

Calendar No. 438

104TH CONGRESS }
2d Session }

SENATE

{ REPORT
104-281

SMALL BUSINESS JOB PROTECTION ACT OF 1996

JUNE 18, 1996.—Ordered to be printed

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

REPORT

[To accompany H.R. 3448]

[Including cost estimate of the Congressional Budget Office]

The Committee on Finance, to which was referred the bill (H.R. 3448) to provide tax relief for small businesses, to protect jobs, to create opportunities, to increase the take home pay of workers, to amend the Portal-to-Portal Act of 1947 relating to the payment of wages to employees who use employer owned vehicles, and to amend the Fair Labor Standards Act of 1938 to increase the minimum wage rate and to prevent job loss by providing flexibility to employers in complying with minimum wage and overtime requirements under that Act, having considered the same, reports favorably thereon with an amendment and recommends that the bill as amended do pass.

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I. LEGISLATIVE BACKGROUND

H.R. 3448 (“Small Business Job Protection Act of 1996”) was passed by the House of Representatives on May 22, 1996. On May 23, the House combined H.R. 3448 (revenue provisions as Title I) with the minimum wage and other provisions (as Title II) from H.R. 1227 as passed by the House on May 23.

H.R. 3448 was referred to the Senate Committee on Finance on June 6, 1996. On June 12, 1996, the Senate Committee on Finance marked up a committee amendment as a substitute for the revenue provisions of H.R. 3448 (Title I) as passed by the House. The Committee on Finance approved the committee amendment by unanimous voice vote. The Committee on Finance did not consider Title II of the bill. References to “the bill” in the “Explanation of the Bill” (Part II of this report) are to the Title I revenue provisions.

Most of the provisions in the committee amendment to Title I of H.R. 3448 were previously approved in the Balanced Budget Act of 1995 (H.R. 2491) as passed by the Senate or in the conference agreement to H.R. 2491, which was vetoed by the President.

II. EXPLANATION OF THE BILL (TITLE I)

SMALL BUSINESS AND OTHER TAX PROVISIONS

A. SMALL BUSINESS PROVISIONS

1. Increase in expensing for small businesses (sec. 1111 of the bill and sec. 179 of the Code)

Present law

In lieu of depreciation, a taxpayer with a sufficiently small amount of annual investment may elect to deduct up to \$17,500 of the cost of qualifying property placed in service for the taxable year (sec. 179).¹ 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 \$17,500 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 section 179 expensing provides two important benefits for small businesses. First, it lowers the cost of capital for tangible property used in a trade or business. Second, it eliminates depreciation recordkeeping requirements with respect to expensed property. In order to increase the value of these bene-

¹The amount permitted to be expensed under Code section 179 is increased by up to an additional \$20,000 for certain property placed in service by a business located in an empowerment zone (sec. 1397A).

fits, the Committee would, after a phase-in period, increase the amount allowed to be expensed under section 179 to \$25,000.

The Committee also believes that horses should qualify as section 179 property. The Committee believes that horses are similar to other tangible personal property for which expensing is allowed and that any potential tax shelter abuses inherent in allowing the cost of a horse to be expensed are better addressed by the phase-out and taxable income limitations of section 179, the hobby loss rules of section 183, and the passive loss rules of section 469. Thus, the Committee bill does not adopt a technical correction that would deny section 179 expensing for horses.

Explanation of provision

The provision increases the \$17,500 amount of qualified property allowed to be expensed under Code section 179 to \$25,000. The increase is phased in as follows:

<i>Taxable year beginning in—</i>	<i>Maximum expensing</i>
1997	\$18,000
1998	18,500
1999	19,000
2000	20,000
2001	24,000
2002	24,000
2003 and thereafter	25,000

The bill clarifies the present-law provision that horses are qualified property for purposes of section 179.

Effective date

The provision increasing the amount allowed to be expensed under section 179 is effective for property placed in service in taxable years beginning after December 31, 1996, subject to the phase-in schedule set forth above.

2. Tax credit for Social Security taxes paid with respect to employee cash tips (sec. 1112 of the bill and sec. 45B of the Code)

Present law

Employee tip income is treated as employer-provided wages for purposes of the Federal Insurance Contributions Act (“FICA”). Employees are required to report to the employer the amount of tips received. The Omnibus Budget Reconciliation Act of 1993 (“OBRA 1993”) provided a business tax credit with respect to certain employer FICA taxes paid with respect to tips treated as paid by the employer. The credit applies to tips received from customers in connection with the provision of food or beverages for consumption on the premises of an establishment with respect to which the tipping of employees is customary. OBRA 1993 provided that the FICA tip credit is effective for taxes paid after December 31, 1993. Temporary Treasury regulations provide that the tax credit is available only with respect to tips reported by the employee. The temporary regulations also provide that the credit is effective for FICA taxes paid by an employer after December 31, 1993, with respect to tips received for services performed after December 31, 1993.

Reasons for change

The Committee believes it appropriate to clarify the effective date and scope of the credit for FICA taxes paid on employer cash tips. Despite the statutory language, there has been some confusion regarding the effective date. The FICA tip credit was included in the Senate version of H.R. 4210, the Tax Fairness and Economic Growth Act of 1992, and was included in the conference agreement of H.R. 4210 as passed by the 102d Congress and vetoed by President Bush. The effective date of that provision would have applied to “tips received and wages paid after the date of enactment.” The FICA tip credit was also included in the House and Senate versions of H.R. 11, the Revenue Act of 1992, as considered by the 102d Congress. The effective date of both those provisions was the same as in H.R. 4210, specifically tips received and wages paid after the date of enactment. The provision was included in the conference agreement of H.R. 11, as adopted by the Congress and vetoed by President Bush; however, the effective date of that provision was modified to apply to “taxes paid after” December 31, 1992, i.e., no limitation with respect to tips earned after December 31, 1992, was included.

In 1993, the House and Senate versions of the Omnibus Budget Reconciliation Act of 1993 (“OBRA 1993”) did not contain the FICA tip provision, but it was included in the conference agreement. The FICA tip provision as included in OBRA 1993 has the same effective date as the provision in the conference agreement for H.R. 11, except that the date was moved one year, to taxes paid after December 31, 1993. The Committee believes that the legislative history of this provision indicates intent to change the effective date, and that the Treasury’s interpretation of that date is not consistent with the provision as finally adopted.

The Committee also believes it appropriate to apply the credit to all persons who provide food and beverages, whether for consumption on or off the premises.

Explanation of provision

The provision clarifies the credit with respect to employer FICA taxes paid on tips by providing that the credit is (1) available whether or not the employee reported the tips on which the employer FICA taxes were paid pursuant to section 6053(a), and (2) effective with respect to taxes paid after December 31, 1993, regardless of when the services with respect to which the tips are received were performed.

The provision also modifies the credit so that it applies with respect to tips received from customers in connection with the delivery or serving of food or beverages, regardless of whether the food or beverages are for consumption on the premises of the establishment.

Effective date

The clarifications relating to the effective date and nonreported tips are effective as if included in OBRA 1993. The provision expanding the tip credit to the provision of food or beverages not for consumption on the premises of the establishment is effective with

respect to FICA taxes paid on tips received with respect to services performed after December 31, 1996.

3. *Treatment of dues paid to agricultural or horticultural organizations (sec. 1113 of the bill and sec. 512 of the Code)*

Present law

Tax-exempt organizations generally are subject to the unrelated business income tax (“UBIT”) on income derived from a trade or business regularly carried on that is not substantially related to the performance of the organization’s tax-exempt functions (secs. 511–514). Dues payments made to a membership organization generally are not subject to the UBIT. However, several courts have held that, with respect to postal labor organizations, dues payments were subject to the UBIT when received from individuals who were not postal workers, but who became “associate” members for the purpose of obtaining health insurance available to members of the organization. See *National League of Postmasters of the United States v. Commissioner*, No. 8032–93, T.C. Memo (May 11, 1995); *American Postal Workers Union, AFL-CIO v. United States*, 925 F.2d 480 (D.C. Cir. 1991); *National Association of Postal Supervisors v. United States*, 944 F.2d 859 (Fed. Cir. 1991).

In Rev. Proc. 95–21 (issued March 23, 1995), the IRS set forth its position regarding when associate member dues payments received by an organization described in section 501(c)(5) will be treated as subject to the UBIT. The IRS stated that dues payments from associate members will not be treated as subject to UBIT unless, for the relevant period, “the associate member category has been formed or availed of for the principal purpose of producing unrelated business income.” Thus, under Rev. Proc. 95–21, the focus of the inquiry is upon the organization’s purposes in forming the associate member category (and whether the purposes of that category of membership are substantially related to the organization’s exempt purposes other than through the production of income) rather than upon the motive of the individuals who join as associate members.

Reasons for change

In order to reduce uncertainty and legal disputes involving the UBIT treatment of certain associate member dues, the Committee believes that it is appropriate to provide a special rule exempting from the UBIT annual dues not exceeding \$100 paid to a tax-exempt agricultural or horticultural organization.

Explanation of provision

Under the provision, if an agricultural or horticultural organization described in section 501(c)(5) requires annual dues not exceeding \$100 to be paid in order to be a member of such organization, then in no event will any portion of such dues be subject to the UBIT by reason of any benefits or privileges to which members of such organization are entitled. For taxable years beginning after 1995, the \$100 amount will be indexed for inflation. The term “dues” is defined as “any payment (whether or not designated as

dues) which is required to be made in order to be recognized by the organization as a member of the organization.” Thus, if a person is recognized as a member of an organization by virtue of having paid annual dues for his or her membership, then any subsequent payments made by that person during the year to purchase another membership in the same organization will not be within the scope of the provision.

Effective date

The provision applies to taxable years beginning after December 31, 1994.²

4. *Clarify employment tax status of certain fishermen (sec. 1114 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 the Federal Insurance Contributions Act (“FICA”) and the Federal Unemployment Tax Act (“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. If a crew member receives any other cash, e.g., payment for services as an engineer, the exemption from FICA and FUTA taxes does not apply. Crew members to which the exemption applies are subject to self-employment taxes. Special reporting requirements apply to the operators of boats on which exempt crew members serve.

Reasons for change

The Committee believes that providing a statutory definition for determining whether the crew of a fishing boat normally consists of fewer than 10 individuals would make the provision easier to apply and administer. Providing that the exemption continues to apply even if an individual receives, in addition to a share of the catch, a small amount of cash for certain duties performed would recognize long-standing industry practice.

Explanation of provision

The operating crew of a boat is 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 fewer than 10 individuals. In addition, the exemption still applies even if the crew member receives certain cash payments. The cash payments cannot exceed \$100 per trip, must be contingent on a minimum catch, and must be paid solely for additional duties (e.g., as mate, engineer, or cook) for which additional cash remuneration is customary.

²The Committee intends that, with respect to dues payments received prior to the effective date of the provision, general UBIT rules under prior law will be applied in a manner consistent with the provision.

Effective date

The provision applies to remuneration paid after December 31, 1994. It is intended that, with respect to years before the effective date, the Secretary apply the exemption in a manner consistent with the proposal.

5. *Modify rules governing issuance of tax-exempt bonds for first-time farmers (sec. 1115 of the bill and sec. 147 of the Code)*

Present law

Interest on bonds issued by States and local governments to finance governmental activities carried out and paid for by those entities is exempt from the regular corporate and individual income taxes. Interest on bonds issued by the governments to provide financing to private persons is taxable unless an exception is provided in the Internal Revenue Code. One such exception allows States and local governments to issue bonds to finance loans to first-time farmers for the acquisition of farm land (and limited amounts of related depreciable farm property) if the purchasers will be the principal user of the property and will materially participate in the farming operation in which the property is to be used.

The amount of financing provided under this exception may not exceed \$1 million per farmer (and related parties). The \$1 million limit is increased to \$10 million if all capital expenditures by the purchaser in the same county (or incorporated municipality) within a prescribed six-year period are aggregated. Aggregate depreciable farm property financing for any purchaser may not exceed \$250,000, of which no more than \$62,500 may be for used property.

A first-time farmer is defined as an individual who has at no time owned farm land in excess of 15 percent of the median size of a farm in the county in which such land is located, and the fair market value of the land has not at any time when held by the individual exceeded \$125,000.

Under the general rules governing issuance of tax-exempt bonds, bonds for private persons generally may only be issued for acquisition or construction of property (i.e., may not be issued for working capital costs). Use of bond proceeds to finance purchases from related parties is precluded as a working capital financing.

Reasons for change

The Committee determined that minor modifications to the rules governing tax-exempt financing for first-time farmers are appropriate to enable easier utilization of this exception allowing private activity tax-exempt financing by persons desiring to enter that occupation, including entry by younger generations purchasing family farming operations.

Explanation of provision

The bill makes two modifications to the rules governing issuance of tax-exempt bonds for first-time farmers. First, the amount of farm land that an individual may own and still be considered a first-time farmer is doubled, from 15 percent of the median farm

size in the county where the land is located to 30 percent of the median farm size.

Second, proceeds of these tax-exempt bonds are permitted to be used to finance farm purchases by individuals from related parties (e.g., a parent or grandparent), provided that the price paid reflects the fair market value of the property and that the seller has no financial interest in the farming operation conducted on the land after the bond-financed sale occurs.

Effective date

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

6. *Clarify treatment of newspaper distributors and carriers as direct sellers (sec. 1116 of the bill and sec. 3508 of the Code)*

Present law

For Federal tax purposes, there are two classifications of workers: a worker is either an employee of the service recipient or an independent contractor. Significant tax consequences result from the classification of a worker as an employee or independent contractor. These differences relate to withholding and employment tax requirements, as well as the ability to exclude certain types of compensation from income or take tax deductions for certain expenses. Some of these consequences favor employee status, while others favor independent contractor status. For example, an employee may exclude from gross income employer-provided benefits such as pension, health, and group-term life insurance benefits. On the other hand, an independent contractor can establish his or her own pension plan and deduct contributions to the plan. An independent contractor also has greater ability to deduct work-related expenses.

Under present law, the determination of whether a worker is an employee or an independent contractor is generally made under a common-law facts and circumstances test that seeks to determine whether the service provider is subject to the control of the service recipient, not only as to the nature of the work performed, but the circumstances under which it is performed. Under a special safe harbor rule (sec. 530 of the Revenue Act of 1978), a service recipient may treat a worker as an independent contractor for employment tax purposes even though the worker is an employee under the common-law test if the service recipient has a reasonable basis for treating the worker as an independent contractor and certain other requirements are met.

In addition to the common-law test, there are also some persons who are treated by statute as either employees or independent contractors. For example, "direct sellers" are deemed to be independent contractors. A direct seller is a person engaged in the trade or business of selling consumer products in the home or otherwise than in a permanent retail establishment, if substantially all the remuneration for the performance of the services is directly related to sales or other output rather than to the number of hours worked, and the services performed by the person are performed pursuant to a written contract between such person and the service

recipient and such contract provides that the person will not be treated as an employee for Federal tax purposes.

The newspaper industry has generally taken the position that newspaper distributors and carriers should be treated as direct sellers for income and employment tax purposes. The Internal Revenue Service has generally taken the position that the direct seller rules do not apply to newspaper distributors and carriers operating under an agency distribution system (i.e., where the publisher retains title to the newspapers).

Reasons for change

The Committee recognizes that there are presently numerous disputes between newspaper distributors and carriers and the Internal Revenue Service regarding the treatment of newspaper distributors and carriers as direct sellers. The Committee believes that in the vast majority of these cases the newspaper distributors and carriers should properly be treated as direct sellers. Consequently, in order to avoid further disputes, the Committee wishes to clarify the treatment of qualifying newspaper distributors and carriers as direct sellers.

Explanation of provision

The bill clarifies the treatment of qualifying newspaper distributors and carriers as direct sellers. Under the bill, a person engaged in the trade or business of the delivery or distribution of newspapers or shopping news (including any services that are directly related to such trade or business such as solicitation of customers or collection of receipts) qualifies as a direct seller, provided substantially all the remuneration for the performance of the services is directly related to sales or other output rather than to the number of hours worked, and the services performed by the person are performed pursuant to a written contract between such person and the service recipient and such contract provides that the person will not be treated as an employee for Federal tax purposes. The bill is intended to apply to newspaper distributors and carriers whether or not they hire others to assist in the delivery of newspapers. The bill also applies to newspaper distributors and carriers operating under either a buy-sell distribution system (i.e., where the newspaper distributors or carriers purchase the newspapers from the publisher) or an agency distribution system. For example, newspaper distributors and carriers operating under an agency distribution system who are paid based on the number of papers delivered and have an appropriate written agreement qualify as direct sellers. The status of newspaper distributors and carriers who do not qualify as direct sellers under the bill continue to be determined under present-law rules. No inference is intended with respect to the employment status of newspaper distributors and carriers prior to the effective date of the bill. Further, the provision is intended to clarify the worker classification issue for income and employment taxes only. The Committee does not intend the provision to have any impact whatsoever on the interpretation or applicability of Federal, State, or local labor laws.

Effective date

The provision is effective with respect to services performed after December 31, 1995.

7. *Application of involuntary conversion rules to property damaged as a result of Presidentially declared disasters (sec. 1117 of the bill and sec. 1033(h) of the Code)*

Present law

A taxpayer may elect not to recognize gain with respect to property that is involuntarily converted if the taxpayer acquires within an applicable period property similar or related in service or use. If the taxpayer does not replace the converted property with property similar or related in service or use, then gain generally is recognized.

Reasons for change

The property damage in a Presidentially declared disaster may be so great that businesses are forced to suspend operations for a substantial time. During that hiatus, valuable markets and customers may be lost. If this suspension causes the business to fail, and the owners of the business wish to reinvest their capital in a new business venture, the involuntary conversion rules will force them to recognize gain when they buy replacement property that is needed for the new business but not similar to that used in the failed business. This provision will offer relief to such businesses by allowing them to reinvest their funds in any tangible business property without being forced to recognize gain. No such deferral of gain is available, however, if the taxpayer decides not to reinvest in tangible business property.

Explanation of provision

Any tangible property acquired and held for productive use in a business is treated as similar or related in service or use to property that (1) was held for investment or for productive use in a business and (2) was involuntarily converted as a result of a Presidentially declared disaster.

Effective date

The provision is effective for disasters for which a Presidential declaration is made after December 31, 1994, in taxable years ending after that date.

8. *Establish 15-year recovery period for retail motor fuels outlet stores (sec. 1118 of the bill and sec. 168 of the Code)*

Present law

Under present law, property used in the retail gasoline trade is depreciated under section 168 using a 15-year recovery period and the 150-percent declining balance method. Nonresidential real property (such as a grocery store) is depreciated using a 39-year recovery period and the straight-line method. It is understood that

taxpayers generally have taken the position that convenience stores and other buildings installed at retail motor fuels outlets have a 15-year recovery period. The Internal Revenue Service (“IRS”), in a position described in a recent Coordinated Issues Paper, generally limits the application of the 15-year recovery period to instances where the structure: (1) is 1,400 square feet or less or (2) meets a 50-percent test. The 50-percent test is met if: (1) 50 percent or more of the gross revenues that are generated from the building are derived from petroleum sales, and (2) 50 percent or more of the floor space in the building is devoted to petroleum marketing sales.

Reasons for changes

The Committee believes that the position taken by the IRS with respect to certain structures installed at motor fuel retail outlets is contrary to the historical treatment of such property. The Committee seeks to clarify (and restore) the treatment of such property.

Explanation of provision

The provision provides that 15-year property includes any section 1250 property (generally, depreciable real property) that is a retail motor fuels outlet (whether or not food or other convenience items are sold at the outlet). A retail motor fuels outlet does not include any facility related to petroleum or natural gas trunk pipelines or to any section 1250 property used only to an insubstantial extent in the retail marketing of petroleum or petroleum products. In addition, the provision provides a 20-year class life for retail motor fuels outlets for purposes of the alternative depreciation system of section 168(g).

The Committee wishes to clarify what types of property qualify as a retail motor fuels outlet. Section 1250 property will so qualify if it meets a 50-percent test. The 50-percent test is met if: (1) 50 percent or more of the gross revenues that are generated from the property are derived from petroleum sales, or (2) 50 percent or more of the floor space in the property is devoted to petroleum marketing sales. The Committee intends that the determination of whether either prong of this test is met will be made pursuant to the recent Coordinated Issue Paper. Property not meeting the test will not qualify as a retail motor fuels outlet. For property placed in service in taxable years that end after the date of enactment, the determination of whether the property meets the 50-percent test generally will be made in the year the property is placed in service. However, the test may be applied in the subsequent taxable year if the property is placed in service near the end of the taxable year and the use of the property during such short period is not representative of the subsequent use of the property. The Committee intends that, with respect to property placed in service in taxable years that ended before the date of enactment of the provision, the determination of whether the property meets the 50-percent test generally will be made in a manner consistent with the manner in which the 50-percent test of the Coordinated Issues Paper is applied (but by using the disjunctive test intended by the Committee rather than the conjunctive test of the Paper). The Committee also

intends that if property initially meets (or fails to meet) the disjunctive 50-percent test but subsequently fails to meet (or meets) such test for more than a temporary period, such failure (or qualification) may be treated as a change in the use of property to which section 168(i)(5) applies.

In addition, property the size of which is 1,400 square feet or less also will qualify if such property would have qualified under the current Coordinated Issues Paper.

Effective date

The provision is effective for property placed in service on or after the date of enactment. The taxpayer may elect to apply the provision for any property to which the amendments made by section 201 of the Tax Reform Act of 1986 apply (i.e., property subject to the modified Accelerated Cost Recovery System of sec. 168) and which was placed in service prior to the date of enactment. This election shall be made in a manner prescribed by the Secretary of the Treasury. The Secretary of the Treasury may treat such election as a change in the taxpayer's method of accounting for such property and may provide rules similar to those provided in Rev. Proc. 96-31, 1996-20 I.R.B. 11, May 13, 1996.

9. *Treatment of leasehold improvements (sec. 1119 of the bill and sec. 168 of the Code)*

Present law

Depreciation of leasehold improvements

Depreciation allowances for property used in a trade or business generally is determined under the modified Accelerated Cost Recovery System ("MACRS") of section 168. Depreciation allowances for improvements made on leased property are determined under MACRS, even if the MACRS recovery period assigned to the property is longer than the term of the lease (sec. 168(i)(8)).³ This rule applies regardless whether the lessor or lessee places the leasehold improvements in service.⁴ If a leasehold improvement constitutes an addition or improvement to nonresidential real property already placed in service, the improvement is depreciated using the straight-line method over a 39-year recovery period, beginning in the month the addition or improvement was placed in service (secs. 168 (b)(3), (c)(1), (d)(2), and (i)(6)).⁵

³Prior to the adoption of the Accelerated Cost Recovery System ("ACRS") by the Economic Recovery Act of 1981, taxpayers were allowed to depreciate the various components of a building as separate assets with separate useful lives. The use of component depreciation was repealed upon the adoption of ACRS. The denial of component depreciation also applies under MACRS, as provided by the Tax Reform Act of 1986.

⁴Former Code sections 168(f)(6) and 178 provided that in certain circumstances, a lessee could recover the cost of leasehold improvements made over the remaining term of the lease. These provisions were repealed by the Tax Reform Act of 1986.

⁵If the improvement is characterized as tangible personal property, ACRS depreciation is calculated using the shorter recovery periods and accelerated methods applicable to such property. The determination of whether certain improvements are characterized as tangible personal property or as nonresidential real property often depends on whether or not the improvements constitute a "structural component" of a building (as defined by Treas. Reg. sec. 1.48-1(e)(1)). See, for example, *Metro National Corp.*, 52 TCM 1440 (1987); *King Radio Corp.*, 486 F.2d 1091 (10th Cir., 1973); *Mallinckrodt, Inc.*, 778 F.2d 402 (8th Cir., 1985) (with respect various leasehold improvements).

Treatment of dispositions of leasehold improvements

A taxpayer generally recovers the adjusted basis of property for purposes of determining gain or loss upon the disposition of the property. Upon the termination of a lease, the adjusted basis of leasehold improvements that were made, but are not retained, by a lessee are taken into account to compute gain or loss by the lessee.⁶ The proper treatment of the adjusted basis of improvements made by a lessor upon termination of a lease is less clear. Proposed Treasury regulation section 1.168-2(e)(1) provides that the unadjusted basis of a building's structural components must be recovered as a whole. In addition, proposed Treasury regulation sections 1.168-2(l)(1) and 1.168-6(b) provide that "disposition" does not include the retirement of a structural component of real property if there is no disposition of the underlying building.⁷ Thus, it appears that it is the position of the Internal Revenue Service that leasehold improvements made by a lessor that constitute structural components of a building must be continued to be depreciated in the same manner as the underlying real property, even if such improvements are retired at the end of the lease term.⁸ Some lessors, on the other hand, may be taking the position that a leasehold improvement is a property separate and distinct from the underlying building and that an abandonment loss under section 165 is allowable at the end of the lease term for the adjusted basis of the property. In addition, lessors may argue that even if a leasehold improvement constitutes a structural component of a building, proposed Treasury regulation section 1.168-2(l)(1) (that seemingly denies the deduction at the end of the lease term) applies only to retirements, but not abandonments or demolitions, of such property.⁹ Thus, it appears that some lessors take the position that, at least in certain circumstances, the adjusted basis of leasehold improvements may be recovered at the end of the term of the lease to which the improvements relate even if there is no disposition of the underlying building.

