.S. Senate, Washington, DC.

DEAR MR. CHAIRMAN: It is with the utmost respect for your leadership and vision that we are compelled to send you this letter. Although we may not always see eye-to-eye on every issue, we know you share our commitment to a strong and prosperous America. As a highly regarded member of the Senate and Chairman of the Committee on Finance, we are calling on you to put the good of our great country ahead of politics.

Throughout the country, people from all walks of life are counting on their elected officials to guide them through these tough economic times. Americans rightfully expect us to refrain from pursuing a short-sighted strategy to score points in the next election. Instead, they want us to shed partisan differences and work together to develop a bold long-term strategy to strengthen our economy and propel America into the next century.

Over the last six months, many economists have appeared before Congress and advised us to proceed with great care this year. They cautioned against a short-term fix which will be counterproductive over the long-term. There was a clear consensus that a significant tax increase at a time when the economy is struggling to get back on its feet will not stimulate economic growth and jobs creation.

Regretfully, the majority in the Senate—like the majority in the House—appear intent on advancing legislation that will significantly raise taxes while doing little to rebuild the competitive position of America. This approach will not stimulate investment in productive endeavors so that Americans can look forward to securing a good family wage, owning a home, raising a family, and enjoying a prosperous retirement.

Even the Chairman of the House Ways and Means Committee acknowledged that the House bill is essentially a political document, when he said last week: "I really don't want a bill if I can avoid doing it. But the political climate insists we have something." [The New York Times, February 24, 1992]

Clearly, as long as the bill contains significant tax increases, it will be vetoed by the President and the veto will be sustained. If the majority insists on following this course, we urge that it be done expeditiously. Vote the bill out of the Finance Committee today, waive the two-day layover rule, take the bill to Senate floor immediately for final passage, conference quickly with the House, and be done with it.

However, we sincerely hope this futile course will not be pursued. We urge the Committee to lay this bill aside, and begin working together immediately to draft a plan to reinvigorate our economy and provide a blueprint for our future.

This is no time for the Senate to succumb to political expediency. This bill is not a solution to the economic problems facing this country, and we all know it. We have the opportunity to rise above the fray and do something for the good of America. We should seize this opportunity now.

Sincerely,

BOB PACKWOOD.
BOB DOLE.
BILL ROTH.
JACK DANFORTH.
JOHN CHAFEE.
DAVID DURENBERGER.
CHUCK GRASSLEY.
STEVE SYMMS.
ORRIN HATCH.

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