Reasons for change

The Committee believes that costs that relate to the leasing of property should not be recovered beyond the term of the lease to the extent the costs do not provide a future benefit beyond such term. The Committee also believes that the proper present-law treatment of leasehold improvements disposed of at the end of the term of a lease is unclear. Thus, the Committee provides that the unrecovered costs of leasehold improvements that were placed in service by a lessor with respect to a lease and are irrevocably disposed of at the end of the lease term should be taken into account at that time.

⁶See, Report of the Committee on Ways and Means on H.R. 3838 (H. Rept. 99-426), p. 158, and Senate Finance Committee Report on H.R. 3838 (S. Rept. 99-313), p. 105 (Tax Reform Act of 1986, 99th Cong.).

⁷For example, if a taxpayer places a new roof on building subject to ACRS, the taxpayer must continue to depreciate the allocable cost of the old roof as part of the cost of the underlying building. (Prop. Treas. reg. sec. 1.168-6(b)(1)) See, also, Joint Committee on Taxation, General Explanation of the Economic Recovery Tax Act of 1981 (97th Cong.), p. 86.

⁸See, IRS General Information Letter, dated Sept. 17, 1992.

⁹Compare the second and fourth sentences of proposed Treasury regulation section 1.168-2(l)(1).

Explanation of provision

Under the provision, a lessor of leased property that disposes of a leasehold improvement which was made by the lessor for the lessee of the property may take the adjusted basis of the improvement into account for purposes of determining gain or loss if the improvement is irrevocably disposed of or abandoned by the lessor at the termination of the lease. The provision thus conforms the treatment of lessors and lessees with respect to leasehold improvements disposed of at the end of a term of lease.

For purposes of applying the provision, it is expected that a lessor must be able to separately account for the adjusted basis of the leasehold improvement that is irrevocably disposed of or abandoned. In addition, the Secretary of the Treasury may provide guidance, as necessary, regarding the determination of when a leasehold improvement is made for a lessee and when such property is irrevocably abandoned or disposed of.

Effective date

The provision is effective for leasehold improvements disposed of after June 12, 1996. No inference is intended as to the proper treatment of such dispositions before June 13, 1996.

10. Increase deductibility of business meal expenses for certain seafood processing facilities (sec. 1120 of the bill and sec. 274 of the Code)

Present law

In general, 50 percent of meal and entertainment expenses incurred in connection with a trade or business that are ordinary and necessary (and not lavish or extravagant) are deductible (sec. 274). Food or beverage expenses are fully deductible provided that they are (1) required by Federal law to be provided to crew members of a commercial vessel, (2) provided to crew members of similar commercial vessels not operated on the oceans, or (3) provided on certain oil or gas platforms or drilling rigs.

Reasons for change

The Committee believes that it is appropriate to treat remote seafood processing facilities in the same way that remote oil or gas platforms and drilling rigs are treated for purposes of the deductibility of business meal expenses.

Explanation of provision

The provision adds remote seafood processing facilities located in the United States north of 53 degrees north latitude to the present-law list of entities not subject to the 50 percent limitation on the deductibility of business meals. Consequently, these expenses are fully deductible. A seafood processing facility is remote when there are insufficient eating facilities in the vicinity of the employer's premises.¹⁰

¹⁰ See Treas. Reg. sec. 1.119-1(a)(2)(ii)(c) and 1.119-1(f) (Example 7).

Effective date

The provision applies to taxable years beginning after December 31, 1996.

11. *Provide a lower rate of tax on certain hard ciders (sec. 1121 of the bill and sec. 5041 of the Code)*

Present law

Under present law, distilled spirits are taxed at a rate of \$13.50 per proof gallon; beer is taxed at a rate of \$18 per barrel (approximately 58 cents per gallon); and still wines of 14 percent alcohol or less are taxed at a rate of \$1.07 per wine gallon. Higher rates of tax are provided for wines with greater alcohol content and for sparkling wines.

Certain small wineries may claim a credit against the excise tax on wine of 90 cents per wine gallon on the first 100,000 gallons of wine produced annually. Certain small breweries pay a reduced excise tax of \$7.00 per barrel (approximately 22.6 cents per gallon) on the first 60,000 barrels (1,860,000 gallons) of beer produced annually.

Apple cider containing alcohol is classified and taxed as wine.

Reasons for change

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

Explanation of provision

The bill adjusts the tax rate on apple cider having an alcohol content of no more than seven percent to 22.6 cents per gallon. Apple cider production will continue to be counted in determining whether other production of a producer qualifies for the tax credit for small producers. The bill does not change the classification of qualifying apple cider as wine.

Effective date

The provision is effective for apple cider removed after December 31, 1996.

12. *Modifications to section 530 of the Revenue Act of 1978 (sec. 1122 of the bill and sec. 530 of the Revenue Act of 1978)*

Present law

In general

For Federal tax purposes, there are two classifications of workers: a worker is either an employee of the service recipient or an independent contractor. Significant tax consequences result from the classification of a worker as an employee or independent contractor. These differences relate to withholding and employment tax requirements, as well as the ability to exclude certain types of compensation from income or to take tax deductions for certain expenses. Some of these consequences favor employee status, while others favor independent contractor status. For example, an employee may exclude from gross income employer-provided benefits such as pension, health, and group-term life insurance benefits. On the other hand, an independent contractor can establish his or her own pension plan and deduct contributions to the plan. An independent contractor also has greater ability to deduct work-related expenses.

In general, the determination of whether an employer-employee relationship exists for Federal tax purposes is made under a common-law test. Treasury regulations provide that an employer-employee relationship generally exists if the person contracting for services has the right to control not only the result of the services, but also the means by which that result is accomplished. In other words, an employer-employee relationship generally exists if the person providing the services "is subject to the will and control of the employer not only as to what shall be done but how it shall be done."¹¹ Under the Treasury regulations, it is not necessary that the employer actually control the manner in which the services are performed, rather it is sufficient that the employer have a right to control. Whether the requisite control exists is determined based on all the relevant facts and circumstances.¹² The Internal Revenue Service ("IRS") recently issued a draft training guide for field agents that provides current IRS views regarding worker classification issues.¹³

Section 530

In general

With increased enforcement of the employment tax laws beginning in the late 1960s, controversies developed between the IRS and taxpayers as to whether businesses had correctly classified certain workers as self employed rather than as employees. In some instances when the IRS prevailed in reclassifying workers as employees under the common-law test, the employing business became liable for substantial portions of its employees' employment

¹¹ Treas. Reg. sec. 31.3401(c)-(1)(b).

¹² The Internal Revenue Service ("IRS") has developed a list of 20 factors that may be examined in determining whether an employer-employee relationship exists Rev. Rul. 87-41, 1987-1 C.B. 296.

¹³ *Employee or Independent Contractor?*, (Draft, February 28, 1996)(hereinafter the "IRS Draft Training Guide")

and income tax liabilities (that the employer had failed to withhold and pay over) and the employer's portion of such tax liabilities, although the employees might have fully paid their liabilities for self-employment and income taxes.

In response to this problem, the Congress enacted section 530 of the Revenue Act of 1978 ("section 530").¹⁴ That provision generally allows a taxpayer to treat a worker as not being an employee for employment tax purposes (but not income tax purposes), regardless of the individual's actual status under the common-law test, unless the taxpayer has no reasonable basis for such treatment. Section 530 was initially scheduled to terminate at the end of 1979 to give the Congress time to resolve the many complex issues regarding worker classification. It was extended through the end of 1980 by P.L. 96-167 and through June 30, 1982, by P.L. 96-541. The provision was extended permanently by the Tax Equity and Fiscal Responsibility Act of 1982.¹⁵

Under section 530, a reasonable basis for treating a worker as an independent contractor is considered to exist if the taxpayer reasonably relied on (1) published rulings or judicial precedent, (2) past IRS audit practice with respect to the taxpayer, (3) long-standing recognized practice of a significant segment of the industry of which the taxpayer is a member, or (4) if the taxpayer has any "other reasonable basis" for treating a worker as an independent contractor. The legislative history states that section 530 is to be "construed liberally in favor of taxpayers."¹⁶

The relief under section 530 is available with respect to an individual only if certain additional requirements are satisfied. The taxpayer must not have treated the individual as an employee for any period, and for periods since 1978 all Federal tax returns, including information returns, must have been filed on a basis consistent with treating such individual as an independent contractor. Further, the taxpayer (or a predecessor) must not have treated any individual holding a substantially similar position as an employee for purposes of employment taxes for any period beginning after 1977.

Under section 1706 of the Tax Reform Act of 1986, section 530 does not apply in the case of an individual who, pursuant to an arrangement between the taxpayer and another person, provides services for such other person as an engineer, designer, drafter, computer programmer, systems analyst, or other similarly skilled worker engaged in a similar line of work. Thus, the determination of whether such individuals are employees or self employed is made in accordance with the common-law test.

Section 530 also prohibits the issuance of Treasury regulations and revenue rulings on common-law employment status. Taxpayers may, however, obtain private letter rulings from the IRS regarding the status of workers as employees or independent contractors.

¹⁴ P.L. 95-600.

¹⁵ P.L. 97-248.

¹⁶ H. Rept. No. 1748 (95th Cong., 2d Sess., 5 (1978)). The conference agreement to the Revenue Act of 1978 adopted the provisions of the House bill and therefore incorporates this legislative history.

Status of worker

There is no explicit statement in the language of section 530 requiring that there first be a determination that a worker is an employee under the common-law test before the relief under section 530 becomes available. It is the position of the IRS, based on legislative history, that section 530 can only apply after such a determination is made.¹⁷ The IRS does not require the taxpayer to concede or agree to a determination that the worker is an employee.¹⁸

Several courts that have explicitly considered the question have held that section 530 relief is available irrespective of whether there has been an initial determination of worker classification under the common law.¹⁹ Courts in the cases cited in the IRS Draft Training Guide in support of the IRS' position did determine worker status before applying section 530. However, it is unclear whether such determination was made because the court believed a threshold determination was required or merely as a natural consequence of the court's disposition of the case (i.e., the taxpayers first argued that the workers were not employees under the common law test, or in the alternative, section 530 provided relief).²⁰

Judicial or administrative precedent safe harbor

Under section 530, reliance on judicial precedent, published rulings, technical advice with respect to the taxpayer, or a letter ruling to the taxpayer is deemed a reasonable basis for treating a worker as an independent contractor. If a taxpayer relies on this safe harbor, the IRS will look to see whether the facts of the judicial precedent or published ruling are sufficiently similar to the taxpayer's facts.²¹

Prior audit safe harbor

Under the prior-audit safe harbor, reasonable reliance is generally found to exist if the IRS failed to raise an employment tax issue on audit, even though the audit was not related to employment tax matters. A taxpayer can also rely on a prior audit in which an employment tax issue was raised, but was resolved in favor of the taxpayer. According to the IRS, an "audit" must involve an examination of the taxpayer's books and records; mere inquiries from an IRS service center or a "compliance check" to determine whether a taxpayer has filed all returns will not suffice.²² In order to rely on a prior audit, the IRS requires that the taxpayer must have treated the workers at issue as independent contractors during the period covered by the prior audit.²³

¹⁷ IRS Draft Training Guide, at 3-4.

¹⁸ IRS Draft Training Guide, at 3-5 and 3-6; TAM 9443002 (December 3, 1993).

¹⁹ See e.g., *Lambert's Nursery and Landscaping, Inc. v. U.S.*, 894 F.2d 154 (5th Cir. 1990) ("It is not necessary to determine whether [taxpayer's] workers were independent contractors or employees for employment tax purposes."); *J & J Cab Service, Inc. v. U.S.*, 75 AFTR2d No. 95-618 (W.D. N.C. 1995) ("Section 530 relief may be granted irrespective of whether individuals were incorrectly treated as other than employees"); *Queensgate Dental Family Practice, Inc. v. U.S.*, 91-2 USTC No. 50,536 (M.D. Pa. 1991) (disagreeing with the IRS' contention that the court must first determine worker classification before applying section 530).

²⁰ See e.g., *Overeen v. U.S.*, 91-2 USTC No. 50, 459 (W.D. Okla. 1991); *Galbraith and Green, Inc. v. U.S.*, 80-2 USTC No. 9,629 (Az. 1980).

²¹ See e.g., TAM 9443002 (December 3, 1993); TAM 9330007 (April 28, 1993).

²² IRS Draft Training Guide, at 3-17.

²³ IRS Draft Training Guide, at 3-19.

Industry practice safe harbor

A taxpayer is also treated as having a reasonable basis for treating a worker as an independent contractor under section 530 if the taxpayer reasonably relied on long-standing recognized practice of a significant segment of the industry in which the taxpayer is engaged. In applying this safe harbor, a number of issues arise including the definition of: (1) a long-standing practice, (2) the taxpayer's industry, and (3) a significant segment of the industry.

Section 530 does not specify a period of time in order for a practice to be long standing. The IRS Draft Training Guide provides that a practice is most clearly long standing if the industry has treated workers as independent contractors since 1978.²⁴ According to the IRS Draft Training Guide, the safe harbor is not met if the industry only recently began to treat workers as independent contractors. One court has held that seven years qualifies as long standing.²⁵

The IRS Draft Training Guide recognizes that a taxpayer may use the industry practice safe harbor even if it began business after 1978.²⁶ However, the IRS Draft Training Guide provides that if the industry practice changed by the time the taxpayer joined the industry, the taxpayer cannot rely on the former practice. The IRS position with respect to whether a new industry (i.e., one beginning after 1978) can take advantage of the industry practice safe harbor is unclear; the IRS Draft Training Guide is silent on this issue. However, given the IRS position with respect to new taxpayers, the IRS may take a similar position with respect to new industries.

A taxpayer's industry generally consists of businesses competing for the same customers and providing the same or a similar product or service.²⁷ Further, what constitutes the taxpayer's industry generally will be determined by reference to the geographic or metropolitan area in which the taxpayer conducts its business.²⁸

Neither section 530, nor the legislative history, provides a clear standard as to what constitutes a significant segment of a taxpayer's industry. The IRS Draft Training Guide provides that the determination will be based on the facts and circumstances, including the percentage of employers and workers subject to the practice.²⁹ A few courts have addressed this issue. In one case, the IRS argued that a significant segment of the industry means more than 50 percent of the industry.³⁰ However, that court held that a significant segment is less than a majority of the firms in an industry. Another court held that 15 out of 84 industry respondents (18 percent) treating workers as independent contractors would constitute a significant segment of an industry.³¹

²⁴ IRS Draft Training Guide, at 3-23.

²⁵ *REAG, Inc. v. U.S.*, 801 F.Supp. 494 (W.D. Okla. 1992).

²⁶ IRS Draft Training Guide, at 3-23.

²⁷ See *Sanderson III v. U.S.*, 862 F.Supp. 196 (N.D. Ohio 1994) (court held that relevant industry was owner-operated truckers rather than trucking industry as a whole); IRS Draft Training Guide, at 3-22.

²⁸ See *General Investment Corp. v. U.S.*, 823 F.2d 337 (9th Cir. 1987) (court held the taxpayer's industry consisted of small mining business located in the taxpayer's county, rather than all mining businesses throughout the county); TAM 9443002 (December 3, 1993).

²⁹ IRS Draft Training Guide, at 3-24.

³⁰ *In re Bentley*, 73 AFTR2d No. 94-667 (Bkrtcy. E.D. Tenn. 1994).

³¹ *REAG, Inc. v. U.S.*, 801 F.Supp. 494 (W.D. Okla. 1992).

Even if a taxpayer can establish a long-standing recognized practice of a significant segment of the industry, the IRS requires the taxpayer to show that it had knowledge of the practice at the time it began treating workers as independent contractors.³² For instance, the IRS Draft Training Guide states that “[i]f the taxpayer relied on a survey, the survey must focus on the treatment of the workers at the time the taxpayer started treating its workers as independent contractors, not the treatment of workers at the time of the examination.”³³

Other reasonable basis

Even if a taxpayer is unable to rely on one of the three safe harbors described above, a taxpayer may still be entitled to relief under section 530 if the taxpayer has any other reasonable basis for treating a worker as an independent contractor.

Under case law, reliance on the advice of an attorney or an accountant may constitute a reasonable basis for treating a worker as an independent contractor.³⁴ The IRS appears to agree with this position, provided there is a showing that the attorney or accountant was knowledgeable about the law and the facts in rendering the advice.³⁵

Taxpayers generally have argued successfully that reliance on the common-law test can constitute a reasonable basis for purposes of applying section 530.³⁶ However, the IRS does not concur with this view.³⁷

Reporting consistency

To be entitled to relief under section 530, the taxpayer must not have treated the worker as an employee for any period, and, for periods since 1978, all Federal tax returns, including information returns, must have been filed on a basis consistent with treating such worker as an independent contractor. For example, withholding income and employment taxes from a worker’s remuneration would not be consistent with treatment as an independent contractor, and the taxpayer must file a Form 1099 (if required) with respect to the worker as opposed to a Form W-2.³⁸ If a taxpayer does not file the required information return for a period it will not be entitled to section 530 relief for such period.³⁹ Further, the courts have generally held that since 1978 (or such shorter period as the taxpayer has been in business), Federal tax reporting with respect to the worker (and all similarly situated workers) must have been consistent with independent contractor treatment.⁴⁰ The filing of

³²TAM 9619001 (January 29, 1996).

³³IRS Draft Training Guide, at 3-26.

³⁴See e.g., *Smoky Mountain Secrets, Inc. v. U.S.*, 910 F.Supp. 1316 (E.D. 1995); *In re Arndt*, 72 AFTR2d No. 93-5325 (Bkrcty. M.D. Fl. 1993).

³⁵IRS Draft Training Guide, at 3-28; see also *In re McAtee*, 66 AFTR2d No. 94-667 (Bkrcty. N.D. Iowa 1990)(taxpayer could not rely on advice of accountant where it is not established accountant had expertise in employment tax matters).

³⁶See e.g., *Critical Care Register Nursing, Inc. v. U.S.*, 776 F.Supp. 1025 (E.D. Pa. 1991); *American Institute of Family Relations v. U.S.*, 79-1 USTC No. 9,364 (C.D. Cal. 1979).

³⁷IRS Draft Training Guide, at 3-29.

³⁸Rev. Proc. 85-18, 1985-1 C.B. 518.

³⁹*General Investment Corp. v. U.S.*, 823 F.2d 337 (9th Cir. 1987); Rev. Rul. 81-224, 1981-2 C.B. 197.

⁴⁰*Henry v. U.S.*, 793 F.2d 289 (Fed.Cir. 1986); *In re McAtee*, 66 AFTR2d No. 94-667 (Bkrcty. N.D. Iowa 1990).

consistent Federal tax returns for the period of examination will not be sufficient.

Consistency among workers with substantially similar positions

In order for section 530 to apply, the taxpayer (or a predecessor) must not have treated any worker holding a substantially similar position as an employee for purposes of employment taxes for any period beginning after 1977. Whether workers are similarly situated is dependent on the facts and circumstances. The IRS Draft Training Guide states that a “substantially similar position exists if the job functions, duties, and responsibilities are substantially similar and the control and supervision of those duties and responsibilities is substantially similar.”⁴¹

There have been a few court decisions addressing this issue. For example, in *REAG, Inc. v. U.S.*,⁴² the court held that the position of appraisers who were owner-officers of the business was not substantially similar to appraisers who were not owners since the owner-officers had managerial responsibilities. By contrast, in *Lowen Corp. v. U.S.*,⁴³ the court found that all workers engaged in the business of selling real estate signs had substantially similar positions even though some were salaried and had to file daily reports while others were paid by commission and did not have to file such reports.

Burden of proof

The IRS Draft Training Guide states that the burden of proof is on the taxpayer to demonstrate that it had a reasonable basis for treating a worker as an independent contractor.⁴⁴ However, in light of the Congressional instruction in the legislative history to construe section 530 liberally,⁴⁵ courts appear to be split as to how stringent a burden to apply.

In *McClellan v. U.S.*,⁴⁶ the court held that section 530 requires the “taxpayer to come forward with an explanation and enough evidence to establish prima facie grounds for a finding of reasonableness. . . . [T]his threshold burden is relatively low, and can be met with any reasonable showing. Once the taxpayer has made this prima facie showing, the burden then shifts to the IRS to verify or refute the taxpayer’s explanation.” By contrast, in *Boles Trucking, Inc., v. U.S.*,⁴⁷ the court held that the burden is on the taxpayer to show, based on a preponderance of the evidence, that it had a reasonable basis for treating workers as independent contractors.

⁴¹ IRS Draft Training Guide, at 3–10.

⁴² 801 F.Supp. 494 (W.D. Okla. 1992). The IRS has nonacquiesced. IRS Draft Training Guide, at 3–13.

⁴³ 785 F.Supp. 913 (D. Kan. 1992).

⁴⁴ IRS Draft Training Guide, at 3–25.

⁴⁵ H. Rept. No. 1748 (95th Cong., 2d Sess., 5 (1978)). The conference agreement to the Revenue Act of 1978 adopted the provisions of the House bill and therefore incorporates this legislative history.

⁴⁶ 900 F.Supp. 101 (E.D. Mich. 1995). See also *REAG, Inc. v. U.S.*, 801 F.Supp. 494 (W.D. Okla. 1992)(a taxpayer need only show a substantial rational basis for its decision to treat the workers as independent contractors).

⁴⁷ 77 F.3d 236 (8th Cir. 1996). See also *Springfield v. U.S.*, 873 F.Supp.1403 (S.D. Cal. 1994)(taxpayer has the burden to show it satisfies the requirements of section 530).

Reasons for change

The Committee recognizes that the IRS and taxpayers continue to have disputes over the proper classification of workers, particularly with respect to the application of section 530. Many of these disputes involve small businesses without adequate resources to challenge the IRS position. Accordingly, the Committee believes it is appropriate to make certain clarifications of and modifications to section 530 which are designed to provide both the IRS and taxpayers with clearer uniform standards. The Committee believes these clearer standards will reduce the number of disputes between the IRS and taxpayers over the application of section 530 and will reduce unnecessary and costly litigation. Further, in light of the unique nature of the legislative history to section 530 which provides that it should be construed liberally in favor of taxpayers, the Committee believes that the burden of proof should generally be on the IRS once the taxpayer establishes a prima facie case that it was reasonable not to treat the worker as an employee and provided the taxpayer fully cooperates with reasonable requests for information by the IRS.

Explanation of provision

The bill makes several clarifications of and modifications to section 530. First, under the bill, a worker does not have to otherwise be an employee of the taxpayer in order for section 530 to apply. The provision is intended to reverse the IRS position, as stated in the IRS Draft Training Guide, that there first must be a determination that the worker is an employee under the common law standards before application of section 530.

The bill modifies the prior audit safe harbor so that taxpayers may not rely on an audit commencing after December 31, 1996, unless such audit included an examination for employment tax purposes of whether the worker involved (or any worker holding a position substantially similar to the position held by the worker involved) should be treated as an employee of the taxpayer. The provision does not affect the ability of taxpayers to rely on prior audits that commenced before January 1, 1997, even though the audit was not related to employment tax matters, as under present law.

Under the bill, section 530 will not apply with respect to a worker unless the taxpayer and the worker sign a statement (at such time and in such manner as the Secretary may prescribe) which provides that the worker will not be treated as an employee for employment tax purposes. Also, the bill provides that an officer or employee of the IRS must, at (or before) the commencement of an audit involving worker classification issues, provide the taxpayer with written notice of the provisions of section 530.

The bill makes a number of changes to the industry practice safe harbor. First, the bill provides that a significant segment of the taxpayer's industry under the industry practice safe harbor does not require a reasonable showing of the practice of more than 25 percent of an industry (determined without taking into account the taxpayer). The provision is intended to be a safe harbor; a lower percentage may constitute a significant segment of the taxpayer's industry based on the particular facts and circumstances.

The bill also provides that an industry practice need not have continued for more than 10 years in order for the industry practice to be considered long standing. As with the significant segment safe harbor, this provision is intended to be a safe harbor; an industry practice in existence for a shorter period of time may be considered long standing based on the particular facts and circumstances. In addition, the bill clarifies that an industry practice will not fail to be treated as long standing merely because such practice began after 1978. Consequently, the provision clarifies that new industries can take advantage of section 530.

The bill modifies the burden of proof in section 530 cases by providing that if a taxpayer establishes a prima facie case that it was reasonable not to treat a worker as an employee for purposes of section 530,⁴⁸ the burden of proof shifts to the IRS with respect to such treatment.⁴⁹ In order for the shift in burden of proof to occur, the taxpayer must fully cooperate with reasonable requests by the IRS for information relevant to the taxpayer's treatment of the worker as an independent contractor under section 530. The Committee intends that a request by the IRS will not be treated as reasonable if complying with the request would be impracticable given the particular circumstances and the relative costs involved. The shift in the burden of proof does not apply for purposes of determining whether the taxpayer had any other reasonable basis for treating the worker as an independent contractor, but does apply to all other aspects of section 530. So, for example, provided the taxpayer establishes its prima facie case and fully cooperates with the IRS' reasonable requests, the burden of proof shifts to the IRS with respect to all other aspects of section 530, including whether the taxpayer had a reasonable basis for treating the worker as an independent contractor under the judicial or administrative precedent, prior audit, or long-standing industry practice safe harbors, whether the taxpayer filed all Federal tax returns on a basis consistent with treating the worker as an independent contractor, and whether the taxpayer treated any worker holding a substantially similar position as an employee. No inference is intended with respect to the application of the burden of proof in section 530 cases prior to the effective date of this provision.

Effective date

The provisions generally apply to periods after December 31, 1996. The provision regarding the burden of proof applies to disputes with respect to periods after December 31, 1996. In the case of workers engaged to perform services for a taxpayer before January 1, 1997, the provision requiring a written statement that such workers are not employees for employment tax purposes is effective for periods after December 31, 1997 (unless the taxpayer elects to apply the provision earlier). The provision requiring the IRS to no-

⁴⁸ For example, the taxpayer must establish a prima facie case that it reasonably satisfies the requirements of section 530 for not treating the worker as an employee, including the reporting consistency and consistency among workers with substantially similar positions requirements, and the requirement that the taxpayer have a reasonable basis for not treating the worker as an employee.

⁴⁹ The provision is generally intended to codify the holding in *McClellan v. U.S.*, discussed above, with respect to the burden of proof in section 530 cases.

tify taxpayers of the provisions of section 530 applies to audits commencing after December 31, 1996.

B. EXTENSION OF CERTAIN EXPIRING PROVISIONS

1. *Work opportunity tax credit (sec. 1201 of the bill and sec. 51 of the Code)*

Prior law

General rules

Prior to January 1, 1995, the targeted jobs tax credit was available on an elective basis for employers hiring individuals from one or more of nine targeted groups. The credit generally was equal to 40 percent of qualified first-year wages. Qualified first-year wages consisted of wages attributable to service rendered by a member of a targeted group during the one-year period beginning with the day the individual began work for the employer. For a vocational rehabilitation referral, however, the period began the day the individual began work for the employer on or after the beginning of the individual's vocational rehabilitation plan.

No more than \$6,000 of wages during the first year of employment were permitted to be taken into account with respect to any individual. Thus, the maximum credit per individual was \$2,400.

With respect to economically disadvantaged summer youth employees, the credit was equal to 40 percent of up to \$3,000 of qualified first-year wages, for a maximum credit of \$1,200.

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

Certification of members of targeted groups

In general, an individual was not treated as a member of a targeted group unless certification that the individual was a member of such a group was received or requested in writing by the employer from the designated local agency on or before the day on which the individual began work for the employer. In the case of a certification of an economically disadvantaged youth participating in a cooperative education program, this requirement was satisfied if the certification was requested or received from the participating school on or before the day on which the individual began work for the employer. The "designated local agency" was the State employment security agency.

If a certification was incorrect because it was based on false information provided as to the employee's membership in a targeted group, the certification was revoked. Wages paid after the revocation notice was received by the employer were not treated as qualified wages.

The U.S. Employment Service, in consultation with the Internal Revenue Service, was directed to take whatever steps necessary to keep employers informed of the availability of the credit.

Targeted groups eligible for the credit

The nine groups eligible for the credit were either recipients of payments under means-tested transfer programs, economically dis-

advantaged (as measured by family income), or disabled individuals.

(1) Vocational rehabilitation referrals

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

(2) Economically disadvantaged youths

Economically disadvantaged youths were individuals certified by the designated local employment agency as (1) members of economically disadvantaged families and (2) at least age 18 but not age 23 on the date they were hired by the employer. An individual was determined to be a member of an economically disadvantaged family if, during the six months immediately preceding the earlier of the month in which the determination occurred or the month in which the hiring date occurred, the individual's family income was, on an annual basis, not more than 70 percent of the Bureau of Labor Statistics' lower living standard. A determination that an individual was a member of an economically disadvantaged family was valid for 45 days from the date on which the determination was made.

Except as otherwise noted below, a determination of whether an individual was a member of an economically disadvantaged family was made on the same basis and was subject to the same 45-day limitation, where required in connection with the four other targeted groups that excluded individuals who were not economically disadvantaged.

(3) Economically disadvantaged Vietnam-era veterans

The third targeted group was Vietnam-era veterans certified by the designated local employment agency as members of economically disadvantaged families. For these purposes, a Vietnam-era veteran was an individual who had served on active duty (other than for training) in the Armed Forces for more than 180 days, or who had been discharged or released from active duty in the Armed Forces for a service-connected disability, but in either case, the active duty must have taken place after August 4, 1964, and before May 8, 1975. However, any individual who had served for a period of more than 90 days during which the individual was on active duty (other than for training) was not an eligible employee if any of this active duty occurred during the 60-day period ending on the date the individual was hired by the employer. This latter rule was intended to prevent employers who hired current members of the armed services (or those departed from service within the last 60-days) from receiving the credit.

(4) SSI recipients

The fourth targeted group was individuals receiving either Supplemental Security Income ("SSI") under Title XVI of the Social Security Act or State supplements described in section 1616 of that Act or section 212 of P.L. 93-66. To be an eligible employee, the individual must have received SSI payments during at least a one-month period ending during the 60-day period that ended on the date the individual was hired by the employer. The designated local agency was to issue the certification after a determination by the agency making the payments that these conditions had been fulfilled.

(5) General assistance recipients

General assistance recipients were individuals who received general assistance for a period of not less than 30 days if that period ended within the 60-day period ending on the date the individual was hired by the employer. General assistance programs were State and local programs that provided individuals with money payments, vouchers, or scrip based on need. These programs were referred to by a wide variety of names, including home relief, poor relief, temporary relief, and direct relief. Because of the wide variety of such programs, Congress provided that a recipient was an eligible employee only after the program had been designated by the Secretary of the Treasury as a program that provided money payments, vouchers, or scrip to needy individuals. Certification was performed by the designated local agency.

(6) Economically disadvantaged former convicts

The sixth targeted group included any individual who was certified by the designated local employment agency as (1) having at some time been convicted of a felony under State or Federal law, (2) being a member of an economically disadvantaged family, and (3) having been hired within five years of the later of release from prison or date of conviction.

(7) Economically disadvantaged cooperative education students

The seventh targeted group was youths who (1) actively participated in qualified cooperative education programs, (2) had attained age 16 but had not attained age 20, (3) had not graduated from high school or vocational school, and (4) were members of economically disadvantaged families. The definitions of a qualified cooperative education program and a qualified school were similar to those used in the Vocational Education Act of 1963. Thus, a qualified cooperative education program meant a program of vocational education for individuals who, through written cooperative arrangements between a qualified school and one or more employers, received instruction, including required academic instruction, by alternation of study in school with a job in any occupational field, but only if these two experiences were planned and supervised by the school and the employer so that each experience contributed to the student's education and employability.

For this purpose, a qualified school was (1) a specialized high school used exclusively or principally for the provision of vocational

education to individuals who were available for study in preparation for entering the labor market, (2) the department of a high school used exclusively or principally for providing vocational education to individuals who were available for study in preparation for entering the labor market, or (3) a technical or vocational school used exclusively or principally for the provision of vocational education to individuals who had completed or left high school and who were available for study in preparation for entering the labor market. In order for a nonpublic school to be a qualified school, it must have been exempt from income tax under section 501(a) of the Code.

The certification was performed by the school participating in the cooperative education program. After initial certification, an individual remained a member of the targeted group only while meeting the program participation, age, and degree status requirements of (a), (b), and (c), above.

(8) AFDC recipients

The eighth targeted group included any individual who was certified by the designated local employment agency as being eligible for Aid to Families with Dependent Children ("AFDC") and as having continually received such aid during the 90 days before being hired by the employer.

(9) Economically disadvantaged summer youth employees

The ninth targeted group included youths who performed services during any 90-day period between May 1 and September 15 of a given year and who were certified by the designated local agency as (1) being 16 or 17 years of age on the hiring date and (2) a member of an economically disadvantaged family. A youth must not have been an employee of the employer prior to that 90-day period. With respect to any particular employer, an employee could qualify only one time for this summer youth credit. If, after the end of the 90-day period, the employer continued to employ a youth who was certified during the 90-day period as a member of another targeted group, the limit on qualified first-year wages took into account wages paid to the youth while a qualified summer youth employee.

Definition of wages

In general, wages eligible for the credit were defined by reference to the definition of wages under the Federal Unemployment Tax Act (FUTA) in section 3306(b) of the Code, except that the dollar limits did not apply. Because wages paid to economically disadvantaged cooperative education students and to certain agricultural and railroad employees were not FUTA wages, special rules were provided for these wages.

Wages were taken into account for purposes of the credit only if more than one-half of the wages paid during the taxable year to an employee were for services in the employer's trade or business. The test as to whether more than one-half of an employee's wages were for services in a trade or business was applied to each separate employer without treating related employers as a single employer.

Other rules

In order to prevent taxpayers from eliminating all tax liability by reason of the credit, the amount of the credit could not exceed 90 percent of the taxpayer's income tax liability. Furthermore, the credit was allowed only after certain other nonrefundable credits had been taken. If, after applying these other credits, 90 percent of an employer's remaining tax liability for the year was less than the targeted jobs tax credit, the excess credit could be carried back three years and carried forward 15 years.

All employees of all corporations that were members of a controlled group of corporations were to be treated as if they were employees of the same corporation for purposes of determining the years of employment of any employee and wages for any employee up to \$6,000. Generally, under the controlled group rules, the credit allowed the group was the same as if the group were a single company. A comparable rule was provided in the case of partnerships, sole proprietorships, and other trades or businesses (whether or not incorporated) that were under common control, so that all employees of such organizations generally were to be treated as if they were employed by a single person. The amount of targeted jobs tax credit allowable to each member of the controlled group was its proportionate share of the wages giving rise to the credit.

No credit was available for the hiring of certain related individuals (primarily dependents or owners of the taxpayer). The credit was also not available for wages paid to an individual who was employed by the employer at any time during which the individual was not a certified member of a targeted group.

No credit was available for wages paid by an employer to an individual for services that were the same as, or substantially similar to, those services performed by employees participating in, or affected by, a strike or lockout during the period of such strike or lockout. This rule applied to wages paid to individuals whose principal place of employment was a plant or facility where there was a strike or lockout.

No credit was allowed for wages paid unless the eligible individual was either (1) employed by the employer for at least 90 days (14 days in the case of economically disadvantaged summer youth employees) or (2) had completed at least 120 hours (20 hours for summer youth) of services performed for the employer.

Reasons for change

While the prior-law targeted jobs tax credit was the subject of some criticism, the Committee believes that a tax credit mechanism can provide an important incentive for employers to undertake the expense of providing jobs and training to economically disadvantaged individuals, many of whom are underskilled and/or undereducated. The bill creates a new program whose design will focus on individuals with poor workplace attachments, streamline administrative burdens, promote longer-term employment, and thereby reduce costs relative to the prior-law program. The Committee intends that this short-term program will provide the Congress and the Treasury and Labor Departments an opportunity to

assess fully the operation and effectiveness of the new credit as a hiring incentive.

Explanation of provision

General rules

The bill replaces the targeted jobs tax credit with the “work opportunity tax credit.” The work opportunity tax credit is available on an elective basis for employers hiring individuals from one or more of seven targeted groups. The credit generally is equal to 35 percent of qualified wages. Qualified wages consist of wages attributable to service rendered by a member of a targeted group during the one-year period beginning with the day the individual begins work for the employer. For a vocational rehabilitation referral, however, the period will begin on the day the individual begins work for the employer on or after the beginning of the individual’s vocational rehabilitation plan as under prior law.

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

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

Certification of members of targeted groups

In general, an individual is not to be treated as a member of a targeted group unless: (1) on or before the day the individual begins work for the employer, the employer received in writing a certification from the designated local agency that the individual is a member of a specific targeted group, or (2) on or before the day the individual is offered work with the employer, a pre-screening notice is completed with respect to that individual by the employer and within 21 days after the individual begins work for the employer, the employer submits such notice, signed by the employer and the individual under penalties of perjury, to the designated local agency as part of a written request for certification. The pre-screening notice will contain the information provided to the employer by the individual that forms the basis of the employer’s belief that the individual is a member of a targeted group.

If a certification is incorrect because it is based on false information provided as to the individual’s membership in a targeted group, the certification will be revoked. No credit will be allowed on wages paid after receipt by the employer of the revocation notice.

If a designated local agency rejects a certification request it will have to provide a written explanation of the basis of the rejection.

Targeted groups eligible for the credit

(1) Families receiving AFDC

An eligible recipient is an individual certified by the designated local employment agency as being a member of a family receiving benefits under AFDC or its successor program for a period of at

least nine months part of which is during the nine-month period ending on the hiring date. For these purposes, each member of the family receiving such assistance is treated as receiving such assistance and therefore is treated as an eligible recipient.

(2) Qualified ex-felon

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

(3) High-risk-youth

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

(4) Vocational rehabilitation referral

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

(5) Qualified summer youth employee

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

(6) Qualified veteran

A qualified veteran is a veteran who is a member of a family certified as receiving assistance under: (1) AFDC for a period of at least nine months part of which is during the 12-month period ending on the hiring date, or (2) a food stamp program under the Food Stamp Act of 1977 for a period of at least three months part of which is during the 12-month period ending on the hiring date.

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

(7) Families receiving Food Stamps

An eligible recipient is an individual aged 18 but not 25 certified by a designated local employment agency as being a member of a family receiving assistance under a food stamp program under the Food Stamp Act of 1977 for a period of at least three months ending on the hiring date. For these purposes, each member of the family receiving such assistance is treated as receiving such assistance and therefore is treated as an eligible recipient.

Definition of wages and other rules

In general, wages eligible for the credit are defined by reference to the definition of wages under the Federal Unemployment Tax Act ("FUTA") in section 3306(b) of the Code, except that the dollar limits do not apply.

Wages are taken into account for purposes of the credit only if more than one-half of the wages paid during the taxable year to an employee are for services in the employer's trade or business. The test as to whether more than one-half of an employee's wages are for services in a trade or business are applied to each separate employer without treating related employers as a single employer.

In order to prevent taxpayers from eliminating all tax liability by reason of the credit, the amount of the credit may not exceed 90 percent of the taxpayer's income tax liability. Furthermore, the credit is allowed only after certain other nonrefundable credits had been taken. If, after applying these other credits, 90 percent of an employer's remaining tax liability for the year is less than the targeted jobs tax credit, the excess credit can be carried back three years and carried forward 15 years.

All employees of all corporations that are members of a controlled group of corporations are treated as if they were employees of the same corporation for purposes of determining the years of employment of any employee and wages for any employee up to \$6,000. Generally, under the controlled group rules, the credit al-

lowed the group is the same as if the group were a single company. A comparable rule is provided in the case of partnerships, sole proprietorships, and other trades or businesses (whether or not incorporated) that are under common control, so that all employees of such organizations generally are treated as if they were employed by a single person. The amount of the credit allowable to each member of the controlled group is its proportionate share of the wages giving rise to the credit.

No credit is available for the hiring of certain related individuals (primarily dependents or owners of the taxpayer). The credit is also not available for wages paid to an individual who is employed by the employer at any time during which the individual is not a certified member of a targeted group.

No credit is available for wages paid by an employer to an individual for services that are the same as, or substantially similar to, those services performed by employees participating in, or affected by, a strike or lockout during the period of such strike or lockout. This rule applies to wages paid to individuals whose principal place of employment is a plant or facility where there is a strike or lockout.

Minimum employment period

No credit is allowed for wages paid unless the eligible individual is employed by the employer for at least 180 days (20 days in the case of a qualified summer youth employee) or 375 hours (120 hours in the case of a qualified summer youth employee).

Effective date

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

2. Employer-provided educational assistance (sec. 1202 of the bill and sec. 127 of the Code)

Present and prior law

For taxable years beginning before January 1, 1995, an employee's gross income and wages did not include amounts paid or incurred by the employer for educational assistance provided to the employee if such amounts were paid or incurred pursuant to an educational assistance program that met certain requirements. This exclusion, which expired for taxable years beginning after December 31, 1994, was limited to \$5,250 of educational assistance with respect to an individual during a calendar year. The exclusion applied whether or not the education was job related. In the absence of this exclusion, educational assistance is excludable from income only if it is related to the employee's current job.

Reasons for change

The section 127 exclusion for employer-provided educational assistance was first established on a temporary basis by the Revenue Act of 1978 (through 1983). It subsequently was extended, again on a temporary basis, by Public Law 98-611 (through 1985), by the

Tax Reform Act of 1986 (through 1987), by the Technical and Miscellaneous Revenue Act of 1988 (through 1988), by the Omnibus Budget Reconciliation Act of 1989 (through September 30, 1990), by the Omnibus Budget Reconciliation Act of 1990 (through 1991), by the Tax Extension Act of 1991 (through June 30, 1992), and by the Omnibus Budget Reconciliation Act of 1993 (through December 31, 1994). Public Law 98-611 adopted a \$5,000 annual limit on the exclusion; this limit was subsequently raised to \$5,250 in the Tax Reform Act of 1986. The Technical and Miscellaneous Revenue Act of 1988 made the exclusion inapplicable to graduate-level courses. The restriction on graduate-level courses was repealed by the Omnibus Budget Reconciliation Act of 1990, effective for taxable years beginning after December 31, 1990.

The Committee believes that the exclusion for employer-provided educational assistance should be extended because it provides needed assistance to workers and aids U.S. competitiveness by encouraging a better-educated work force. The need to balance the Federal budget necessitates limiting the exclusion (as other expiring tax provisions) to a temporary extension.

Explanation of provision

The provision extends the exclusion for employer-provided educational assistance (including the application of the exclusion to graduate education) for taxable years beginning after December 31, 1994, and before January 1, 1997.

To the extent employers have previously filed Forms W-2 reporting the amount of educational assistance provided as taxable wages, present Treasury regulations require the employer to file Forms W-2c (i.e., corrected Forms W-2) with the Internal Revenue Service.⁵⁰ It is intended that employers also be required to provide copies of Form W-2c to affected employees.

The Secretary is directed to establish expedited procedures for the refund of any overpayment of taxes paid on excludable educational assistance provided in 1995 and 1996, including procedures for waiving the requirement that an employer obtain an employee's signature if the employer demonstrates to the satisfaction of the Secretary that any refund collected by the employer on behalf of the employee will be paid to the employee.

Because the exclusion is extended, no interest and penalties should be imposed if an employer failed to withhold income and employment taxes on excludable educational assistance or failed to report such educational assistance. Further, it is intended that the Secretary establish expedited procedures for refunding any interest and penalties relating to educational assistance previously paid.

Effective date

The provision is effective with respect to taxable years beginning after December 31, 1994, and before January 1, 1997.

⁵⁰Treasury regulation section 31.6051-1(c).

3. *Research and experimentation tax credit (sec. 1203 of the bill and sec. 41 of the Code)*

Present and prior law

General rule

Prior to July 1, 1995, section 41 of the Internal Revenue Code provided for a research tax credit equal to 20 percent of the amount by which a taxpayer's qualified research expenditures for a taxable year exceeded its base amount for that year. The research tax credit expired and does not apply to amounts paid or incurred after June 30, 1995.

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

Computation of allowable credit

Except for certain university basic research payments made by corporations, the research tax credit applies only to the extent that the taxpayer's qualified research expenditures for the current taxable year exceed its base amount. The base amount for the current year generally is computed by multiplying the taxpayer's "fixed-base percentage" by the average amount of the taxpayer's gross receipts for the four preceding years. If a taxpayer both incurred qualified research expenditures and had gross receipts during each of at least three years from 1984 through 1988, then its "fixed-base percentage" is the ratio that its total qualified research expenditures for the 1984–1988 period bears to its total gross receipts for that period (subject to a maximum ratio of .16). All other taxpayers (so-called "start-up firms") are assigned a fixed-base percentage of 3 percent.⁵¹

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

To prevent artificial increases in research expenditures by shifting expenditures among commonly controlled or otherwise related entities, research expenditures and gross receipts of the taxpayer

⁵¹The Omnibus Budget Reconciliation Act of 1993 included a special rule designed to gradually recompute a start-up firm's fixed-base percentage based on its actual research experience. Under this special rule, a start-up firm (i.e., any taxpayer that did not have gross receipts in at least three years during the 1984–1988 period) will be assigned a fixed-base percentage of 3 percent for each of its first five taxable years after 1993 in which it incurs qualified research expenditures. In the event that the research credit is extended beyond the scheduled June 30, 1995 expiration date, a start-up firm's fixed-base percentage for its sixth through tenth taxable years after 1993 in which it incurs qualified research expenditures will be a phased-in ratio based on its actual research experience. For all subsequent taxable years, the taxpayer's fixed-base percentage will be its actual ratio of qualified research expenditures to gross receipts for any five years selected by the taxpayer from its fifth through tenth taxable years after 1993 (sec. 41(c)(3)(B)).

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

Eligible expenditures

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

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

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

Relation to deduction

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

Reasons for change

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

Explanation of provision

The bill extends the research tax credit (including the university basic research credit) for the period July 1, 1996, through June 30, 1997.

The bill also expands the definition of “start-up firms” under section 41(c)(3)(B)(I) to include any firm if the first taxable year in which such firm had both gross receipts and qualified research expenses began after 1983.⁵²

In addition, the bill allows taxpayers to elect an alternative incremental research credit regime. If a taxpayer elects to be subject to this alternative regime, the taxpayer is assigned a three-tiered fixed-base percentage (that is lower than the fixed-base percentage otherwise applicable under present law) and the credit rate likewise is reduced. Under the alternative credit regime, a credit rate of 1.65 percent applies to the extent that a taxpayer’s current-year research expenses exceed a base amount computed by using a fixed-base percentage of 1 percent (i.e., the base amount equals 1 percent of the taxpayer’s average gross receipts for the four preceding years) but do not exceed a base amount computed by using a fixed-base percentage of 1.5 percent. A credit rate of 2.2 percent applies to the extent that a taxpayer’s current-year research expenses exceed a base amount computed by using a fixed-base percentage of 1.5 percent but do not exceed a base amount computed by using a fixed-base percentage of 2 percent. A credit rate of 2.75 percent applies to the extent that a taxpayer’s current-year research expenses exceed a base amount computed by using a fixed-base percentage of 2 percent. An election to be subject to this alternative incremental credit regime may be made only for a taxpayer’s first taxable year beginning after June 30, 1996, and such an election applies to that taxable year and all subsequent years unless revoked with the consent of the Secretary of the Treasury.

The bill also provides for a special rule for payments made to certain nonprofit research consortia. Under this special rule, 75 percent of amounts paid to a research consortium for qualified research is treated as qualified research expenses eligible for the research credit (rather than 65 percent under the present-law section 41(b)(3) rule governing contract research expenses) if (1) such research consortium is a tax-exempt organization that is described in

⁵²In applying the start-up firm rules, the test is whether a taxpayer, in fact, both incurred research expenses (which under the present-law rules would be qualified research expenses) and had gross receipts in a particular year, not whether the taxpayer claimed a research tax credit for that year.

section 501(c)(3) (other than a private foundation) or section 501(c)(6) and is organized and operated primarily to conduct scientific research, and (2) such qualified research is conducted by the consortium on behalf of the taxpayer and one or more persons not related to the taxpayer.

Effective date

Extension of the research tax credit is effective for expenditures paid or incurred during the period July 1, 1996, through June 30, 1997. The modification to the definition of “start-up firms” is effective for taxable years ending after June 30, 1996. Taxpayers may elect the alternative research credit regime (with lower fixed-base percentages and lower credit rates) for taxable years beginning after June 30, 1996. The rule that treats 75 percent of qualified research consortium payments as qualified research expenses is effective for taxable years beginning after June 30, 1996.

4. *Orphan drug tax credit (sec. 1204 of the bill and secs. 28 and 39 and new sec. 45C of the Code)*

Present and prior law

Prior to January 1, 1995, a 50-percent nonrefundable tax credit was allowed for qualified clinical testing expenses incurred in testing of certain drugs for rare diseases or conditions, generally referred to as “orphan drugs.” Qualified testing expenses are costs incurred to test an orphan drug after the drug has been approved for human testing by the Food and Drug Administration (FDA) but before the drug has been approved for sale by the FDA. A rare disease or condition is defined as one that (1) affects less than 200,000 persons in the United States, or (2) affects more than 200,000 persons, but for which there is no reasonable expectation that businesses could recoup the costs of developing a drug for such disease or condition from U.S. sales of the drug. These rare diseases and conditions include Huntington’s disease, myoclonus, ALS (Lou Gehrig’s disease), Tourette’s syndrome, and Duchenne’s dystrophy (a form of muscular dystrophy).

Under prior law, the orphan drug tax credit could be claimed by a taxpayer only to the extent that its regular tax liability for the year the credit was earned exceeded its tentative minimum tax for that year, after regular tax was reduced by nonrefundable personal credits and the foreign tax credit.⁵³ Unused credits could not be carried back or carried forward to reduce taxes in other years.

The orphan drug tax credit expired after December 31, 1994.

Reasons for change

The Committee believes that it is appropriate to reinstate the orphan drug tax credit.

⁵³To the extent that the orphan drug tax credit could not be used by reason of the minimum tax limitation, the taxpayer’s minimum tax credit was increased (sec. 53(d)(1)(B)(iii)).

Explanation of provision

The bill extends the orphan drug tax credit for the period July 1, 1996, through June 30, 1997.

In addition, the bill allows taxpayers to carry back unused credits to three years preceding the year the credit is earned and to carry forward unused credits to 15 years following the year the credit is earned.

Effective date

The provision applies to qualified clinical testing expenses paid or incurred during the period July 1, 1996, through June 30, 1997. The provision allowing for the carry back and carry forward of unused credits is effective for taxable years ending after June 30, 1996. No portion of the unused business credit that is attributable to the orphan drug credit may be carried back under section 39 to a taxable year ending before July 1, 1996.

5. Contributions of stock to private foundations (sec. 1205 of the bill and sec. 173(e)(5) of the Code)

Present and prior 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.⁵⁴ However, in the case of a charitable contribution of short-term gain, inventory, or other ordinary income property, the amount of the deduction generally is limited to the taxpayer's basis in the property. In the case of a charitable contribution of tangible personal property, the deduction is limited to the taxpayer's basis in such property if the use by the recipient charitable organization is unrelated to the organization's tax-exempt purpose.⁵⁵

In cases involving contributions to a private foundation (other than certain private operating foundations), the amount of the deduction is limited to the taxpayer's basis in the property. However, under a special rule contained in section 170(e)(5), taxpayers were allowed a deduction equal to the fair market value of "qualified appreciated stock" contributed to a private foundation prior to January 1, 1995. Qualified appreciated stock was defined as publicly traded stock which is capital gain property. The fair-market-value deduction for qualified appreciated stock donations applied only to the extent that total donations made by the donor to private foundations of stock in a particular corporation did not exceed 10 percent of the outstanding stock of that corporation. For this purpose,

⁵⁴The 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)).

⁵⁵As part of the Omnibus Budget Reconciliation Act of 1993, Congress eliminated the treatment of contributions of appreciated property (real, personal, and intangible) as a tax preference for alternative minimum tax (AMT) purposes. Thus, if a taxpayer makes a gift to charity of property (other than short-term gain, inventory, or other ordinary income property, or gifts to private foundations) that is real property, intangible property, or tangible personal property the use of which is related to the donee's tax-exempt purpose, the taxpayer is allowed to claim the same fair-market-value deduction for both regular tax and AMT purposes (subject to present-law percentage limitations).

an individual was treated as making all contributions that were made by any member of the individual's family. This special rule contained in section 170(e)(5) expired after December 31, 1994.

Reasons for change

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

Explanation of provision

The bill extends the special rule contained in section 170(e)(5) for contributions of qualified appreciated stock made to private foundations for contributions made during the period July 1, 1996, through June 30, 1997.⁵⁶

Effective date

The provision is effective for contributions of qualified appreciated stock to private foundations made during the period July 1, 1996, through June 30, 1997.

6. *Tax credit for producing fuel from a nonconventional source (sec. 1206 of the bill and sec. 29 of the Code)*

Present law

Certain fuels produced from "nonconventional sources" and sold to unrelated parties are eligible for an income tax credit equal to \$3 (generally adjusted for inflation) per barrel or BTU oil barrel equivalent (sec. 29) (referred to as the "section 29 credit"). Qualified fuels must be produced within the United States. Qualified fuels include:

- (1) oil produced from shale and tar sands;
- (2) gas produced from geopressured brine, Devonian shale, coal seams, tight formations ("tight sands"), or biomass; and
- (3) liquid, gaseous, or solid synthetic fuels produced from coal (including lignite).

In general, the credit is available only with respect to fuels produced from wells drilled or facilities placed in service after December 31, 1979, and before January 1, 1993. An exception extends the January 1, 1993 expiration date for facilities producing gas from biomass and synthetic fuel from coal if the facility producing the fuel is placed in service before January 1, 1997, pursuant to a binding contract entered into before January 1, 1996.

The credit may be claimed for qualified fuels produced and sold before January 1, 2003 (in the case of nonconventional sources subject to the January 1, 1993 expiration date) or January 1, 2008 (in the case of biomass gas and synthetic fuel facilities eligible for the extension period).

⁵⁶ If, during this period, a taxpayer contributes qualified appreciated stock as defined in section 170(e)(5) and the amount of such contribution exceeds the percentage limitation under section 170(b)(1)(D), the excess may be carried over to succeeding taxable years. See, e.g., LTR 9444029, LTR 9424020.

Reasons for change

The Committee believes that a short-term extension of the section 29 credit is appropriate to allow projects currently in negotiation or under development to be placed in service in a more orderly manner than is possible under the present-law scheduled expiration.

Explanation of provision

The binding contract date for facilities producing synthetic fuels from coal and gas from biomass is extended until the date which is six months after the date of the provision's enactment, and the placed in service date is extended for one year. The present sunset on production qualifying for the credit is not changed. Under the provision, synthetic fuels from coal and gas from biomass produced from a facility placed in service before January 1, 1998, pursuant to a binding contract entered into before the date which is six months after the date of the provision's enactment, will be eligible for the tax credit if produced before January 1, 2008.

Effective date

The provision is effective upon enactment.

7. *Suspend imposition of diesel fuel tax on recreational motorboats (sec. 1207 of the bill and sec. 6427 of the Code)*

Present law

Diesel fuel used in recreational motorboats is subject to a 24.4 cents-per-gallon excise tax through December 31, 1999. This tax was enacted by the Omnibus Budget Reconciliation Act of 1993 as a revenue offset for repeal of the excise tax on certain luxury boats.

The diesel fuel tax is imposed on removal of the fuel from a registered terminal facility (i.e., at the "terminal rack"). Present law provides that tax is imposed on all diesel fuel removed from terminal facilities unless the fuel is destined for a nontaxable use and is indelibly dyed pursuant to Treasury Department regulations. If fuel on which tax is paid at the terminal rack (i.e., undyed diesel fuel) ultimately is used in a nontaxable use, a refund is allowed. Depending on the aggregate amount of tax to be refunded, this refund may be claimed either by a direct filing with the Internal Revenue Service or as a credit against income tax.

Dyed diesel fuel (fuel on which no tax is paid) may not be used in a taxable use. Present law imposes a penalty equal to the greater of \$10 per gallon or \$1,000 on persons found to be violating this prohibition.

Reasons for change

The Committee understands that market conditions in the marine industry have produced shortages of diesel fuel for recreational boat use in some areas. This is reported to have occurred because some marinas primarily serve commercial vessels that burn nontaxable, dyed diesel fuel, and have resisted installing supplemental fuel tanks for the taxable, undyed diesel fuel required for rec-

reational boats. The Committee believes, therefore, that a temporary suspension of this tax is appropriate to allow review of possible alternative collection regimes, and to allow marinas additional time in which to adapt to the requirements of the present-law rules, if satisfactory alternatives are not found.

Explanation of provision

No tax will be imposed on diesel fuel used in recreational motorboats during the period July 1, 1996, through June 30, 1997.

This exemption will temporarily address current supply problems. The Committee requests the Treasury Department to study possible alternatives to the current collection regime for motorboat diesel fuel that will provide comparable compliance with the law, and to report to the Senate Committee on Ways and Means and the Senate Committee on Finance no later than April 1, 1997.

Effective date

The provision is effective on July 1, 1996.

C. PROVISIONS RELATING TO S CORPORATIONS

1. S corporations permitted to have 75 shareholders (sec. 1301 of the bill and sec. 1361 of the Code)

Present law

The taxable income or loss of an S corporation is taken into account by the corporation's shareholders, rather than by the entity, whether or not such income is distributed. A small business corporation may elect to be treated as an S corporation. A "small business corporation" is defined as a domestic corporation which is not an ineligible corporation and which does not have (1) more than 35 shareholders, (2) as a shareholder, a person (other than certain trusts or estates) who is not an individual, (3) a nonresident alien as a shareholder, and (4) more than one class of stock. For purposes of the 35-shareholder limitation, a husband and wife are treated as one shareholder.

Reasons for change

The Committee believes that increasing the maximum number of shareholders of an S corporation will facilitate corporate ownership by additional family members, employees and capital investors.

Explanation of provision

The provision increases the maximum number of shareholders from 35 to 75.

Effective date

The provision applies to taxable years beginning after December 31, 1996.

2. *Electing small business trusts (sec. 1302 of the bill and sec. 1361 of the Code)*

Present law

Under present law, trusts other than grantor trusts, voting trusts, certain testamentary trusts and “qualified subchapter S trusts” may not be shareholders in an S corporation. A “qualified subchapter S trust” is a trust which, under its terms, (1) is required to have only one current income beneficiary (for life), (2) any corpus distributed during the life of the beneficiary must be distributed to the beneficiary, (3) the beneficiary’s income interest must terminate at the earlier of the beneficiary’s death or the termination of the trust, and (4) if the trust terminates during the beneficiary’s life, the trust assets must be distributed to the beneficiary. All the income (as defined for local law purposes) must be currently distributed to that beneficiary. The beneficiary is treated as the owner of the portion of the trust consisting of the stock in the S corporation.

Reasons for change

The Committee believes that a trust that provides for income to be distributed to (or accumulated for) a class of individuals should be allowed to hold S corporation stock. This would allow an individual to establish a trust to hold S corporation stock and “spray” income among family members (or others) who are beneficiaries of the trust. The Committee believes allowing such an arrangement will facilitate family financial planning.

Explanation of provision

In general

The provision allows stock in an S corporation to be held by certain trusts (“electing small business trusts”). In order to qualify for this treatment, all beneficiaries of the trust must be individuals or estates eligible to be S corporation shareholders, except that charitable organizations may hold contingent remainder interests.⁵⁷ No interest in the trust may be acquired by purchase. For this purpose, “purchase” means any acquisition of property with a cost basis (determined under sec. 1012). Thus, interests in the trust must be acquired by reason of gift, bequest, etc.

A trust must elect to be treated as an electing small business trust. An election applies to the taxable year for which made and could be revoked only with the consent of the Secretary of the Treasury or his delegate.

Each potential current beneficiary of the trust is counted as a shareholder for purposes of the proposed 75 shareholder limitation (or if there were no potential current beneficiaries, the trust would be treated as the shareholder). A potential current income beneficiary means any person, with respect to the applicable period, who is entitled to, or at the discretion of any person may receive,

⁵⁷For taxable years beginning after 1997, charitable organizations may hold current interests in a trust.

a distribution from the principal or income of the trust. Where the trust disposes of all the stock in an S corporation, any person who first became so eligible during the 60 days before the disposition is not treated as a potential current beneficiary.

A qualified subchapter S trust with respect to which an election is in effect or an exempt trust is not eligible to qualify as an electing small business trust.

Treatment of items relating to S corporation stock

The portion of the trust which consists of stock in one or more S corporations is treated as a separate trust for purposes of computing the income tax attributable to the S corporation stock held by the trust. The trust is taxed at the highest individual rate (currently, 39.6 percent on ordinary income and 28 percent on net capital gain) on this portion of the trust's income. The taxable income attributable to this portion includes (1) the items of income, loss, or deduction allocated to it as an S corporation shareholder under the rules of subchapter S, (2) gain or loss from the sale of the S corporation stock, and (3) to the extent provided in regulations, any state or local income taxes and administrative expenses of the trust properly allocable to the S corporation stock. Otherwise allowable capital losses are allowed only to the extent of capital gains.

In computing the trust's income tax on this portion of the trust, no deduction is allowed for amounts distributed to beneficiaries, and no deduction or credit is allowed for any item other than the items described above. This income is not included in the distributable net income of the trust, and thus is not included in the beneficiaries' income. No item relating to the S corporation stock could be apportioned to any beneficiary.

On the termination of all or any portion of an electing small business trust the loss carryovers or excess deductions referred to in section 642(h) is taken into account by the entire trust, subject to the usual rules on termination of the entire trust.

Treatment of remainder of items held by trust

In determining the tax liability with regard to the remaining portion of the trust, the items taken into account by the subchapter S portion of the trust are disregarded. Although distributions from the trust are deductible in computing the taxable income on this portion of the trust, under the usual rules of subchapter J, the trust's distributable net income does not include any income attributable to the S corporation stock.

Termination of trust and conforming amendment applicable to all trusts

Where the trust terminates before the end of the S corporation's taxable year, the trust takes into account its pro rata share of S corporation items for its final year. The provision makes a conforming amendment applicable to all trusts and estates clarifying that this is the present-law treatment of trusts and estates that terminate before the end of the S corporation's taxable year.

Effective date

The provision applies to taxable years beginning after December 31, 1996.

3. *Expansion of post-death qualification for certain trusts (sec. 1303 of the bill and sec. 1361 of the Code)*

Present law

Under present law, trusts other than grantor trusts, voting trusts, certain testamentary trusts and “qualified subchapter S trusts” may not be shareholders in an S corporation. A grantor trust may remain an S corporation shareholder for 60 days after the death of the grantor. The 60-day period is extended to 2 years if the entire corpus of the trust is includible in the gross estate of the deemed owner. In addition, a trust may be an S corporation shareholder for 60 days after the transfer of the S corporation stock pursuant to a will.

Reasons for change

The Committee believes that the 60-day holding period applicable to certain testamentary trusts should be expanded to facilitate estate administration.

Explanation of provision

The provision expands the post-death holding period to 2 years for all testamentary trusts.

Effective date

The provision applies to taxable years beginning after December 31, 1996.

4. *Financial institutions permitted to hold safe harbor debt (sec. 1304 of the bill and sec. 1361 of the Code)*

Present law

A small business corporation eligible to be an S corporation may not have more than one class of stock. Certain debt (“straight debt”) is not treated as a second class of stock so long as such debt is an unconditional promise to pay on demand or on a specified date a sum certain in money if: (1) the interest rate (and interest payment dates) are not contingent on profits, the borrower’s discretion, or similar factors; (2) there is no convertibility (directly or indirectly) into stock, and (3) the creditor is an individual (other than a nonresident alien), an estate, or certain qualified trusts.

Reasons for change

The Committee believes that bona fide debt that is held by a financial institution should be able to satisfy the “straight debt” safe harbor.

Explanation of provision

The definition of “straight debt” is expanded to include debt held by creditors, other than individuals, that are actively and regularly engaged in the business of lending money.

Effective date

The provision applies to taxable years beginning after December 31, 1996.

5. *Rules relating to inadvertent terminations and invalid elections (sec. 1305 of the bill and sec. 1362 of the Code)*

Present law

Under present law, if the Internal Revenue Service (“IRS”) determines that a corporation’s Subchapter S election is inadvertently terminated, the IRS 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. Such waivers generally are obtained through the issuance of a private letter ruling. Present law does not grant the IRS 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 IRS may not validate a late election.

Reasons for change

The Committee believes that the Secretary of the Treasury should have the same authority to validate inadvertently defective subchapter S elections as it has for inadvertent subchapter S terminations.

Explanation of provision

Under the provision, the authority of the IRS to waive the effect of an inadvertent termination is extended to allow the IRS 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 provision also allows the IRS to treat a late Subchapter S election as timely where the IRS determines that there was reasonable cause for the failure to make the election timely. The IRS may exercise this authority in cases where the taxpayer never filed an election. It is intended that the IRS be reasonable in exercising this authority and apply standards that are similar to those applied under present law to inadvertent subchapter S terminations and other late or invalid elections.

Effective date

The provision applies to taxable years beginning after December 31, 1982.⁵⁸

6. *Agreement to terminate year (sec. 1306 of the bill and sec. 1377 of the Code)*

Present law

In general, each item of S corporation income, deduction and loss is allocated to shareholders on a per-share, per-day basis. However, if any shareholder terminates his or her interest in an S corporation during a taxable year, the S corporation, with the consent of all its shareholders, may elect to allocate S corporation items by closing its books as of the date of such termination rather than applying the per-share, per-day rule.

Reasons for change

The Committee believes that the election to close the books of an S corporation does not need the consent of shareholders whose tax liability is unaffected by the election.

Explanation of provision

The provision provides that, under regulations to be prescribed by the Secretary of the Treasury, the election to close the books of the S corporation upon the termination of a shareholder's interest is made by all affected shareholders and the corporation, rather than by all shareholders. The closing of the books applies only to the affected shareholders. For this purpose, "affected shareholders" means any shareholder whose interest is terminated and all shareholders to whom such shareholder has transferred shares during the year. If a shareholder transferred shares to the corporation, "affected shareholders" includes all persons who were shareholders during the year.

Effective date

The provision applies to taxable years beginning after December 31, 1996.

7. *Expansion of post-termination transition period (sec. 1307 of the bill and secs. 1377 and 6037 of the Code)*

Present law

Distributions made by a former S corporation during its post-termination transition period are treated in the same manner as if the distributions were made by an S corporation (e.g., treated by shareholders as nontaxable distributions to the extent of the accumulated adjustment account). Distributions made after the post-termination transition period are generally treated as made by a C corporation (i.e., treated by shareholders as taxable dividends to the extent of earnings and profits).

⁵⁸This is the effective date of the present-law provision regarding inadvertent terminations.

The “post-termination transition period” is the period beginning on the day after the last day of the last taxable year of the S corporation and ending on the later of: (1) a date that is one year later, or (2) the due date for filing the return for the last taxable year and the 120-day period beginning on the date of a determination that the corporation’s S corporation election had terminated for a previous taxable year.

In addition, the audit procedures adopted by the Tax Equity and Fiscal Responsibility Act of 1982 (“TEFRA”) with respect to partnerships also apply to S corporations. Thus, the tax treatment of items is determined at the corporate, rather than individual level.

Reasons for change

The Committee believes that the current scope of the “post-termination transition period” is insufficient under present law. In addition, the Committee believes that the TEFRA audit procedures should be inapplicable to entities with a limited number of owners.

Explanation of provision

The present-law definition of “post-termination transition period” is expanded to include the 120-day period beginning on the date of any determination pursuant to an audit of the taxpayer that follows the termination of the S corporation’s election and that adjusts a subchapter S item of income, loss or deduction of the S corporation during the S period. In addition, the definition of “determination” is expanded to include a final disposition of the Secretary of the Treasury of a claim for refund and, under regulations, certain agreements between the Secretary and any person, relating to the tax liability of the person.

In addition, the provision repeals the TEFRA audit provisions applicable to S corporations and would provide other rules to require consistency between the returns of the S corporation and its shareholders.

Effective date

The provision applies to taxable years beginning after December 31, 1996.

8. *S corporations permitted to hold subsidiaries (sec. 1308 of the bill and secs. 1361 and 1362 of the Code)*

Present law

A small business corporation may not be a member of an affiliated group of corporations (other than by reason of ownership in certain inactive corporations). Thus, an S corporation may not own 80 percent or more of the stock of another corporation (whether an S corporation or a C corporation).

In addition, a small business corporation may not have as a shareholder another corporation (whether an S corporation or a C corporation).

Reasons for change

The Committee understands that there are situations where taxpayers may wish to separate different trades or businesses in different corporate entities. The Committee believes that, in such situations, shareholders should be allowed to arrange these separate corporate entities under parent-subsidary arrangements as well as brother-sister arrangements.

Explanation of provision

C corporation subsidiaries

An S corporation is allowed to own 80 percent or more of the stock of a C corporation. The C corporation subsidiary could elect to join in the filing of a consolidated return with its affiliated C corporations. An S corporation is not allowed to join in such election. Dividends received by an S corporation from a C corporation in which the S corporation has an 80 percent or greater ownership stake are not treated as passive investment income for purposes of sections 1362 and 1375 to the extent the dividends are attributable to the earnings and profits of the C corporation derived from the active conduct of a trade or business.

S corporation subsidiaries

In addition, an S corporation is allowed to own a qualified subchapter S subsidiary. The term "qualified subchapter S subsidiary" means a domestic corporation that is not an ineligible corporation (i.e., a corporation that would be eligible to be an S corporation if the stock of the corporation were held directly by the shareholders of its parent S corporation) if (1) 100 percent of the stock of the subsidiary were held by its S corporation parent and (2) the parent elects to treat the subsidiary as a qualified subchapter S subsidiary. If a subsidiary ceases to be a qualified subchapter S subsidiary (either because the subsidiary fails to qualify or the parent revokes the election) another such election may not be made for the subsidiary by the parent for five years without the consent of the Secretary of the Treasury.

Under the election, the qualified subchapter S subsidiary is not treated as a separate corporation and all the assets, liabilities, and items of income, deduction, loss, and credit of the subsidiary are treated as the assets, liabilities, and items of income, deduction, loss, and credit of the parent S corporation. Thus, transactions between the S corporation parent and qualified subchapter S subsidiary are not taken into account and items of the subsidiary (including accumulated earnings and profits, passive investment income, built-in gains, etc.) are considered to be items of the parent. In addition, if a subsidiary ceases to be a qualified subchapter S subsidiary (e.g., fails to meet the wholly-owned requirement), the subsidiary will be treated as a new corporation acquiring all of its assets (and assuming all of its liabilities) immediately before such cessation from the parent S corporation in exchange for its stock.⁵⁹

⁵⁹ Similar rules apply with respect to wholly owned subsidiaries of real estate investment trusts ("REITs") under section 856(i) of present law.

Under the provision, if an election is made to treat an existing corporation (whether or not its stock was acquired from another person or previously held by the S corporation) as a qualified subchapter S subsidiary, the subsidiary will be deemed to have liquidated under sections 332 and 337 immediately before the election is effective. The built-in gains tax under section 1374 and the LIFO recapture tax under section 1363(d) may apply where the subsidiary was previously a C corporation. Where the stock of the subsidiary was acquired by the S corporation in a qualified stock purchase, an election under section 338 with respect to the subsidiary may be made.

Because the parent and each subsidiary corporation that is a qualified subchapter S subsidiary are treated for Federal income tax purposes as a single corporation, debt issued by a subsidiary to a shareholder of the parent corporation will be treated as debt of the parent for purposes of determining the amount of losses that may flow through to shareholders of the parent corporation under section 1366(d)(1)(B). The Secretary of the Treasury may prescribe rules as to the order that losses pass through where debt of both the parent and subsidiary corporations are held by shareholders of the parent. To the extent a shareholder of the parent S corporation is not at-risk with respect to losses of a subsidiary, the at-risk rules of section 465 may cause losses of the subsidiary to be suspended.

Effective date

The provision applies to taxable years beginning after December 31, 1996.

9. Treatment of distributions during loss years (sec. 1309 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 the shareholder's adjusted basis in his or her stock of the corporation 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 property.

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 require that the adjustments to basis for items of both income and loss for any taxable year apply before the adjustment for distributions applies.⁶⁰

These rules limiting losses and allowing tax-free distributions up to the amount of the shareholder's adjusted basis are similar in

⁶⁰See section 1368(d)(1); H. Rept. 97-826, p. 17; S. Rept. 97-640, p. 18; Treas. reg. sec. 1.1367-1(e).

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.⁶¹

In addition, if the S corporation has accumulated earnings and profits,⁶² 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 Committee believes that the rules regarding the treatment of distributions by S corporations during loss years should be the same as the rules applicable to partnerships.

Explanation of provision

The provision 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 provision 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 adjustments (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 corporation A, a calendar year S corporation with no accumulated earnings and profits. X's adjusted basis in the stock of A on January 1, 1998, is \$1,000 and X holds no debt of A. During 1998, A makes a distribution to X of \$600, recognizes a capital gain of \$200 and sustains an operating loss of \$900. Under the provision, 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).

⁶¹Treas. reg. sec. 1.704-1(d)(2); Rev. Rul. 66-94, 1966-1 C.B. 166.

⁶²An S corporation may have earnings and profits from years prior to its subchapter S election or from pre-1983 subchapter S years.

Example 2.—The facts are the same as in Example 1, except that on January 1, 1998, A has accumulated earnings and profits of \$500 and an accumulated adjustments account of \$200. Under the provision, 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, 1999, of \$700 (zero plus \$200 less \$900).

As to X, \$200 of the distribution is applied against X's adjusted basis 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, 1999, is \$100 (\$1,000 plus \$200 less \$200 less \$900).

Effective date

The provision applies to taxable years beginning after December 31, 1996.

10. Treatment of S corporations under subchapter C (sec. 1310 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)). In 1988, the IRS took 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.⁶³ In 1992, the IRS reversed its position, stating that the prior ruling was incorrect.⁶⁴

Reasons for change

The Committee wishes to clarify that the position taken by the IRS in 1992 that allows the tax-free liquidation of a C corporation into an S corporation represents the proper policy.

Explanation of provision

The provision repeals the rule that treats an S corporation in its capacity as a shareholder of another corporation as an individual. Thus, the provision clarifies that 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 also will be eligible to make a section 338 election (assuming all the requirements are otherwise met), resulting 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.

Effective date

The provision applies to taxable years beginning after December 31, 1996.

11. Elimination of certain earnings and profits (sec. 1311 of the bill and secs. 1362 and 1375 of the Code)

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 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 or her income the accumulated earnings and profits when it is distributed by the corporation. The 1982 revision to subchapter S repealed this rule for earnings

⁶³ PLR 8818049 (Feb. 10, 1988).

⁶⁴ PLR 9245004, (July 28, 1992).

attributable to taxable years beginning after 1982 but did not do so for previously accumulated S corporation earnings and profits.

Reasons for change

The Committee believes that the existence of pre-1983 earnings and profits of an S corporation unnecessarily complicates corporate recordkeeping and constitutes a potential trap for the unwary.

Explanation of provision

The provision provides that if a corporation is an S corporation for its first taxable year beginning after December 31, 1996, the accumulated earnings and profits of the corporation as of the beginning of that year is 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 are 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 or her share of the taxable income of the S corporation.

Effective date

The provision applies to taxable years beginning after December 31, 1996.

12. *Carryover of disallowed losses and deductions under at-risk rules allowed (sec. 1312 of the bill and sec. 1366 of the Code)*

Present law

Under section 1366, the amount of loss an S corporation shareholder may take into account cannot exceed the sum of the shareholder's adjusted basis in his or her stock of the corporation and the unadjusted basis in any indebtedness of the corporation to the shareholder. Any disallowed loss is carried forward to the next taxable year. Any loss that is disallowed for the last taxable year of the S corporation may be carried forward to the post-termination transition period. The "post-termination transition period" is the period beginning on the day after the last day of the last taxable year of the S corporation and ending on the later of: (1) a date that is one year later, or (2) the due date for filing the return for the last taxable year and the 120-day period beginning on the date of a determination that the corporation's S corporation election had terminated for a previous taxable year.

In addition, under section 465, a shareholder of an S corporation may not deduct losses that are flowed through from the corporation to the extent the shareholder is not "at-risk" with respect to the loss. Any loss not deductible in one taxable year because of the at-risk rules is carried forward to the next taxable year.

Reasons for change

The Committee believes that losses suspended by the at-risk rules should be conformed to the treatment of losses suspended by the subchapter S basis rules.

Explanation of provision

Losses of an S corporation that are suspended under the at-risk rules of section 465 are carried forward to the S corporation's post-termination transition period.

Effective date

The provision applies to taxable years beginning after December 31, 1996.

13. *Adjustments to basis of inherited S stock to reflect certain items of income (sec. 1313 of the bill and sec. 1367 of the Code)*

Present law

Income in respect to a decedent ("IRD") generally consists of items of gross income that accrued during the decedent's lifetime but were not includible in the decedent's income before his or her death under his or her 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 such person (sec. 691(c)). The cost or 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 is often 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 (Treas. reg. sec. 1.742-1). This rule insures that the items of IRD held by a partnership are not later offset by a loss arising from a stepped-up basis. Although an S corporation and its shareholders generally are taxed in a manner similar to the taxation of a partnership and its partners, no comparable regulation requires a reduction in the basis of stock in an S corporation acquired from a decedent where the S corporation holds items of IRD.

Reasons for change

The Committee believes that the present-law treatment of IRD items of an S corporation is unclear and that the treatment of such items should be similar to the treatment of identical items held by a partnership.

Explanation of provision

The provision provides that a person acquiring stock in an S corporation from a decedent would treat as IRD his or her pro rata

share of any item of income of the corporation that would have been IRD if that item had been acquired directly from the decedent. Where an 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 in an S corporation acquired from a decedent is 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.

Effective date

The provision applies with respect to decedents dying after the date of enactment.

14. *S corporations eligible for rules applicable to real property subdivided for sale by noncorporate taxpayers (sec. 1314 of the bill and sec. 1237 of the Code)*

Present law

Under present-law section 1237, a lot or parcel of land held by a taxpayer other than a corporation generally is not treated as ordinary income property solely by reason of the land being subdivided if (1) such parcel had not previously been held as ordinary income property and if in the year of sale, the taxpayer did not hold other real property; (2) no substantial improvement has been made on the land by the taxpayer, a related party, a lessee, or a government; and (3) the land has been held by the taxpayer for five years.

Reasons for change

The Committee believes that rules generally applicable to individuals should be applicable to S corporations.

Explanation of provision

The provision allows the present-law capital gains presumption in the case of land held by an S corporation. It is expected that rules similar to the attribution rules for partnerships will apply to S corporation (Treas. reg. sec. 1.1237-1(b)(3)).

Effective date

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

15. *Certain financial institutions as eligible corporations (sec. 1315 of the bill and sec. 1361 of the Code)*

Present law

A small business corporation may elect to be treated as an S corporation. A "small business corporation" is defined as a domestic corporation which is not an ineligible corporation and which meets certain other requirements. An "ineligible corporation" means any corporation which is a member of an affiliated group, certain depos-

itory financial institutions (i.e., banks, domestic savings and loan associations, mutual savings banks, and certain cooperative banks), certain insurance companies, a section 936 corporation, or a DISC or former DISC.

Reasons for change

The Committee believes that any otherwise eligible corporation should be allowed to elect to be treated as an S corporation regardless of the type of trade or business conducted by the corporation, so long as special corporate tax benefits provided to such trades or businesses do not flow through to individual taxpayers.

Explanation of provision

A bank (as defined in sec. 581) is allowed to be an eligible small business corporation unless such institution uses a reserve method of accounting for bad debts. Thus, a large bank (as defined by sec. 585(c)(2)) that meets all the subchapter S eligibility requirements may elect to be treated as an S corporation. An otherwise qualified small bank may elect to be treated as an S corporation if it uses the specific charge-off method of section 166 to account for its bad debts.

Effective date

The provision applies to taxable years beginning after December 31, 1996.

16. *Certain tax-exempt entities allowed to be shareholders (sec. 1316 of the bill and secs. 404, 512, 1042, and 1361 of the Code)*

Present law

A small business corporation may elect to be treated as an S corporation. A “small business corporation” is defined as a domestic corporation which is not an ineligible corporation and which does not have (1) more than 35 shareholders; (2) as a shareholder, a person (other than certain trusts or estates) who is not an individual; (3) a nonresident alien as a shareholder; and (4) more than one class of stock. Thus, a tax-exempt organization described in section 401(a) (relating to qualified retirement plan trusts) or section 501(c)(3) (relating to certain charitable organizations) cannot be a shareholder in an S corporation.

A tax-exempt organization may be a partner in a partnership. If the partnership carries on a trade or business that is an unrelated trade or business with respect to the tax-exempt organization, the tax-exempt partner is required to include its distributed share of income from such trade or business as unrelated business taxable income (“UBTI”) (sec. 512(c)).

Reasons for change

The Committee believes that the present-law prohibition of certain tax-exempt organizations being S corporation shareholders may inhibit employee ownership of closely-held businesses, frustrate estate planning, discourage charitable giving, and restrict

sources of capital for closely-held businesses. The Committee seeks to lift these barriers by allowing certain tax-exempt organizations to be shareholders in S corporations. However, the provisions of subchapter S were enacted in 1958 and substantially modified in 1982 on the premise that all income of the S corporation (including all gains on the sale of the stock) would be subject to a shareholder-level income tax. This underlying premise allows the rules governing S corporations to be relatively simple (in contrast, for example, to the partnership rules of subchapter K) because of the lack of concern about “transferring” income to non-taxpaying persons. Consistent with this underlying premise of subchapter S, the provision treats all the income flowing through to a tax-exempt shareholder, and gains and losses from the disposition of the stock, as unrelated business taxable income.

Explanation of provision

Tax-exempt organizations described in Code sections 401(a) and 501(c)(3) (“qualified tax-exempt shareholders”) are allowed to be shareholders in S corporations. For purposes of determining the number of shareholders of an S corporation, a qualified tax-exempt shareholder will count as one shareholder.

Items of income or loss of an S corporation will flow-through to qualified tax-exempt shareholders as UBTI, regardless of the source or nature of such income (e.g., passive income of an S corporation will flow through to the qualified tax-exempt shareholders as UBTI.) In addition, gain or loss on the sale or other disposition of stock of an S corporation by a qualified tax-exempt shareholder will be treated as UBTI. If a qualified tax-exempt shareholder has gain on the sale of the stock in a C corporation that once was an S corporation while held by the shareholder, the tax-exempt shareholder will treat as UBTI the amount of gain that the shareholder would have recognized had it sold the stock for its fair market value as of the last day of the corporation’s last taxable year as an S corporation.

In addition, certain special tax rules relating to employee stock ownership plans (“ESOPs”) will not apply with respect to S corporation stock held by the ESOP. These rules include rules relating to certain contributions to ESOPs (sec. 404(a)(9)), the deduction for dividends paid on employer securities (sec. 404(k)), and the rollover of gain on the sale of stock to an ESOP (sec. 1042).

Effective date

The provision applies to taxable years beginning after December 31, 1997.

17. *Reelection of subchapter S status (sec. 1317(b) of the bill and sec. 1362 of the Code)*

Present law

A small business corporation that terminates its subchapter S election (whether by revocation or otherwise) may not make another election to be an S corporation for five taxable years unless the Secretary of the Treasury consents to such election.

Reasons for change

The Committee believes that, given the changes made by the Committee to subchapter S, it is appropriate to allow corporations that terminated their elections under subchapter S within the last five years to re-elect subchapter S status without requiring the consent of the Secretary.

Explanation of provision

For purposes of the five-year rule, any termination of subchapter S status in effect immediately before the date of enactment of the provision is not to be taken into account. Thus, any small business corporation that had terminated its S corporation election within the five-year period before the date of enactment may re-elect subchapter S status upon enactment of the provision without the consent of the Secretary of the Treasury.

Effective date

The provision is effective for terminations occurring in a taxable year beginning before January 1, 1997.

PENSION SIMPLIFICATION PROVISIONS

A. SIMPLIFIED DISTRIBUTION RULES (SECS. 1401–1404 OF THE BILL AND SECS. 72(D), 101(B), 401(A)(9), AND 402(D) OF THE CODE)

Present law

In general, a distribution of benefits from a tax-favored retirement arrangement (i.e., a qualified plan, a qualified annuity plan, and a tax-sheltered annuity contract (sec. 403(b) annuity)) generally is includible in gross income in the year it is paid or distributed under the rules relating to the taxation of annuities.

Lump-sum distributions

Lump-sum distributions from qualified plans and qualified annuity plans are eligible for special 5-year forward averaging. 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 first, on account of the death of the employee, second, after the employee attains age 59½, third, on account of the employee's separation from service, or fourth, in the case of self-employed individuals, on account of disability. Lump-sum treatment is not available for distributions from a tax-sheltered annuity.

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. In general, this election allows the taxpayer to pay a separate tax on the lump-sum distribution that approximates the tax that would be due if the lump-sum distribution were received in 5 equal installments. If the election is made, the taxpayer is entitled to deduct the amount of the lump-sum distribution from gross in-

come. Only one such election on or after age 59½ may be made with respect to any employee.

Under the Tax Reform Act of 1986 (the "1986 Act"), individuals who attained age 50 by January 1, 1986, can elect to use 10-year averaging (under the rates in effect prior to the 1986 Act) in lieu of 5-year averaging. In addition, such individuals may elect to retain capital gains treatment with respect to the pre-1974 portion of a lump sum distribution.

\$5,000 exclusion for 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

Amounts received as an annuity under a qualified plan 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). 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.

Under a simplified alternative method provided by the IRS, the taxable portion of qualifying annuity payments is determined under a simplified exclusion ratio method.

In no event can the total amount excluded from income as nontaxable return of basis be greater than the recipient's total investment in the contract.

Required distributions

Present law provides uniform minimum distribution rules generally applicable to all types of tax-favored retirement vehicles, including qualified plans and annuities, IRAs, and tax-sheltered annuities.

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 first, such April 1, or second, the April 1 of the year following the year in which the participant retires.

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) 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 (3) whether or not a portion of the distribution is excludable from income as a death benefit.

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.

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 in the Unemployment Compensation Amendments of 1992 increased taxpayers' ability to determine the time of the income inclusion of pension distributions, and eliminates the need for special rules such as 5-year forward income averaging to prevent bunching of income.

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. However, the accrued benefit of employees who retire after age 70½ generally should be actuarially increased to take into account the period after age 70½ in which the employee was not receiving benefits.

Explanation of provisions

Lump-sum distributions

The bill repeals 5-year averaging for lump-sum distributions from qualified plans. Thus, the bill repeals the separate tax paid on a lump-sum distribution and also repeals the deduction from gross income for taxpayers who elect to pay the separate tax on a lump-sum distribution. The bill preserves the transition rules adopted in the Tax Reform Act of 1986 (i.e., 10-year averaging and capital gains treatment for the pre-1974 portion of the lump-sum distribution), but not 5-year averaging, with respect to lump-sum distributions to individuals eligible for such transition rules.

\$5,000 exclusion for employer-provided death benefits

The bill repeals the \$5,000 exclusion for employer-provided death benefits.

Recovery of basis

The bill provides that basis recovery on payments from qualified plans generally is determined under a method similar to the present-law simplified alternative method provided by the IRS. The

portion of each annuity payment that represents a return of basis equals to the employee's total basis as of the annuity starting date, divided by the number of anticipated payments under the following table:

<i>Age</i>	<i>Number of Payments:</i>
Not more than 55	360
56-60	310
61-65	260
66-70	210
More than 70	160

Required distributions

The bill modifies the rule that requires all participants in qualified plans to commence distributions by age 70½ without regard to whether the participant is still employed by the employer and generally replaces it with the rule in effect prior to the Tax Reform Act of 1986. Under the bill, distributions generally are required to begin by April 1 of the calendar year following the later of first, the calendar year in which the employee attains age 70½ or second, the calendar year in which the employee retires. However, 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 70½.

In addition, in the case of an employee (other than a 5-percent owner) who retires in a calendar year after attaining age 70½, the bill generally requires the employee's accrued benefit to be actuarially increased to take into account the period after age 70½ 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 70½ 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 70½ does not apply, under the bill, in the case of a governmental plan or church plan.

Effective date

Lump-sum distributions

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

\$5,000 exclusion for employer-provided death benefits

The provision applies with respect to decedents dying after date of enactment.

Recovery of basis

The provision is effective with respect to annuity starting dates beginning 90 days after the date of enactment.

Required distributions

The provision is effective for years beginning after December 31, 1996. If a participant is currently receiving distributions, but does not have to under the provision, the Committee intends that a plan (or annuity contract) could (but would not be required to) permit the participant to stop receiving distributions until such distributions are required under the provision.

B. INCREASED ACCESS TO RETIREMENT SAVINGS PLANS

1. *Establish SIMPLE retirement plans for small employers (secs. 1421-1422 of the bill and secs. 401(k) and 408(p) of the Code)*

Present law

Present law does not contain rules relating to SIMPLE retirement plans. However, present law does provide a number of ways in which individuals can save for retirement on a tax-favored basis. These include employer-sponsored retirement plans that meet the requirements of the Internal Revenue Code (a "qualified plan") and individual retirement arrangements ("IRAs"). Employees can earn significant retirement benefits under employer-sponsored retirement plans. However, in order to receive tax-favored treatment, such plans must comply with a variety of rules, including complex nondiscrimination and administrative rules (including top-heavy rules). Such plans are also subject to certain requirements under the labor law provisions of the Employee Retirement Income Security Act of 1974 ("ERISA").

IRAs are not subject to the same rules as qualified plans, but the amount that can be contributed in any year is significantly less. The maximum deductible IRA contribution for a year is limited to \$2,000. Distributions from IRAs and employer-sponsored retirement plans are generally taxable when made. In addition, distributions prior to age 59½ generally are subject to an additional 10-percent early withdrawal tax.

Contributions to an IRA can also be made by an employer at the election of an employee under a salary reduction simplified employee pension ("SARSEP"). Under SARSEPs, which are not qualified plans, employees can elect to have contributions made to the SARSEP or to receive the contributions in cash. The amount the employee elects to have contributed to the SARSEP is not currently includible in income. The annual amount an employee can elect to contribute to a SARSEP is limited to \$9,500 for 1996. This dollar limit is indexed for inflation in \$500 increments. The election to have amounts contributed to a SARSEP or received in cash is available only if at least 50 percent of the eligible employees of the employer elect to have amounts contributed to the SARSEP. In addition, such election is available for a taxable year only if the employer maintaining the SARSEP had 25 or fewer eligible employees at all times during the prior taxable year. Elective deferrals under SARSEPs are subject to a special nondiscrimination test.

Under one type of qualified plan that can be maintained by an employer, employees can elect to reduce their taxable compensation and have nontaxable contributions made to the plan. Such contributions are called elective deferrals, and the plans which allow

such contributions are called qualified cash or deferred arrangements (or “401(k) plans”). Like SARSEPs, the maximum annual amount of elective deferrals that can be made by an individual is \$9,500 for 1996. A special nondiscrimination test applies to elective deferrals. An employer may make contributions based on an employee’s elective contributions. Such contributions are called matching contributions, and are subject to a special nondiscrimination test similar to the special nondiscrimination test applicable to elective deferrals.

Reasons for Change

Retirement plan coverage is lower among small employers than among medium and large employers. The Committee believes that one of the reasons small employers do not establish tax-qualified retirement plans is the complexity of rules relating to such plans and the cost of complying with such rules. The Committee believes it is appropriate to encourage small employers to adopt retirement plans by providing a simplified retirement plan that is not subject to the complex rules applicable to tax-qualified plans.

Among the rules applicable to tax-qualified plans are nondiscrimination rules that help to ensure that plans cover a broad range of employees, not just an employer’s highly compensated employees. The Committee believes that the goal of the nondiscrimination rules, broad pension coverage, is an important one. Unfortunately, the complicated nature of these rules may prevent small employers from establishing any plan. The Committee believes that the purposes of the nondiscrimination rules will be served in the case of small employers if all full-time employees are given the opportunity to participate in the plan, the employer is required to match employee contributions, and there are limits on the total contributions that can be made.

The Committee believes that employees should be encouraged to save for retirement, and thus believes a penalty should be imposed on amounts withdrawn within a short period after the retirement plan is adopted.

Explanation of provision

In general

The bill creates a simplified retirement plan for small business called the savings incentive match plan for employees (“SIMPLE”) retirement plan. SIMPLE plans can be adopted by employers who employed 100 or fewer employees earning at least \$5,000 in compensation for the preceding year and who do not maintain another employer-sponsored retirement plan. A SIMPLE plan can be either an IRA for each employee or part of a qualified cash or deferred arrangement (“401(k) plan”). If established in IRA form, a SIMPLE plan is not subject to the nondiscrimination rules generally applicable to qualified plans (including the top-heavy rules) and simplified reporting requirements apply. Within limits, contributions to a SIMPLE plan are not taxable until withdrawn.

A SIMPLE plan can also be adopted as part of a 401(k) plan. In that case, the plan does not have to satisfy the special non-

discrimination tests applicable to 401(k) plans and is not subject to the top-heavy rules. The other qualified plan rules continue to apply.

SIMPLE retirement plans in IRA form

In general

A SIMPLE retirement plan allows employees to make elective contributions to an IRA. Employee contributions have to be expressed as a percentage of the employee's compensation, and cannot exceed \$6,000 per year. The \$6,000 dollar limit is indexed for inflation in \$500 increments.

Under the bill, the employer is required to satisfy one of two contribution formulas. Under the matching contribution formula, the employer generally is required to match employee elective contributions on a dollar-for-dollar basis up to 3 percent of the employee's compensation. Under a special rule, the employer could elect a lower percentage matching contribution for all employees (but not less than 1 percent of each employee's compensation). In order for the employer to lower the matching percentage for any year, the employer has to notify employees of the applicable match within a reasonable time before the 60-day election period for the year (described below). In addition, a lower percentage cannot be elected for more than 2 out of any 5 years.

Alternatively, for any year, an employer is permitted to elect, in lieu of making matching contributions, to make a 2 percent of compensation nonelective contribution on behalf of each eligible employee with at least \$5,000 in compensation for such year. If such an election were made, the employer has to notify eligible employees of the change within a reasonable period before the 60-day election period for the year (described below). No contributions other than employee elective contributions and required employer matching contributions (or, alternatively, required employer nonelective contributions) can be made to a SIMPLE account.

Only employers who employed 100 or fewer employees earning at least \$5,000 in compensation for the preceding year and who do not currently maintain a qualified plan can establish SIMPLE retirement accounts for their employees. Under a special rule, employers are given a 2-year grace period to maintain a SIMPLE plan once they are no longer eligible.

Each employee of the employer who received at least \$5,000 in compensation from the employer during any 2 prior years and who is reasonably expected to receive at least \$5,000 in compensation during the year must be eligible to participate in the SIMPLE plan. Nonresident aliens and employees covered under a collective bargaining agreement do not have to be eligible to participate in the SIMPLE plan. Self-employed individuals can participate in a SIMPLE plan.

All contributions to an employee's SIMPLE account have to be fully vested.

Distributions from a SIMPLE plan generally are taxed as under the rules relating to IRAs, except that an increased early withdrawal tax (25 percent) applies to distributions within the first 2 years the employee first participates in the SIMPLE plan.

Tax treatment of SIMPLE accounts, contributions, and distributions

Contributions to a SIMPLE account generally are deductible by the employer. In the case of matching contributions, the employer will be allowed a deduction for a year only if the contributions are made by the due date (including extensions) for the employer's tax return. Contributions to a SIMPLE account are excludable from the employee's income. SIMPLE accounts, like IRAs, are not subject to tax. Distributions from a SIMPLE retirement account generally are taxed under the rules applicable to IRAs. Thus, they are includable in income when withdrawn. Tax-free rollovers can be made from one SIMPLE account to another. A SIMPLE account can be rolled over to an IRA on a tax-free basis after a two-year period has expired since the individual first participated in the SIMPLE plan. To the extent an employee is no longer participating in a SIMPLE plan (e.g., the employee has terminated employment), the employee's SIMPLE account will be treated as an IRA.

Early withdrawals from a SIMPLE account generally are subject to the 10-percent early withdrawal tax applicable to IRAs. However, withdrawals of contributions during the 2-year period beginning on the date the employee first participated in the SIMPLE plan are subject to a 25-percent early withdrawal tax (rather than 10 percent).

Employer matching or nonelective contributions to a SIMPLE account are not treated as wages for employment tax purposes.

Administrative requirements

Each eligible employee can elect, within the 60-day period before the beginning of any year (or the 60-day period before first becoming eligible to participate), to participate in the SIMPLE plan (i.e., to make elective deferrals), and to modify any previous elections regarding the amount of contributions. An employer is required to contribute employees' elective deferrals to the employee's SIMPLE account within 30 days after the end of the month to which the contributions relate. Employees must be allowed to terminate participation in the SIMPLE plan at any time during the year (i.e., to stop making contributions). The plan can provide that an employee who terminates participation cannot resume participation until the following year. A plan can permit (but is not required to permit) an individual to make other changes to his or her salary reduction contribution election during the year (e.g., reduce contributions). An employer is permitted to designate a SIMPLE account trustee to which contributions on behalf of eligible employees are made.

The bill also amends parts 1 and 4, Subtitle B, Title I of ERISA so that only simplified reporting requirements apply to SIMPLE plans and so that the employer (and any other plan fiduciary) will not be subject to fiduciary liability resulting from the employee (or beneficiary) exercising control over the assets in the SIMPLE account. For this purpose, an employee (or beneficiary) will be treated as exercising control over the assets in his or her account upon the earlier of (1) an affirmative election with respect to the initial investment of any contributions, (2) a rollover contribution (including a trustee-to-trustee transfer) to another SIMPLE account or IRA, or (3) one year after the SIMPLE account is established. The Com-

mittee intends that once an employee (or beneficiary) is treated as exercising control over his or her SIMPLE account, the relief from fiduciary liability would extend to the period prior to when the employee (or beneficiary) was deemed to exercise control.

Reporting requirements

Trustee requirements.—The trustee of a SIMPLE account is required each year to prepare, and provide to the employer maintaining the SIMPLE plan, a summary description containing the following basic information about the plan: the name and address of the employer and the trustee; the requirements for eligibility; the benefits provided under the plan; the time and method of making salary reduction elections; and the procedures for and effects of, withdrawals (including rollovers) from the SIMPLE account. At least once a year, the trustee is also required to furnish an account statement to each individual maintaining a SIMPLE account. In addition, the trustee is required to file an annual report with the Secretary. A trustee who fails to provide any of such reports or descriptions will be subject to a penalty of \$50 per day until such failure is corrected, unless the failure is due to reasonable cause.

Employer reports.—The employer maintaining a SIMPLE plan is required to notify each employee of the employee's opportunity to make salary reduction contributions under the plan as well as the contribution alternative chosen by the employer immediately before the employee becomes eligible to make such election. This notice must include a copy of the summary description prepared by the trustee. An employer who fails to provide such notice will be subject to a penalty of \$50 per day on which such failure continues, unless the failure is due to reasonable cause.

Definitions

For purposes of the rules relating to SIMPLE plans, compensation means compensation required to be reported by the employer on Form W-2, plus any elective deferrals of the employee. In the case of a self-employed individual, compensation means net earnings from self-employment. The \$150,000 compensation limit (sec. 401(a)(17)) applies only for purposes of the 2 percent of compensation nonelective contribution formula.⁶⁵ The term employer includes the employer and related employers. Related employers includes trades or businesses under common control (whether incorporated or not), controlled groups of corporations, and affiliated service groups. In addition, the leased employee rules apply.

For purposes of the rule prohibiting an employer from establishing a SIMPLE plan, if the employer has another qualified plan, an employer is treated as maintaining a qualified plan if the employer (or a predecessor employer) maintained a qualified plan with respect to which contributions were made, or benefits were accrued, with respect to service for any year in the period beginning with the year the SIMPLE plan became effective and ending with the year for which the determination is being made. A qualified plan

⁶⁵ So, for example, the maximum employer contribution that can be made on behalf of any single eligible employee under the 2 percent of compensation nonelective contribution formula is \$3,000. By contrast, the maximum employer contribution that can be made on behalf of any single eligible employee under the matching contribution formula is \$6,000.

includes a qualified retirement plan, a qualified annuity plan, a governmental plan, a tax-sheltered annuity, and a simplified employee pension.

SIMPLE 401(k) plans

In general, under the bill, a cash or deferred arrangement (i.e., 401(k) plan), will be deemed to satisfy the special nondiscrimination tests applicable to employee elective deferrals and employer matching contributions if the plan satisfies the contribution requirements applicable to SIMPLE plans. In addition, the plan is not subject to the top-heavy rules for any year for which this safe harbor is satisfied. The plan is subject to the other qualified plan rules.

The safe harbor is satisfied if, for the year, the employer does not maintain another qualified plan and (1) employee's elective deferrals are limited to no more than \$6,000, (2) the employer matches employees' elective deferrals up to 3 percent of compensation (or, alternatively, makes a 2 percent of compensation nonelective contribution on behalf of all eligible employees with at least \$5,000 in compensation), and (3) no other contributions are made to the arrangement. Contributions under the safe harbor have to be 100 percent vested. The employer cannot reduce the matching percentage below 3 percent of compensation.

Repeal of SARSEPs

Under the bill, the present-law rules permitting SARSEPs no longer apply after December 31, 1996, unless the SARSEP was established before January 1, 1997. Consequently, an employer is not permitted to establish a SARSEP after December 31, 1996. SARSEPs established before January 1, 1997, can continue to receive contributions under present-law rules, and new employees of the employer hired after December 31, 1996, can participate in the SARSEP in accordance with such rules.

Effective date

The provisions relating to SIMPLE plans are effective for years beginning after December 31, 1996.

2. *Tax-exempt organizations eligible under section 401(k) (sec. 1426 of the bill and sec. 401(k) of the Code)*

Present law

Under present law, tax-exempt and State and local government organizations are generally prohibited from establishing qualified cash or deferred arrangements (sec. 401(k) plans). Qualified cash or deferred arrangements (1) of rural cooperatives, (2) adopted by State and local governments before May 6, 1986, or (3) adopted by tax-exempt organizations before July 2, 1986, are not subject to this prohibition.

There is no specific statutory provision governing the Federal income tax liability of Indian tribes.⁶⁶ However, the Internal Revenue Service (“IRS”) has long taken the position that Indian tribal governments, as well as wholly-owned tribal corporations chartered under Federal law, are not taxable entities and, thus, are immune from Federal income taxes.⁶⁷ More recently, the IRS has ruled that any income earned by an unincorporated Indian tribal government or Federally chartered tribal corporation is not subject to Federal income tax, regardless of whether the activities that produced the income are conducted on or off the tribe’s reservation.⁶⁸

Reasons for change

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 tax-exempt organizations (including, for this purpose, Indian tribal governments, a subdivision of an Indian tribal government, an agency or instrumentality of an Indian tribal government or subdivision thereof, or a corporation chartered under Federal, State, or tribal law which is owned in whole or in part by any of such entities) to maintain qualified cash or deferred arrangements. The bill retains the present-law prohibition against the maintenance of cash or deferred arrangements by State and local governments, except to the extent it may apply to Indian tribal governments.

Effective date

The provision is effective for plan years beginning after December 31, 1996. The Committee intends no inference with respect to whether Indian tribal governments are permitted to maintain qualified cash or deferred arrangements under present law.

3. Spousal IRAs (sec. 1427 of the bill and sec. 219 of the Code)

Present law

Within limits, an individual is allowed a deduction for contributions to an individual retirement account or an individual retirement annuity (an “IRA”). An individual generally is not subject to income tax on amounts held in an IRA, including earnings on contributions, until the amounts are withdrawn from the IRA.

Under present law, the maximum deductible contribution that can be made to an IRA generally is the lesser of \$2,000 or 100 percent of an individual’s compensation (earned income in the case of

⁶⁶Section 7871 provides that Indian tribal governments are treated as States for certain limited tax purposes, such as the issuance of certain tax-exempt bonds, certain excise tax exemptions, and for eligibility to receive deductible charitable contributions. Section 7871 also treats Indian tribal governments as States for purposes of the provision that permits State and local government educational organizations to maintain tax-sheltered annuity plans (sec. 403(b)). However, section 7871 does not treat Indian tribal governments as States or State governments for purposes of section 401(k).

⁶⁷See Rev. Rul. 67-284, 1967-2 C.B. 55; Rev. Rul. 81-295, 1981-2 C.B. 15.

⁶⁸See Rev. Rul. 94-16, 1994-1 C.B. 19; Rev. Rul. 94-65, 1994-2 C.B. 14.

a self-employed individual). In the case of a married individual whose spouse has no compensation (or elects to be treated as having no compensation), the \$2,000 limit on IRA contributions is increased to \$2,250.

Reasons for change

The Committee is concerned about the national savings rate, and believes that individuals should be encouraged to save. The Committee believes that the ability to make deductible contributions to an IRA is a significant savings incentive. However, this incentive is not available to all taxpayers under present law. The Committee believes that the present-law rules relating to deductible IRAs penalize American homemakers. The Committee believes that IRA contributions should be permitted for both spouses even though only one spouse works.

Explanation of provision

The bill modifies the present-law rules relating to deductible IRAs by permitting deductible IRA contributions of up to \$2,000 to be made for each spouse (including, for example, a homemaker who does not work outside the home) if the combined compensation of both spouses is at least equal to the contributed amount.

Effective date

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

C. NONDISCRIMINATION PROVISIONS

1. *Definition of highly compensated employees and repeal of family aggregation rules (sec. 1431 of the bill and secs. 401(a)(17), 404(l), and 414(g) of the Code)*

Present law

Definition of highly compensated employee

An employee, including a self-employed individual, is treated as highly compensated 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 \$100,000 (for 1996) in annual compensation from the employer, (3) received more than \$66,000 (for 1996) 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 in excess of \$60,000 (for 1996). If, for any year, no officer has compensation in excess of the threshold, then the highest paid officer of the employer is treated as a highly compensated employee.

Family aggregation rules

A special rule applies with respect to the treatment of family members of certain highly compensated employees for purposes of the nondiscrimination rules applicable to qualified plans. 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 spouses of a lineal ascendant or descendant of the employee.

Similar family aggregation rules apply with respect to the \$150,000 (for 1996) limit on compensation that may be taken into account under a qualified plan (sec. 401(a)(17)) and for deduction purposes (sec. 404(1)). 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 plan sponsors to determine which employees are highly compensated can be significant. The various categories of highly compensated employees require employers to perform a number of calculations that for many employers have largely duplicative results.

The family aggregation rules impose undue restrictions on the ability of a family-owned small business to provide adequate retirement benefits for all members of the family working for the business. In addition, the complexity of the calculations required under the family aggregation rules appears to be unnecessary in light of the numerous other provisions that ensure that qualified pension plans do not disproportionately favor highly compensated employees.

Explanation of provisions

Definition of highly compensated employee

Under the bill, an employee is treated as highly compensated 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 \$80,000 (indexed for inflation). The bill also repeals the rule requiring the highest paid officer to be treated as a highly compensated employee.

Family aggregation rules

The bill repeals the family aggregation rules.

Effective date

The provisions are effective for years beginning after December 31, 1996.

2. *Modification of additional participation requirements (sec. 1432 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 of (a) 50 employees of the employer or (b) 40 percent of all employees of the employer (sec. 401(a)(26)). This requirement may not be satisfied by aggregating comparable plans, but may 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 contributions or benefits, such an arrangement may still discriminate in favor of highly compensated employees.

However, it is appropriate to better target the minimum participation rule by limiting the scope of the rule to defined benefit pension plans and increasing the minimum number of employees required to be covered under very small plans.

Also, 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 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) 50 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 bill provides that the requirement that a line of business has at least 50 employees does not apply in determining whether a plan satisfies the minimum participation rule on a separate line of business basis.

Effective date

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

3. *Nondiscrimination rules for qualified cash or deferred arrangements and matching contributions (sec. 1433 of the bill and secs. 401(k) and 401(m) of the Code)*

Present law

Under present law, a special nondiscrimination test applies to qualified cash or deferred arrangements (sec. 401(k) plans). The special nondiscrimination test 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.

Employer matching contributions and after-tax employee contributions under qualified defined contribution plans are subject to a special nondiscrimination test (the actual contribution percentage ("ACP") test) similar to the special nondiscrimination test applicable to qualified cash or deferred arrangements. Employer matching contributions that satisfy certain requirements can be used to satisfy the ADP test, but, to the extent so used, such contributions cannot be considered when calculating the ACP test.

A plan that would otherwise fail to meet the special nondiscrimination test for qualified cash or deferred arrangements is not treated as failing such test if excess contributions (with allocable income) are distributed to the employee or, in accordance with Treasury regulations, recharacterized as after-tax employee contributions. For purposes of this rule, in determining 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. A similar rule applies to employer matching contributions.

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.

The Committee believes that the complexity of nondiscrimination requirements, particularly after the Tax Reform Act of 1986 changes that imposed a dollar cap on elective deferrals (\$9,500 in 1996), is not justified by the marginal additional participation of rank-and-file employees that might be achieved by the operation of these requirements. The result that the nondiscrimination rules are intended to produce can also be achieved by creating an incentive for employers to provide certain matching contributions or non-elective contributions on behalf of rank-and-file employees. Such contributions should create a sufficient inducement to rank-and-file employee participation. Thus, the Committee believes it is appro-

appropriate to provide a design-based safe harbor for qualified cash or deferred arrangements. Plans that satisfy the safe harbors would not have to satisfy the nondiscrimination tests for cash or deferred arrangements.

In addition, 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, particularly small 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.

Simplifying the nondiscrimination tests will also reduce administrative burdens for those plans that do not utilize the safe harbor.

Explanation of provisions

Prior-year data

The bill modifies the special nondiscrimination tests applicable to elective deferrals and employer matching and after-tax employee contributions to provide that the maximum permitted actual deferral percentage (and actual contribution percentage) for highly compensated employees for the year is determined by reference to the actual deferral percentage (and actual contribution percentage) for nonhighly compensated employees for the preceding, rather than the current, year. A special rule applies for the first plan year.

Alternatively, under the bill, an employer is allowed to elect to use the current year actual deferral percentage (and actual contribution percentage). Such an election can be revoked only as provided by the Secretary.

Safe harbor for cash or deferred arrangements

The bill provides that a cash or deferred arrangement satisfies the special nondiscrimination tests if the plan satisfies one of two contribution requirements and satisfies a notice requirement.

A plan satisfies the contribution requirements under the safe harbor rule for qualified cash or deferred arrangements if the plan either first, satisfies a matching contribution requirement or second, 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: first, the employer makes a matching contribution on behalf of each nonhighly compensated employee that is equal to (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 second, the rate of match with respect to any elective contribution for highly compensated employees is not greater than the rate of match for nonhighly compensated employees.

Alternatively, if the rate of matching contribution with respect to any rate of elective contribution requirement is not equal to the percentages described in the preceding paragraph, the matching contribution requirement will be deemed to be satisfied if first, the rate of an employer's matching contribution does not increase as an employee's rate of elective contribution increases and second, the aggregate amount of matching contributions at such rate of elective contribution at least equals the aggregate amount of matching contributions that would be made if matching contributions satisfied the above percentage requirements. For example, the alternative test will be satisfied if 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. However, the alternative test will not be satisfied if an employer matches 80 percent of an employee's elective contributions up to the first 5 percent of compensation. The former example satisfies the alternative test because the employer match does not increase and the aggregate amount of matching contributions at any rate of elective contribution is at least equal to the aggregate amount of matching contributions required under the general safe harbor rule.

Employer matching and nonelective contributions used to satisfy the contribution requirements of the safe harbor rules are required to be nonforfeitable and are 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)). It is intended that employer matching and nonelective contributions used to satisfy the contribution requirements of the safe harbor rules can be used to satisfy other qualified retirement plan nondiscrimination rules (except the special nondiscrimination test applicable to employer matching contributions (the ACP test)). So, for example, a cross-tested defined contribution plan that includes a qualified cash or deferred arrangement can consider such employer matching and nonelective contributions in testing.⁶⁹

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.

⁶⁹The Committee intends that if two plans which include qualified cash or deferred arrangements are treated as one plan for purposes of the nondiscrimination and coverage rules, such qualified cash or deferred arrangements will be treated as one qualified cash or deferred arrangement for purposes of the safe harbor rules. In such a case, unless both qualified cash or deferred arrangements satisfied the safe harbor, both qualified cash or deferred arrangements tested together will have to satisfy the ADP and ACP tests.

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 (the ACP test). Under this safe harbor, a plan is treated as meeting the special nondiscrimination test if first, 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 second, the plan satisfies a special limitation on matching contributions.

The limitation on matching contributions is satisfied if: first, the employer 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; second, the rate of an employer's matching contribution does not increase as the rate of an employee's contributions or elective deferrals increases; and third, the matching contribution with respect to any highly compensated employee at any rate of employee contribution or elective deferral is not greater than that with respect to an employee who is not highly compensated.

Any after-tax employee contributions made under the qualified cash or deferred arrangement will continue to be tested under the ACP test. Employer matching and nonelective contributions used to satisfy the safe harbor rules for qualified cash or deferred arrangements cannot be considered in calculating such test. However, employer matching and nonelective contributions in excess of the amount required to satisfy the safe harbor rules for qualified cash or deferred arrangements can be taken into account in calculating such test.

Distribution of excess contributions and excess aggregate contributions

The bill provides that the total amount of excess contributions (and excess aggregate contributions) is determined as under present law, but the distribution of excess contributions (and excess aggregate contributions) are required to be made on the basis of the amount of contribution by, or on behalf of, each highly compensated employee. Thus, excess contributions (and excess aggregate contributions) are deemed attributable first to those highly compensated employees who have the greatest dollar amount of elective deferrals.

Effective date

The provisions relating to use of prior-year data and the distribution of excess contributions and excess aggregate contributions are effective for years beginning after December 31, 1996. The provisions providing for a safe harbor for qualified cash or deferred arrangements and the alternative method of satisfying the special nondiscrimination test for matching contributions are effective for years beginning after December 31, 1998.

4. *Definition of compensation for purposes of the limits on contributions and benefits (sec. 1434 of the bill and sec. 415 of the Code)*

Present law

Present law imposes limits on contributions and benefits under qualified plans based on the type of plan. For purposes of these limits, present law provides that the definition of compensation generally does not include elective employee contributions to certain employee benefit plans.

Reasons for change

The Committee believes that not treating employee elective contributions as compensation for purposes of the limits on benefits and contributions under qualified plans unduly restricts the amount that employees, particularly employees who are not highly compensated, can earn under qualified plans.

Explanation of provision

The bill provides that elective deferrals to section 401(k) plans and similar arrangements, elective contributions to nonqualified deferred compensation plans of tax-exempt employers and State and local governments (sec. 457 plans), and salary reduction contributions to a cafeteria plan are considered compensation for purposes of the limits on contributions and benefits.

Effective date

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

D. MISCELLANEOUS PENSION SIMPLIFICATION

1. *Plans covering self-employed individuals (sec. 1441 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 of unincorporated businesses 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, 1996.

2. *Elimination of special vesting rule for multiemployer plans (sec. 1442 of the bill and sec. 411(a) of the Code)*

Present law

Under present law, except in the case of multiemployer plans, a plan is not a qualified plan unless a participant's employer-provided benefit vests at least as rapidly as under one of two alternative minimum vesting schedules. A plan satisfies the first schedule if a participant acquires a nonforfeitable right to 100 percent of the participant's accrued benefit derived from employer contributions upon the participant's completion of 5 years of service. A plan satisfies the second schedule if a participant has a nonforfeitable right to at least 20 percent of the participant's accrued benefit derived from employer contributions after 3 years of service, 40 percent at the end of 4 years of service, 60 percent at the end of 5 years of service, 80 percent at the end of 6 years of service, and 100 percent at the end of 7 years of service.

In the case of a multiemployer plan, a participant's accrued benefit derived from employer contributions is required to be 100-percent vested no later than upon the participant's completion of 10 years of service. This special rule applies only to employees covered by the plan pursuant to a collective bargaining agreement.

Reasons for change

The present-law vesting rules for multiemployer plans add to complexity because there are different vesting schedules for different types of plans, and different vesting schedules for persons within the same multiemployer plan. In addition, the present-law rule prevents some workers from earning a pension under a multiemployer plan. Conforming the multiemployer plan rules to the rules for other plans would mean that workers could earn additional benefits.

Explanation of provision

The bill conforms the vesting rules for multiemployer plans to the rules applicable to other qualified plans.

Effective date

The provision is effective for plan years beginning on or after the earlier of (1) the later of January 1, 1997, or the date on which the last of the collective bargaining agreements pursuant to which the plan is maintained terminates, or (2) January 1, 1999, with respect to participants with an hour of service after the effective date.

3. *Distributions under rural cooperative plans (sec. 1443 of the bill and sec. 401(k)(7) of the Code)*

Present law

A qualified cash or deferred arrangement can permit withdrawals of employee elective deferrals only after the earlier of (1) the participant's separation from service, death, or disability, (2) termination of the arrangement, or (3) in the case of a profit-sharing or stock bonus plan, the attainment of age 59½ or the occurrence of a hardship of the participant. In the case of a money purchase pension plan, including a rural cooperative 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. It is also appropriate to clarify that certain public utility districts and a national association of rural cooperatives should be treated as rural cooperatives for this purpose.

Explanation of provision

The bill provides that a rural cooperative plan that includes a cash or deferred arrangement may permit distributions to plan participants after the attainment of age 59½ or on account of hardship. In addition, the definition of a rural cooperative is expanded to include certain public utility districts.

Effective date

The provision generally is effective for distributions after the date of enactment. The modifications to the definition of a rural cooperative apply to plan years beginning after December 31, 1996.

4. *Treatment of governmental plans under section 415 (sec. 1444 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). Certain special rules apply to State and local governmental plans under which such plans may provide benefits greater than those permitted by the limits on benefits applicable to plans maintained by private employers.

In the case of defined benefit pension plans, the limit on the annual retirement benefit is the lesser of (1) 100 percent of compensation or (2) \$120,000 (indexed for inflation). The dollar limit is reduced in the case of early retirement or if the employee has less than 10 years of plan participation.

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) the 100 percent of compensation limitation on defined benefit pension plan benefits would not apply; and
- (2) the early retirement reduction and the 10-year phase-in of the defined benefit pension plan dollar limit would not apply to certain disability and survivor benefits.

The bill also permits State and local government employers to maintain excess benefit plans without regard to the limits on unfunded deferred compensation arrangements of State and local government employers (sec. 457).

Effective date

The provision is effective for years beginning after December 31, 1994. No inference is intended with respect to whether a governmental plan complies with the requirements of section 415 with respect to years beginning before January 1, 1995. With respect to such years, the Secretary is directed to enforce the requirements of section 415 consistent with the provision.

- 5. *Uniform retirement age (sec. 1445 of the bill and sec. 401(a)(5) 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. It is believed 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 rules (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 are not treated as not being available to employees on the same terms

merely because they are based on an employee's Social Security retirement age (as defined in sec. 415).

Effective date

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

6. *Contributions on behalf of disabled employees (sec. 1446 of the bill and sec. 415(c)(3) 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

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 is effective for years beginning after December 31, 1996.

7. *Treatment of deferred compensation plans of State and local governments and tax-exempt organizations (sec. 1447 of the bill and sec. 457(e) of the Code)*

Present law

Under a section 457 plan, an employee who elects to defer the receipt of current compensation is taxed on the amounts deferred when such amounts are paid or made available. The maximum annual deferral under such a plan is the lesser of (1) \$7,500 or (2) 33 $\frac{1}{3}$ percent of compensation (net of the deferral).

Amounts deferred under a section 457 plan may not be made available to an employee before the earliest of (1) the calendar year in which the participant attains age 70 $\frac{1}{2}$, (2) when the participant is separated from the service with the employer, or (3) when the participant is faced with an unforeseeable emergency.

Benefits under a section 457 plan are not treated as made available if the participant may elect to receive a lump sum payable after separation from service and within 60 days of the election. This exception is available only if the total amount payable to the participant under the plan does not exceed \$3,500 and no additional amounts may be deferred under the plan with respect to the participant.

Reasons for change

It is appropriate to index the dollar limits on deferrals under section 457 plans to maintain the value of the deferral and to provide two additional exceptions to the principle of constructive receipt with respect to distributions from such plans.

Explanation of provision

The bill makes three changes to the rules governing section 457 plans.

The bill: (1) permits in-service distributions of accounts that do not exceed \$3,500 under certain circumstances; (2) increases the number of elections that can be made with respect to the time distributions must begin under the plan, and (3) provides for indexing (in \$500 increments) of the dollar limit on deferrals.

Effective date

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

8. *Trust requirement for deferred compensation plans of State and local governments (sec. 1448 of the bill and sec. 457 of the Code)*

Present law

Until deferrals under a section 457 plan are made available to a plan participant, such amounts deferred, all property and rights purchased with such amounts, and all income attributable to such amounts, property, or rights must remain solely the property and rights of the employer, subject only to the claims of the employer's general creditors.

Reasons for change

The Committee is concerned about the potential for employees of certain State and local governments to lose significant portions of their retirement savings because their employer has chosen to provide benefits through an unfunded deferred compensation plan rather than a qualified pension plan. Therefore, the Committee finds it appropriate to require that benefits under a section 457 plan of a State and local government should be held in a trust (or custodial account or annuity contract) to insulate the retirement benefits of employees from the claims of the employer's creditors.

Explanation of provision

Under the bill, all amounts deferred under a section 457 plan maintained by a State and local governmental employer have to be held in trust (or custodial account or annuity contract) for the exclusive benefit of employees. The trust (or custodial account or annuity contract) is provided tax-exempt status. Amounts will not be considered made available merely because they are held in a trust, custodial account, or annuity contract.⁷⁰

Effective date

The provision generally is effective with respect to amounts held on or after the date of enactment. In the case of plans in existence on the date of enactment, a trust will not need to be established by reason of the provision until January 1, 1999.

9. *Correction of GATT interest and mortality rate provisions in the Retirement Protection Act (sec. 1449 of the bill and sec. 767 of the General Agreement on Tariffs and Trade)*

Present law

The Retirement Protection Act of 1994, enacted as part of the implementing legislation for the General Agreement on Tariffs and Trade ("GATT"), modified the actuarial assumptions that must be used in adjusting benefits and limitations. In general, in adjusting a benefit that is payable in a form other than a straight life annuity and in adjusting the dollar limitation if benefits begin before age 62, the interest rate to be used cannot be less than the greater of 5 percent or the rate specified in the plan. Under GATT, if the benefit is payable in a form subject to the requirements of section 417(e)(3), then the interest rate on 30-year Treasury securities is substituted for 5 percent. Also under GATT, for purposes of adjusting any limit or benefit, the mortality table prescribed by the Secretary must be used.

This provision of GATT is generally effective as of the first day of the first limitation year beginning in 1995.

GATT made similar changes to the interest rate and mortality assumptions used to calculate the value of lump-sum distributions for purposes of the rule permitting involuntary dispositions of certain accrued benefits. In the case of a plan adopted and in effect before December 8, 1995, those provisions do not apply before the earlier of (1) the date a plan amendment applying the new assumption is adopted or made effective (whichever is later), or (2) the first day of the first plan year beginning after December 31, 1999.

Reasons for change

The Committee is aware that the GATT provisions enacted in the 103rd Congress had the result of reducing the benefit payments to certain pension plan beneficiaries. The Committee believes that it is appropriate to ameliorate this result by providing the same transition period for the modifications to limits on contributions and

⁷⁰So, for example, the constructive receipt rules contained in the Code (secs. 83 and 402(b)) do not apply to amounts deferred under the section 457 plan and contributed to the trust.

benefits to that provided under similar GATT provisions, and by providing that the interest rate to be used to reduce the dollar limit on benefits under section 415 in cases where the participant retires before age 62 should be the same regardless of the form of benefit.

Explanation of provision

The bill conforms the effective date of the new interest rate and mortality assumptions that must be used under section 415 to calculate the limits on benefits and contributions to the effective date of the provision relating to the calculation of lump-sum distributions. This rule applies only in the case of plans that were adopted and in effect before the date of enactment of GATT (December 8, 1994). To the extent plans have already been amended to reflect the new assumptions, plan sponsors are permitted within 1 year of the date of enactment to amend the plan to reverse retroactively such amendment.⁷¹

The bill also repeals the GATT provision which requires that if the benefit is payable before age 62 in a form subject to the requirements of section 417(e)(3) (e.g., lump sum), then the interest rate to be used to reduce the dollar limit on benefits under section 415 cannot be less than the greater of the rate on 30-year Treasury securities or the rate specified in the plan. Consequently, regardless of the form of benefit, the interest rate to be used cannot be less than the greater of 5 percent or the rate specified in the plan.

Effective date

The provision is effective as if included in GATT.

10. Multiple salary reduction agreements permitted under section 403(b) (sec. 1450(a) of the bill and sec. 403(b) of the Code)

Present law

Under Treasury regulations, a participant in a tax-sheltered annuity plan (sec. 403(b)) is not permitted to enter into more than one salary reduction agreement in any taxable year. These regulations further provide that a salary reduction agreement is effective only with respect to amounts “earned” after the agreement becomes effective, and that a salary reduction agreement must be irrevocable with respect to amounts earned while the agreement is in effect.

These restrictions do not apply to other elective deferral arrangements such as a qualified cash or deferred arrangement (sec. 401(k)). Under present law, employee elective contributions to a qualified cash or deferred arrangement are not treated as distrib-

⁷¹The Committee intends that plan sponsors will have flexibility in adopting the actuarial assumptions required under GATT. For example, plan sponsors are permitted to apply the actuarial assumptions that must be used for 415 purposes retroactively as provided under GATT. Alternatively, plan sponsors can apply such actuarial assumptions prospectively by either (1) providing a benefit equal to (i) the accrued benefit as of the effective date of the adoption of the new actuarial assumptions determined after applying section 415 using the old actuarial assumptions, plus (ii) the benefit accrued after such effective date determined after applying section 415 using the new actuarial assumptions; or (2) providing a benefit equal to the greater of (i) the accrued benefit as the effective date of the adoption of the new actuarial assumptions determined after applying section 415 using the old actuarial assumptions, or (ii) the entire accrued benefit determined after applying section 415 using the new actuarial assumptions.

uted or made available merely because such arrangement permits the employee to elect between making the contribution or receiving the amount in cash (sec. 402(e)(3)). Under Treasury regulations, participants in a qualified cash or deferred arrangement may enter into more than one salary reduction agreement in a taxable year, such an agreement is effective with respect to compensation currently available to the participant after the agreement becomes effective even though previously “earned,” and the agreement may be revoked by the participant.

Reasons for change

It is appropriate to conform the treatment of salary reduction agreements under section 403(b) to the treatment of qualified cash or deferred arrangements.

Explanation of provision

The bill clarifies that amounts are not treated as distributed or made available merely because a participant enters into a salary reduction agreement with respect to a tax-sheltered annuity plan. In addition, for participants in a tax-sheltered annuity plan, the frequency that a salary reduction agreement may be entered into, the compensation to which such agreement applies, and the ability to revoke such agreement shall be determined under the rules applicable to qualified cash or deferred arrangements.

Effective date

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

11. Treatment of Indian tribal governments under section 403(b) (sec. 1450(b) of the bill and sec. 403(b) of the Code)

Present law

Under present law, certain tax-exempt employers and certain State and local government educational organizations are permitted to maintain tax-sheltered annuity plans (sec. 403(b)). Indian tribal governments are treated as States for this purpose, so certain educational organizations associated with a tribal government are eligible to maintain tax-sheltered annuity plans.

Reasons for change

The Committee believes that there is some uncertainty under present law about the ability of Indian tribal governments to establish 403(b) plans for all tribal government employees. Following enactment of the Indian Tribal Government Tax Status Act of 1982, several insurance companies and financial advisors marketed 403(b) plans to tribes representing that the plans could be adopted on a tribal-wide basis to cover all employees. As a result, many tribes adopted 403(b) plans for their employees that are not in compliance with the law. Given this uncertainty, the Committee believes it is appropriate to requalify such plans. In addition, the

Committee believes it is appropriate to permit Indian tribal governments to maintain tax-sheltered annuity plans in the future.

Explanation of provision

The bill provides that any section 403(b) annuity contract purchased in a plan year beginning before January 1, 1997, by an Indian tribal government will be treated as purchased by an entity permitted to maintain a tax-sheltered annuity plan. The bill also provides that such contracts may be rolled over into a section 401(k) plan maintained by the Indian tribal government.

In addition, beginning January 1, 1997, Indian tribal governments will be permitted to maintain tax-sheltered annuity plans.

Effective date

The provision generally is effective on the date of enactment, except that the provision permitting Indian tribal governments to maintain tax-sheltered annuity plans is effective for taxable years beginning after December 31, 1996.

12. Application of elective deferral limit to section 403(b) contracts (sec. 1450(c) of the bill and sec. 403(b) of the Code)

Present law

A tax-sheltered annuity plan must provide that elective deferrals made under the plan on behalf of an employee may not exceed the annual limit on elective deferrals (\$9,500 for 1996). Plans that do not comply with this requirement may lose their tax-favored status.

Reasons for change

The Committee does not believe that employees participating in a tax-sheltered annuity plan should be negatively affected if other employees violate the annual limit on elective deferrals with respect to their individual tax-sheltered annuity contracts (or custodial accounts).

Explanation of provision

Under the bill, each tax-sheltered annuity contract, not the tax-sheltered annuity plan, must provide that elective deferrals made under the contract may not exceed the annual limit on elective deferrals. The Committee intends that the contract terms be given effect in order for this requirement to be satisfied. Thus, for example, if the annuity contract issuer takes no steps to ensure that deferrals under the contract do not exceed the applicable limit, then the contract will not be treated as satisfying section 403(b). The provision is intended to make clear that the exclusion of elective deferrals from gross income by employees who have not exceeded the annual limit on elective deferrals will not be affected to the extent other employees exceed the annual limit. However, if the occurrence of an uncorrected elective deferral made by an employee is attributable to reasonable error, the contract will not fail to satisfy section 403(b), and only the portion of the elective deferral in excess of the annual limit would be includible in gross income.

Effective date

The provision is effective for years beginning after December 31, 1995, except that an annuity contract is not required to meet any change in any requirement by reason of the provision before the 90th day after the date of enactment. The Committee intends no inference as to whether the exclusion of elective deferrals from gross income by employees who have not exceeded the annual limit on elective deferrals is affected to the extent other employees exceed the annual limit prior to the effective date of this provision.

13. Waiver of minimum waiting period for qualified plan distributions (sec. 1451 of the bill and sec. 417(c) of the Code)

Present law

Under present law, in the case of a qualified joint and survivor annuity ("QJSA"), a written explanation of the form of benefit must generally be provided to participants no less than 30 days and no more than 90 days before the annuity starting date. Even if a participant has elected to waive the qualified joint and survivor annuity and the spouse has consented to the distribution, the distribution from the plan cannot be made until 30 days after the written explanation was provided to the participant.⁷²

Reasons for change

The Committee believes that the notice period applicable to a QJSA should not prevent the payment of benefits if such period is waived by the plan participant and, if applicable, the participant's spouse.

Explanation of provision

The bill provides that the minimum period between the date the explanation of the qualified joint and survivor annuity is provided and the annuity starting date does not apply if it is waived by the participant and, if applicable, the participant's spouse. For example, if the participant has not elected to waive the qualified joint and survivor annuity, only the participant needs to waive the minimum waiting period.

Effective date

The provision is effective with respect to plan years beginning after December 31, 1996.

⁷² On September 15, 1995, Treasury issued temporary regulations (T.D. 8620) which provide that a plan may permit a participant to elect (with any applicable spousal consent) a distribution with an annuity starting date before 30 days have elapsed since the explanation was provided, as long as the distribution commences more than seven days after the explanation was provided. Consequently, even if the participant (and spouse, if applicable) has elected to waive the minimum waiting period for receiving a qualified plan distribution, the distribution from the plan cannot be made until seven days have elapsed since the explanation was provided to the participant.

14. *Repeal of combined plan limit (sec. 1452 of the bill and sec. 415(e) of the Code)*

Present law

Combined plan limit

Present law provides limits on contributions and benefits under qualified retirement plans based on the type of plan (i.e., based on whether the plan is a defined contribution plan or a defined benefit pension plan). An overall limit applies if an individual is a participant in both a defined benefit pension plan and a defined contribution plan (called the combined plan limit).

Excess distribution tax

Present law imposes a 15-percent excise tax on excess distributions from qualified retirement plans, tax-sheltered annuities, and IRAs. Excess distributions are generally the aggregate amount of retirement distributions from such plans during any calendar year in excess of \$150,000 (or \$750,000 in the case of a lump-sum distribution). An additional 15-percent estate tax is also imposed on an individual's excess retirement accumulation.

Reasons for change

One of the most significant sources of complexity relating to qualified pension plans is the calculation of the combined plan limit under section 415(e). Many new employers do not establish defined benefit pension plans, which provide employees with the greatest retirement income security. One of the reasons that defined benefit pension plans are not being established is because of the complex rules governing these plan and the significant administrative costs entailed in maintaining them. Section 415(e) is just one of the deterrents to the establishment and maintenance of qualified defined benefit pension plans. Thus, the Committee does not believe that the administrative costs associated with section 415(e) and the complexity of the calculations required are justified. Further, the Committee believes that section 415(e) may have the effect of discouraging employers from providing adequate retirement benefits to their employees.

The excise tax on excess distributions has a similar purpose to the combined plan limit, although it applies to all of an individual's retirement distributions, not just those from a single employer. The Committee believes that both the combined plan limit and the excise tax on excess distributions should not apply at the same time.

EXPLANATION OF PROVISION

Combined plan limit

The bill repeals the combined plan limit.

Excess distribution tax

Until the repeal of the combined plan limit is effective, the bill suspends the excise tax on excess distributions. The additional estate tax on excess accumulations continues to apply.

Effective date

The provision repealing the combined plan limit is effective with respect to limitation years beginning after December 31, 1999. The provision relating to the excise tax on excess distributions is effective with respect to distributions received in 1997, 1998, and 1999.

15. *Tax on prohibited transactions (sec. 1453 of the bill and sec. 4975 of the Code)*

Present law

Present law prohibits certain transactions (prohibited transactions) between a qualified plan and a disqualified person in order to prevent persons with a close relationship to the qualified plan from using that relationship to the detriment of plan participants and beneficiaries. A two-tier excise tax is imposed on prohibited transactions. The initial level tax is equal to 5 percent of the amount involved with respect to the transaction. If the transaction is not corrected within a certain period, a tax equal to 100 percent of the amount involved may be imposed.

Reasons for change

The Committee believes it is appropriate to increase the initial level prohibited transaction tax to discourage disqualified persons from engaging in such transactions.

Explanation of provision

The bill increases the initial-level prohibited transaction tax from 5 percent to 10 percent.

Effective date

The provision is effective with respect to prohibited transactions occurring after the date of enactment.

16. *Treatment of leased employees (sec. 1454 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 any other 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 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, it is believed that situations such as this are outside the intended scope of the rules.

Explanation of provision

Under the bill, the present-law "historically performed" test is replaced with a new test under which an individual is not considered a leased employee unless the individual's services are performed under primary direction or control by the service recipient. As under present law, the determination of whether someone is a leased employee is made after determining whether the individual is a common-law employee of the recipient. Thus, an individual who is not a common-law employee of the service recipient could nevertheless be a leased employee of the service recipient. Similarly, the fact that a person is or is not found to perform services under primary direction or control of the recipient for purposes of the employee leasing rules is not determinative of whether the person is or is not a common-law employee of the recipient.

Whether services are performed by an individual under primary direction or control by the service recipient depends on the facts and circumstances. In general, primary direction and control means that the service recipient exercises the majority of direction and control over the individual. Factors that are relevant in determining whether primary direction or control exists include whether the individual is required to comply with instructions of the service recipient about when, where, and how he or she is to perform the services, whether the services must be performed by a particular person, whether the individual is subject to the supervision of the service recipient, and whether the individual must perform services in the order or sequence set by the service recipient. Factors that generally are not relevant in determining whether such direction or control exists include whether the service recipient has the right to hire or fire the individual and whether the individual works for others.

For example, an individual who works under the direct supervision of the service recipient would be considered to be subject to primary direction or control of the service recipient even if another

company hired and trained the individual, had the ultimate (but unexercised) legal right to control the individual, paid his wages, withheld his employment and income taxes, and had the exclusive right to fire him. Thus, for example, temporary secretaries, receptionists, word processing personnel and similar office personnel who are subject to the day-to-day control of the employer in essentially the same manner as a common law employee are treated as leased employees if the period of service threshold is reached.

On the other hand, an individual who is a common-law employee of Company A who performs services for Company B on the business premises of Company B under the supervision of Company A would generally not be considered to be under primary direction or control of Company B. The supervision by Company A must be more than nominal, however, and not merely a mechanism to avoid the literal language of the direction or control test.

An example of the situation in the preceding paragraph might be a work crew that comes into a factory to install, repair, maintain, or modify equipment or machinery at the factory. The work crew includes a supervisor who is an employee of the equipment (or equipment repair) company and who has the authority to direct and control the crew, and who actually does exercise such direction and control. In this situation, the supervisor and his or her crew are required to comply with the safety and environmental precautions of the manufacturer, and the supervisor is in frequent communication with the employees of the manufacturer. As another example, certain professionals (e.g., attorneys, accountants, actuaries, doctors, computer programmers, systems analysts, and engineers) who regularly make use of their own judgement and discretion on matters of importance in the performance of their services and are guided by professional, legal, or industry standards, are not leased employees even though the common law employer does not closely supervise the professional on a continuing basis, and the service recipient requires the services to be performed on site and according to certain stages, techniques, and timetables. In addition to the example above, outside professionals who maintain their own businesses (e.g., attorneys, accountants, actuaries, doctors, computer programmers, systems analysts, and engineers) generally would not be considered to be subject to such primary direction or control.

Under the direction or control test, clerical and similar support staff (e.g., secretaries and nurses in a doctor's office) generally would be considered to be subject to primary direction or control of the service recipient and would be leased employees provided the other requirements of section 414(n) are met.

In many cases, the "historically performed" test is overly broad, and results in the unintended treatment of individuals as leased employees. One of the principal purposes for changing the leased employee rules is to relieve the unnecessary hardship and uncertainty created for employers in these circumstances. However, it is not intended that the direction or control test enable employers to engage in abusive practices. Thus, it is intended that the Secretary interpret and apply the leased employee rules in a manner so as to prevent abuses. This ability to prevent abuses under the leasing rules is in addition to the present-law authority of the Secretary

under section 414(o). For example, one potentially abusive situation exists where the benefit arrangements of the service recipient overwhelmingly favor its highly compensated employees, the employer has no or very few nonhighly compensated common-law employees, yet the employer makes substantial use of the services of nonhighly compensated individuals who are not its common-law employees.

Effective date

The provision is effective for years beginning after December 31, 1996, except that the bill would not apply to relationships that have been previously determined by an IRS ruling not to involve leased employees. 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.

17. Uniform penalty provisions to apply to certain pension reporting requirements (sec. 1455 of the bill and secs. 6652(i) and 6724(d) of the Code)

Present law

Any person who fails to file an information report with the IRS on or before the prescribed filing date is subject to penalties for each failure. A different, flat-amount penalty applies for each failure to provide information reports to the IRS or statements to payees relating to pension payments.

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.

Effective date

The provision is effective with respect to returns and statements the due date for which is after December 31, 1996.

18. Retirement benefits of ministers not subject to tax on net earnings from self-employment (sec. 1456 of the bill and sec. 1402(a) of the Code)

Present law

Under present law, certain benefits provided to ministers after they retire are subject to self-employment tax.

Reasons for change

The Committee believes that, like retirement benefits paid from qualified plans sponsored by private employers, retirement benefits paid from church plans to ministers should not be subject to self-employment tax. The Committee believes this treatment should also apply to the rental value or allowance of any parsonage (including utilities) provided after retirement.

Explanation of provision

The bill provides that retirement benefits received from a church plan after a minister retires, and the rental value or allowance of a parsonage (including utilities) furnished to a minister after retirement, are not subject to self-employment taxes.

Effective date

The provision is effective for years beginning before, on, or after December 31, 1994.

19. *Treasury to provide model forms for spousal consent and qualified domestic relations orders (sec. 1457 of the bill and secs. 414(p) and 417(a)(2))*

Present law

Present law contains a number of rules designed to provide income to the surviving spouse of a deceased employee. Under these spousal protection rules, defined benefit pension plans and money purchase pension plans are required to provide that vested retirement benefits with a present value in excess of \$3,500 are payable in the form of a qualified joint and survivor annuity (“QJSA”) or, in the case of a participant who dies before the annuity starting date, a qualified preretirement survivor annuity (“QPSA”).

Benefits from a plan subject to the survivor benefit rules may be paid in a form other than a QJSA or QPSA if the participant waives the QJSA or QPSA (or both) and the applicable notice, election, and spousal consent requirements are satisfied.

Present law contains detailed rules regarding the waiver of the QJSA or QPSA forms of benefit and the spousal consent requirements. Generally an election to waive the QJSA or QPSA forms of benefit must be in writing, and, if the participant is married on the annuity starting date, must be accompanied by a written spousal consent acknowledging the effect of such consent and witnessed by a plan representative or notary public. Both the participant’s waiver and the spousal consent must state the specific nonspouse beneficiary who will receive the benefit, and, in the case of a QJSA waiver, must specify the particular optional form of benefit that will be paid. The waiver will not be valid unless the participant has previously received a written explanation of (1) the terms and conditions of the QJSA or QPSA forms of benefit, (2) the participant’s right to make, and the effect of, an election to waive these forms of benefits, (3) the rights of the participant’s spouse, and (4) the right to make, and the effect of, a revocation of an election to waive these forms of benefits.

Also, under present law, benefits under a qualified retirement plan are subject to prohibitions against assignment or alienation of benefits. An exception to this rule generally applies in the case of plan benefits paid to a former spouse pursuant to a qualified domestic relations order (“QDRO”).

Reasons for change

The Committee recognizes that the rules relating to spousal consents and QDROs serve important purposes in protecting spousal rights to retirement plan benefits. However, the Committee also recognizes that these rules are extremely complicated. Consequently, the Committee believes it is appropriate to direct the Secretary to develop model forms for spousal consent and QDROs so that spouses can more easily comply with these important rules.

Explanation of provision

Model spousal consent form

The Secretary is required to develop a model spousal consent form, no later than January 1, 1997, waiving the QJSA and QPSA forms of benefit. Such form must be written in a manner calculated to be understood by the average person, and must disclose in plain form whether the waiver is irrevocable and that it may be revoked by a QDRO.

Model QDRO

The Secretary is required to develop a model QDRO, no later than January 1, 1997, which satisfies the requirements of a QDRO under present law, and the provisions of which focus attention on the need to consider the treatment of any lump sum payment, QJSA, or QPSA.

Effective date

The provision is effective on the date of enactment.

20. Treatment of length of service awards for certain volunteers under section 457 (sec. 1458 of the bill and sec. 457 of the Code)

Present law

Under section 457 of the Code, compensation deferred under an eligible deferred compensation plan of a tax-exempt or governmental employer that meets certain requirements is not includible in gross income until paid or made available. One of the requirements for a section 457 plan is that the maximum annual amount that can be deferred is the lesser of \$7,500 or 33 $\frac{1}{3}$ percent of the individual’s taxable compensation. This maximum limit is coordinated with the annual limit on elective deferrals under qualified cash or deferred arrangements (sec. 401(k) plans) and under tax-sheltered annuities (sec. 403(b) plans), which is \$9,500 for 1996. Under this rule, elective deferrals to section 401(k) and 403(b) plans are treated as amounts deferred under a section 457 plan (and vice versa). Thus, for example, if an individual who is a participant in both a section 403(b) plan and a section 457 plan elects

to contribute \$2,000 to the 403(b) plan, then the maximum amount that can be deferred in that year under the section 457 plan is \$5,500.

Another requirement under section 457 is that (until the compensation is made available to the participant), all amounts of compensation deferred under the plan, all property and rights purchased with such amounts, and all income attributable to such amounts, property, or rights must remain solely the property and rights of the employer, subject only to the claims of the employer's general creditors.

Amounts deferred under plans of tax-exempt and governmental employers that do not meet the requirements of section 457 (other than amounts deferred under tax-qualified retirement plans, section 403(b) annuities and certain other plans) are includible in gross income in the first year in which there is no substantial risk of forfeiture of such amounts.

Reasons for change

The Committee believes it is both appropriate and important to allow for the provision of length of service awards to volunteer firefighters, and other emergency medical (including ambulance services) personnel.

Explanation of provision

Under the bill, the requirements of section 457 do not apply to any plan paying solely length of service awards to bona fide volunteers (or their beneficiaries) on account of fire fighting and prevention, emergency medical, and ambulance services performed by such volunteers. An individual is considered a "bona fide volunteer" if the only compensation received by such individual for performing such services is reimbursement (or a reasonable allowance) for expenses incurred in the performance of such services, or reasonable benefits (including length of service awards) and nominal fees for such services customarily paid by tax-exempt or governmental employers in connection with the performance of such services by volunteers. Under the bill, a length of service award plan will not qualify for this special treatment under section 457 if the aggregate amount of length of service awards accruing with respect to any year of service for any bona fide volunteer exceeds \$3,000.

In addition, any amounts exempt from the requirements of section 457 under the bill are not considered wages for purposes of the Federal Insurance Contribution Act ("FICA") taxes.

Effective date

The provision applies to accruals of length of service awards after December 31, 1996.

21. Date for adoption of plan amendments (sec. 1459 of the bill)

Present law

Plan amendments to reflect amendments to the law generally must be made by 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.

Reasons for change

Plan sponsors should have adequate time to amend plan documents.

Explanation of provision

The bill generally provides that any amendments to a plan or annuity contract required by the pension simplification amendments would not be required to be made before the first plan year beginning on or after January 1, 1997. The date for amendments is extended to the first plan year beginning on or after January 1, 1999, in the case of a governmental plan.

Effective date

The provision is effective on the date of enactment.

OTHER PROVISIONS

A. MISCELLANEOUS REVENUE PROVISIONS

1. *Exempt Alaska from diesel dyeing requirement while Alaska is exempt from similar Clean Air Act dyeing requirement (sec. 1801 of the bill and sec. 4081 of the Code)*

Present law

An excise tax totaling 24.3 cents per gallon is imposed on diesel fuel. In the case of fuel used in highway transportation, 20 cents per gallon is dedicated to the Highway Trust Fund. The remaining portion of this tax is imposed on transportation generally and is retained in the General Fund.

The diesel fuel tax is imposed on removal of the fuel from a pipeline or barge terminal facility (i.e., at the "terminal rack"). Present law provides that tax is imposed on all diesel fuel removed from terminal facilities unless the fuel is destined for a nontaxable use and is indelibly dyed pursuant to Treasury Department regulations.

In general, the diesel fuel tax does not apply to non-transportation uses of the fuel. Off-highway business uses are included within this non-transportation use exemption. This exemption includes use on a farm for farming purposes and as fuel powering off-highway equipment (e.g., oil drilling equipment). Use as heating oil also is exempt. (Most fuel commonly referred to as heating oil is diesel fuel.) The tax also does not apply to fuel used by State and local governments, to exported fuels, and to fuel used in commercial shipping. Fuel used by intercity buses and trains is partially exempt from the diesel fuel tax.

A similar dyeing regime exists for diesel fuel under the Clean Air Act. That Act prohibits the use on highways of diesel fuel with a sulphur content exceeding prescribed levels. This "high sulphur" diesel fuel is required to be dyed by the EPA. The State of Alaska generally was exempted from the Clean Air Act, but not the excise

tax, dyeing regime for three years (until October 1, 1996) (urban areas) or permanently (remote areas).

Reasons for change

Most diesel fuel sold in Alaska is sold for nontaxable, off-highway uses. Due to this fact and the Clean Air Act provision exempting the State from that Act's dyeing requirement, the Committee believes that adequate tax compliance in Alaska can be achieved without dyeing diesel fuel destined for nontaxable uses.

Explanation of provision

Diesel fuel sold in the State of Alaska will be exempt from the diesel dyeing requirement during the period when that State is exempt from the Clean Air Act dyeing requirements. Thus, subject to a certification procedure to be developed by the Treasury Department, undyed diesel fuel which is destined for a nontaxable use may be removed from terminals without payment of tax through September 30, 1996 (urban areas, unless extended by the Environmental Protection Agency) or permanently (remote areas).

Effective date

The provision is effective beginning with the first calendar quarter after the date of enactment.

2. *Application of common paymaster rules to certain agency accounts at State universities (sec. 1802 of the bill and sec. 3121 of the Code)*

Present law

In general, the OASDI portion of the Federal Insurance Contributions Act ("FICA") taxes are payable with respect to employee remuneration which does not exceed the contribution base specified in the law. If an employee works for more than one employer during the year, these taxes are payable for each employer up to the contribution base.

Section 3121(s) of the Internal Revenue Code provides an exception known as the "common paymaster" rule. If two or more related corporations concurrently employ the same individual and compensate that individual through a common paymaster which is one of the corporations, then the common paymaster is considered to be the only employer regardless of the fact that the individual performed services for other related corporations. Thus, the remuneration is subject to taxation only up to the contribution base for the total remuneration.

Section 125 of the Social Security Amendments of 1983 provides that a State university that employs health care professionals as faculty members at a medical school and a tax-exempt faculty practice plan that employs faculty members of the medical school are deemed to be related corporations for purposes of the common paymaster rule, provided that 30 percent or more of the employees of the plan are concurrently employed by the medical school. Remuneration that is disbursed by the faculty practice plan to an individual employed by both the plan and the university which, when

added to remuneration actually disbursed by the university, exceeds the contribution base, will be deemed to have been actually disbursed by the university as a common paymaster and not to have been disbursed by the faculty practice plan. Current Internal Revenue Service interpretation of the statute does not extend the “common paymaster” exception to apply to circumstances where such compensation is made through a university agency account, and not directly by a medical school faculty practice plan.

Reasons for change

The Committee believes that the application of the common paymaster rule is appropriate under the foregoing circumstances where such compensation is made through a university agency account.

Explanation of provision

The bill establishes a common paymaster rule in cases where a: (1) State or state university provides remuneration pursuant to a single contract of employment to certain health care professionals as members of its medical school faculty and, (2) an agency account at such institution also provides remuneration to such health care professionals. The agency account must receive funds for the remuneration from a faculty practice plan described in section 501(c)(3) of the Code. The payments may only be distributed by the agency account to faculty members who render patient care at the medical school. The faculty members receiving payments must comprise at least 30 percent of the membership of the faculty practice plan.

Effective date

The provision is effective for remuneration paid after December 31, 1996. It is intended that, with respect to years before the effective date, the Secretary apply present law in a manner consistent with the proposal.

3. Modifications to excise tax on ozone-depleting chemical

- a. Exempt imported recycled halons from the excise tax on ozone-depleting chemicals (sec. 1803 of the bill and sec. 4682 of the Code)*

Present law

An excise tax is imposed on the sale or use by the manufacturer or importer of certain ozone-depleting chemicals (Code sec. 4681). The amount of tax generally is determined by multiplying the base tax amount applicable for the calendar year by an ozone-depleting factor assigned to each taxable chemical. The base tax amount is \$5.80 per pound in 1996 and will increase by 45 cents per pound per year thereafter. The ozone-depleting factors for taxable halons are 3 for halon-1211, 10 for halon-1301, and 6 for halon-2402.

Taxable chemicals that are recovered and recycled within the United States are exempt from tax.

Reasons for change

The Committee recognizes that, under the Clean Air Act as amended and under the terms of the Montreal Protocol, domestic production of halons generally ceased after 1993. However, these chemicals are valuable as fire suppressants, particularly in those environments where human life may be endangered. The international restriction on production of halons has caused some individuals who had used halons in certain fire suppression systems to withdraw the halons from those systems and make them available for more highly valued uses. The Committee believes that the substantial tax on imported halons impedes the flow of these recovered and recycled halons to their most highly valued uses. The Committee further observes that, because production of new halons is banned domestically, permitting imported recycled halons to enter the domestic market with a rate of tax less than that of new production does not place at a disadvantage domestic producers or dealers in halons. Therefore, the Committee believes it is appropriate to provide comparable tax treatment to imported recycled halons to that accorded domestic recycled halons.

Explanation of provision

The bill extends the exemption from tax for domestically recovered and recycled ozone-depleting chemicals to imported recycled halons. The exemption for imported recycled halons applies only to such chemicals imported from countries that are signatories to the Montreal Protocol on Substances that Deplete the Ozone Layer.

The Committee recognizes that it is generally impossible to distinguish recycled halons from newly manufactured halons. The Committee intends that the Secretary of the Treasury, after consultation with the Administrator of the Environmental Protection Agency, establish a certification procedure drawing upon the international regulatory framework for trade in such chemicals provided under the Montreal Protocol and its subsequent amendments, as ratified by the United States Senate.

Effective date

The provision is effective for chemicals imported after December 31, 1996.

- b. Exempt chemicals used in metered-dose inhalers from the excise tax on ozone-depleting chemicals (sec. 1803 of the bill and sec. 4682 of the Code)*

Present law

An excise tax is imposed on the sale or use by the manufacturer or importer of certain ozone-depleting chemicals (Code sec. 4681). The amount of tax generally is determined by multiplying the base tax amount applicable for the calendar year by an ozone-depleting factor assigned to each taxable chemical. The base tax amount is \$5.80 per pound in 1996 and will increase by 45 cents per pound per year thereafter.

A reduced rate of tax of \$1.67 per pound applies to chemicals used as propellants in metered-dose inhalers (sec. 4682(g)(4)).

Reasons for change

The Committee recognizes that under the Clean Air Act as amended and under the terms of the Montreal Protocol, the use of ozone-depleting chemicals as a propellant in metered-dose inhalers has been designated as an essential use, permitting use of ozone-depleting chemicals as propellants in metered-dose inhalers despite the general prohibition on such chemicals. In light of this, the Committee believes it is appropriate to provide a corresponding exemption from tax for these important medical uses.

Explanation of provision

The bill exempts chemicals used as propellants in metered-dose inhalers from the excise tax on ozone-depleting chemicals.

Effective date

The provision is effective for chemicals sold or used seven days after the date of enactment.

4. *Tax-exempt bonds for the sale of Alaska Power Administration facility (sec. 1804 of the bill and secs. 142 and 147 of the Code)*

Present law

Interest on State and local government bonds generally is excluded from income unless the bonds are issued to provide financing for private parties. Present law includes several exceptions, however, that allow tax-exempt bonds to be used to provide financing for certain specifically identified private purposes (“private activity bonds”), including financing for certain facilities for the furnishing of electricity and gas. State and local government bonds issued to acquire existing output property (other than water facilities) are treated as private activity bonds even if a State or local government owns or operates the property. Similarly, bonds issued to acquire existing property, the output from which will be sold to a private party under a take or pay contract are private activity bonds.

Most private activity bonds are subject to annual State volume limits of the greater of \$50 per resident of the State or \$150 million. Additionally, persons acquiring property financed with most private activity bonds must satisfy a rehabilitation requirement as a condition of the financing.

Reasons for change

Limited tax-exempt financing is an integral component of proposed legislation for the sale of certain facilities by the Alaska Power Administration. That sale legislation has recently been enacted by the Congress. The Committee determined that a limited exception to the tax-exempt bond rules is appropriate to facilitate completion of this unique transaction.

Explanation of provision

The provision provides an exception from the general rehabilitation requirement for private activity bonds used to acquire existing

property for certain bonds to finance the acquisition of the Snettisham hydroelectric project from the Alaska Power Administration pursuant to legislation that has been enacted authorizing that transaction. Bonds for this acquisition will be subject to the State of Alaska's private activity bond volume limit.

Effective date

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

5. *Allow bank common trust funds to transfer assets to regulated investment companies without taxation (sec. 1805 of the bill and sec. 584 of the Code)*

Present law

Common trust funds

A common trust fund is a fund maintained by a bank exclusively for the collective investment and reinvestment of monies contributed by the bank in its capacity as a trustee, executor, administrator, guardian, or custodian of certain accounts and in conformity with rules and regulations of the Board of Governors of the Federal Reserve System or the Comptroller of the Currency pertaining to the collective investment of trust funds by national banks (sec. 584(a)).

The common trust fund is not subject to tax and is not treated as a corporation (sec. 584(b)). Each participant in a common trust fund includes his proportional share of common trust fund income, whether or not the income is distributed or distributable (sec. 584(c)).

No gain or loss is realized by the fund upon admission or withdrawal of a participant. Participants generally treat their admission to the fund as the purchase of an interest. Withdrawals from the fund generally are treated as the sale of an interest by the participant (sec. 584(e)).

Regulated investment companies (RICs)

A RIC also is treated as a conduit for Federal income tax purposes. Conduit treatment is accorded by allowing the RIC a deduction for dividend distributions to its shareholders. Present law is unclear as to the tax consequences when a common trust fund transfers its assets to one or more RICs.

Reasons for change

The Committee understands that administrative costs of managing pools of assets can be reduced for many banks if the bank utilizes the expertise of professional investment managers employed at mutual funds rather than attempting to duplicate the same investment management services within the bank. The Committee further recognizes that generally both common trust funds and mutual funds seek broad diversification of the assets contributed by the investors in the common trust fund or the mutual fund. Because both the common trust fund and the mutual fund are conduit

entities for Federal income tax purposes, the Committee believes that it would be inappropriate to impose a tax when the common trust fund transfers substantially all of its assets to one or more RICs, because only the form of the investment pool has been changed.

Explanation of provision

In general, the bill permits a common trust fund to transfer substantially all of its assets to one or more RICs without gain or loss being recognized by the fund or its participants. The fund must transfer its assets to the RICs solely in exchange for shares of the RICs, and the fund must then distribute the RIC shares to the fund's participants in exchange for the participant's interests in the fund.

The basis of any asset received by a RIC will be the basis of the asset in the hands of the fund prior to transfer (increased by the amount of gain recognized by reason of the rule regarding the assumption of liabilities). In addition, the basis of any RIC shares ("converted shares") that are received by a fund participant will be an allocable portion of the participant's basis in the interests exchanged. If stock in more than one RIC is received in exchange for assets of a common trust fund, the basis of the shares in each RIC shall be determined by allocating the basis of common fund assets used in the exchange among the shares of each RIC received in the exchange on the basis of the respective fair market values of the RICs. For example, assume a common trust fund with basis of \$100 and market value of \$1,000 transfers its assets to two RICs, receiving \$600 worth of shares in the first RIC and \$400 worth of shares in the second RIC. The basis of first RIC shares will be \$600 multiplied by \$100 divided by \$1,000, or \$60. The basis of the second RIC shares will be \$40.

The tax-free transfer is not available to a common trust fund with assets that are not diversified under the requirements of section 368(a)(2)(F)(ii), except that the diversification test is modified so that Government securities are not to be included as securities of an issuer and are to be included in determining total assets for purposes of the 25- and 50-percent tests.

No inference is intended as to the tax consequences under law in effect prior to the effective date of the provision when a common trust fund transfers its assets to one or more RICs.

Effective date

The provision is effective for transfers after December 31, 1995.

6. Treatment of qualified State tuition programs (sec. 1806 of the bill and new sec. 529 of the Code)

Present law

In *Michigan v. United States*, 40 F.3d 817 (6th Cir. 1994), the Sixth Circuit held that the Michigan Education Trust, an entity created by the State of Michigan to operate a prepaid tuition payment program, is an integral part of the State, and, thus, the investment income realized by the Trust is not currently subject to

Federal income tax. The Trust was established to receive advance payments of college tuition, invest the money, and ultimately make disbursements under a program that allows beneficiaries to attend any of the State's public colleges or universities without further tuition costs for a year or more (depending on the terms of the contract).

Section 115 of the Code provides that gross income does not include income derived from any public utility or the exercise of any essential governmental function and accruing to a State or any political subdivision thereof, or the District of Columbia.

Section 2501 imposes a Federal gift tax on certain transfers of property by gift. Section 2503(e) specifically excludes from gifts subject to tax under section 2501 any "qualified transfer," which includes any amount paid on behalf of an individual as tuition to an educational institution (as described in sec. 170(b)(1)(A)(ii)) for the education or training of such individual.

On June 11, 1996, the Treasury Department issued final regulations under the original issue discount ("OID") provisions of the Code (secs. 163(e) and 1271 through 1275), including regulations relating to debt instruments that provide for contingent payments (see TD 8674). These regulations specifically provide that they do not apply to contracts issued pursuant to State-sponsored prepaid tuition programs, whether or not the contracts are debt instruments. In addition, the IRS announced in Rev. Proc. 96-34 that it will not issue advance rulings or determination letters regarding State-sponsored prepaid tuition plans because issues that arise under such plans are being studied.

Reasons for change

The Committee believes that it is appropriate to clarify the tax treatment of State-sponsored prepaid tuition and educational savings programs in order to encourage persons to save to meet post-secondary educational expenses.

Explanation of provision

The bill provides tax-exempt status to "qualified State tuition programs," meaning programs established and maintained by a State (or agency or instrumentality thereof) under which persons may (1) purchase tuition credits or certificates on behalf of a designated beneficiary that entitle the beneficiary to a waiver or payment of qualified higher education expenses of the beneficiary, or (2) make contributions to an account that is established for the sole purpose of meeting qualified higher education expenses of the designated beneficiary of the account. "Qualified higher education expenses" are defined as tuition, fees, books, and equipment required for the enrollment or attendance at a college or university (or certain vocational schools). Although generally exempt from Federal income tax, a qualified State tuition program is subject to the unrelated business income tax (UBIT).⁷³

⁷³ The bill specifically provides that an interest in a qualified State tuition program will not be treated as debt for purposes of the UBIT debt-financed property rules (sec. 514). Consequently, a qualified State tuition program's investment income will not constitute debt-financed property income subject to the UBIT merely because the program accepts contributions and is obligated to pay out (or refund) such contributions and certain earnings thereon to des-

A qualified State tuition program is required to provide that purchases or contributions only be made in cash. Contributors and beneficiaries are not allowed to direct any investments made on their behalf by the program. The program is required to maintain a separate accounting for each designated beneficiary. A specified individual must be designated as the beneficiary at the commencement of participation in a qualified State tuition program (i.e., when contributions are first made to purchase an interest in such a program⁷⁴), unless interests in such a program are purchased by a State or local government or a tax-exempt charity described in section 501(c)(3) as part of a scholarship program operated by such government or charity under which beneficiaries to be named in the future will receive such interests as scholarships. A transfer of credits (or other amounts) from one account benefiting one designated beneficiary to another account benefiting a different beneficiary will be considered a distribution (as will a change in the designated beneficiary of an interest in a qualified State tuition program) unless the beneficiaries are members of the same family.⁷⁵ Earnings on an account may be refunded to a contributor or beneficiary, but the State or instrumentality must impose a more than de minimis monetary penalty unless the refund is (1) used for qualified higher education expenses of the beneficiary, (2) made on account of the death or disability of the beneficiary⁷⁶, or (3) made on account of a scholarship received by the designated beneficiary to the extent the amount refunded does not exceed the amount of the scholarship used for higher education expenses. A qualified State tuition program may not allow any interest in the program or any portion thereof to be used as security for a loan.

In addition, the bill provides that no amount shall be included in the gross income of a contributor to, or beneficiary of, a qualified State tuition program with respect to any contribution to, or earnings under, such program, except that (1) amounts distributed or educational benefits provided to a beneficiary (e.g., when the beneficiary attends college) will be included in the beneficiary's gross income (unless excludable under another Code section) to the extent such amount or the value of the educational benefits exceeds contributions made on behalf of the beneficiary, and (2) amounts distributed to a contributor (e.g., when a parent or other relative receives a refund) will be included in the contributor's gross income to the extent such amounts exceed contributions made by that person.⁷⁷

ignated beneficiaries or to contributors. However, investment income of a qualified State tuition program could be subject to the UBIT as debt-financed property income to the extent the program acquires indebtedness when investing the contributions made on behalf of designated beneficiaries.

⁷⁴ The bill allows for a change in designated beneficiaries, so long as the new beneficiary is a member of the same family as the old beneficiary.

⁷⁵ For this purpose, the term "member of the same family" is defined under present-law section 2032A(e)(2).

⁷⁶ Thus, a State need not impose a monetary penalty when a refund is made from a qualified State tuition program in order to cover medical expenses incurred by (or on behalf of) a designated beneficiary who suffers a disabling illness (and who could be any member of the same family of the originally designated beneficiary).

⁷⁷ Specifically, the bill provides that any distribution under a qualified State tuition program shall be includible in the gross income of the distributee in the same manner as provided under present-law section 72 to the extent not excluded from gross income under any other provision of the Code.

The bill further provides that, for purposes of present-law section 2503(e), contributions made by an individual to a qualified State tuition program are treated as a qualified transfer and, thus, not subject to Federal gift tax.

Effective date

The provision is effective for taxable years ending after the date of enactment. The bill also includes a transition rule providing that if (1) a State maintains (on the date of enactment) a program under which persons may purchase tuition credits on behalf of, or make contributions for educational expenses of, a designated beneficiary, and (2) such program meets the requirements of a qualified State tuition program before the later of (a) one year after the date of enactment, or (b) the first day of the first calendar quarter after the close of the first regular session of the State legislature that begins after the date of enactment, then the provisions of the bill will apply to contributions (and earnings allocable thereto) made before the later of such dates without regard to whether the requirements of a qualified State tuition program are met with respect to such contributions and earnings (e.g., even if the interest in the tuition or educational savings program covers not only qualified higher education expenses but also room and board expenses).

REVENUE OFFSETS

1. *Modifications of the Puerto Rico and possession tax credit (sec. 1601 of the bill and sec. 936 and new sec. 30A of the Code)*

Present law

Certain domestic corporations with business operations in the U.S. possessions (including, for this purpose, Puerto Rico and the U.S. Virgin Islands) may elect the Puerto Rico and possession tax credit which generally eliminates the U.S. tax on certain income related to their operations in the possessions. In contrast to the foreign tax credit, the Puerto Rico and possession tax credit is a “tax sparing” credit. That is, the credit is granted whether or not the electing corporation pays income tax to the possession. Income eligible for the credit under this provision falls into two broad categories: (1) possession business income, which is derived from the active conduct of a trade or business within a U.S. possession or from the sale or exchange of substantially all of the assets that were used in such a trade or business; and (2) qualified possession source investment income (“QPSII”), which is attributable to the investment in the possession or in certain Caribbean Basin countries of funds derived from the active conduct of a possession business.

In order to qualify for the Puerto Rico and possession tax credit for a taxable year, a domestic corporation must satisfy two conditions. First, the corporation must derive at least 80 percent of its gross income for the three-year period immediately preceding the close of the taxable year from sources within a possession. Second, the corporation must derive at least 75 percent of its gross income for that same period from the active conduct of a possession business.

A domestic corporation that has elected the Puerto Rico and possession tax credit and that satisfies these two conditions for a taxable year generally is entitled to a credit based on the U.S. tax attributable to the sum of the taxpayer's possession business income and its QPSII. However, the amount of the credit attributable to possession business income is subject to the limitations enacted by the Omnibus Budget Reconciliation Act of 1993. Under the economic activity limit, the amount of the credit with respect to such income cannot exceed an amount equal to the sum of (i) 60 percent of the taxpayer's qualifying wage and fringe benefit expenses, (ii) specified percentages of the taxpayer's depreciation allowances with respect to qualifying tangible property, and (iii) in certain cases, the taxpayer's qualifying possession income taxes. The credit calculated under the economic activity limit is referred to herein as the "wage credit." In the alternative, the taxpayer may elect to apply a limit equal to the applicable percentage of the credit that would otherwise be allowable with respect to possession business income; the applicable percentage is phased down to 50 percent for 1996, 45 percent for 1997, and 40 percent for 1998 and thereafter. The credit calculated under the applicable percentage limit is referred to herein as the "income credit." The amount of the Puerto Rico and possession tax credit attributable to QPSII is not subject to these limitations.

Reasons for change

The tax benefits provided by the Puerto Rico and possession tax credit are enjoyed by only the relatively small number of U.S. corporations that operate in the possessions. The Committee is concerned that the high cost of these tax benefits is borne by all U.S. taxpayers. In light of current budget constraints, the Committee believes that the tax exemption provided to corporations pursuant to the Puerto Rico and possession tax credit should be modified.

The Committee believes that appropriate transition rules should be provided for corporations with existing operations in the possessions. In this regard, the Committee believes that ten years is an appropriate transition period with respect to the credit computed without regard to the economic activity limit (i.e., the income credit). On the other hand, the credit computed under the economic activity limit (i.e., the wage credit) operates as a credit in the traditional sense, measured by the level of employment and other economic activity generated by the taxpayer in the possession. Accordingly, the Committee believes that it is appropriate to continue the wage credit for corporations with existing possession operations beyond such ten-year period, subject to a tighter limit on the amount of such credit relative to the compensation paid by the corporation in the possession. Moreover, the Committee believes that it is appropriate to move the wage credit with respect to operations in Puerto Rico to a new section of the Code contained in the subpart that includes other business-type credits.

Explanation of provision

In general

The provision generally repeals the Puerto Rico and possession tax credit with respect to possession business income for taxable years beginning after December 31, 1995. However, the provision provides special rules under which a corporation that is an existing credit claimant continues to be eligible to claim credits under the wage credit method. In addition, the provision provides grandfather rules under which a corporation that is an existing credit claimant is eligible to claim credits under the income credit method for a 10-year transition period. Further, a special rule applies to credits attributable to operations in Guam, American Samoa, and the Commonwealth of the Northern Mariana Islands.

The Puerto Rico and possession tax credit attributable to QPSII generally is eliminated for taxable years beginning after December 31, 1995. However, the credit attributable to QPSII continues to be allowed for QPSII earned before July 1, 1996.

For taxable years beginning after December 31, 1995, credits with respect to possession business income under both the income credit and wage credit methods apply only to corporations that qualify as existing credit claimants (as defined below). The determination of whether a corporation is an existing credit claimant is made separately for each possession. A corporation that is an existing credit claimant with respect to such possession is subject to the limitations described below in determining the credit with respect to operations in such possession for taxable years beginning after December 31, 1995. The credit, subject to such limitations, is computed separately for each possession with respect to which the corporation is an existing credit claimant.

Wage credit

For corporations that are existing credit claimants with respect to a possession and that use the wage credit, the wage credit is determined in the same manner as under present law for taxable years beginning after December 31, 1995 and before January 1, 2002. For taxable years beginning after December 31, 2001 and before January 1, 2006, the corporation's possession business income that is eligible for the wage credit is subject to a cap computed as described below. For taxable years beginning in 2006 and thereafter, in computing the economic activity limit on the wage credit, the percentage of the taxpayer's qualifying wage and fringe benefit expenses that is taken into account is reduced from 60 percent to 40 percent; the percentages with respect to the other components of the economic activity limit are not changed. Moreover, for taxable years beginning in 2006 and thereafter, the corporation's business income that is eligible for the wage credit continues to be subject to the cap described below.

The provision adds to the Code a new section which provides a credit determined under the wage credit method for business income from Puerto Rico. Such credit is computed under the rules described above with respect to the possession tax credit determined

under the wage credit method. Such section applies for taxable years beginning after December 31, 1995.

Income credit

For corporations that are existing credit claimants with respect to a possession and that elected to use the income credit, the income credit continues to be determined as under present law for taxable years beginning after December 31, 1995 and before January 1, 1998. For taxable years beginning after December 31, 1997 and before January 1, 2006, the corporation's possession business income that is eligible for the income credit is subject to a cap computed as described below. For taxable years beginning in 2006 and thereafter, the income credit is eliminated.

A corporation that had elected to use the income credit rather than the wage credit is permitted to revoke that election under present law. Under the provision, such a revocation is required to be made not later than with respect to the first taxable year beginning after December 31, 1996; such revocation, if made, applies to such taxable year and to all subsequent taxable years. Accordingly, a corporation that had an election in effect to use the income credit could revoke such election effective for its taxable year beginning in 1997 and thereafter; such corporation would continue to use the income credit for its taxable year beginning in 1996 and would use the wage credit for its taxable year beginning in 1997 and thereafter.

Computation of income cap

The cap on a corporation's possession business income that is eligible for either the income credit or the wage credit is computed based on the corporation's possession business income for the base period years ("average adjusted base period possession business income"). Average adjusted base period possession business income is the average of the adjusted possession business income for each of the corporation's base period years. For the purpose of this computation, the corporation's possession business income for a base period year is adjusted by an inflation factor that reflects inflation from such year to 1995. In addition, as a proxy for real growth in income throughout the base period, the inflation factor is increased by 5 percentage points compounded for each year from such year to the corporation's first taxable year beginning on or after October 14, 1995.

The corporation's base period years generally are three of the corporation's five most recent years ending before October 14, 1995, determined by disregarding the taxable years in which the adjusted possession business incomes were highest and lowest. For purposes of this computation, only years in which the corporation had significant possession business income are taken into account. A corporation is considered to have significant possession business income for a taxable year if such income exceeds 2 percent of the corporation's possession business income for each of the six taxable years ending with the first taxable year ending on or after October 14, 1995. If the corporation has significant possession business income for only four of the five most recent taxable years end-

ing before October 14, 1995, the base period years are determined by disregarding the year in which the corporation's possession business income was lowest. If the corporation has significant possession business income for three years or fewer of such five years, then the base period years are all such years. If there is no year of such five taxable years in which the corporation has significant possession business income, then the corporation is permitted to use as its base period its first taxable year ending on or after October 14, 1995; for this purpose, the amount of possession business income taken into account is the annualized amount of such income for the portion of the year ended September 30, 1995.

As one alternative, the corporation is permitted to elect to use its taxable year ending in 1992 as its base period (with the adjusted possession business income for such year constituting its cap). As another alternative, the corporation is permitted to elect to use as its cap the annualized amount of its possession business income for the first ten months of calendar year 1995, calculated by excluding any extraordinary items (as determined under generally accepted accounting principles) for such period. For this purpose, the Committee intends that transactions with a related party that are not in the ordinary course of business will be considered to be extraordinary items.

If a corporation's possession business income in a year for which the cap is applicable exceeds the cap, then the corporation's possession business income for purposes of computing its income credit or its wage credit for the year is an amount equal to the cap. The corporation's income credit continues to be subject to the applicable percentage limit, with such limit applied based on the corporation's possession business income as reduced to reflect the application of the cap. The corporation's wage credit is subject to the economic activity limit, with such limit applied based on the corporation's possession business income as reduced to reflect the application of the cap.

Qualification as existing credit claimant

A corporation is an existing credit claimant with respect to a possession if (1) the corporation was engaged in the active conduct of a trade or business within the possession on October 13, 1995, and (2) the corporation has elected the benefits of the Puerto Rico and possession tax credit pursuant to an election which is in effect for its taxable year that includes October 13, 1995. A corporation that adds a substantial new line of business after October 13, 1995, ceases to be an existing credit claimant as of the beginning of the taxable year during which such new line of business is added.

For purposes of these rules, a corporation is treated as engaged in the active conduct of a trade or business within a possession on October 13, 1995, if such corporation was engaged in the active conduct of such trade or business before January 1, 1996, and such corporation had in effect on October 13, 1995, a binding contract for the acquisition of assets to be used in, or the sale of property to be produced in, such trade or business. For example, if a corporation had in effect on October 13, 1995, binding contracts for the lease of a facility and the purchase of machinery to be used in a manufacturing business in a possession and if the corporation

began actively conducting that manufacturing business in the possession before January 1, 1996, that corporation will be an existing credit claimant. A change in the ownership of a corporation does not affect its status as an existing credit claimant.

In determining whether a corporation has added a substantial new line of business, the Committee intends that principles similar to those reflected in Treas. Reg. section 1.7704-2(d) (relating to the transition rules for existing publicly traded partnerships) apply. For example, a corporation that modifies its current production methods, expands existing facilities, or adds new facilities to support the production of its current product lines and products within the same four-digit Industry Number Standard Industrial Classification Code (Industry SIC Code) will not be considered to have added a substantial new line of business. In this regard, the Committee intends that the fact that a business which is added is assigned a different four-digit Industry SIC Code than is assigned to an existing business of the corporation will not automatically cause the corporation to be considered to have added a new line of business. For example, a pharmaceutical corporation that begins manufacturing a new drug will not be considered to have added a new line of business. Moreover, a pharmaceutical corporation that begins to manufacture a complete product from the bulk active chemical through the finished dosage form, a process that may be assigned two separate four-digit Industry SIC Codes, will not be considered to have added a new line of business even though it was previously engaged in activities that involved only a portion of the entire manufacturing process from bulk chemicals to finished dosages. The Committee further intends that, in the case of a merger of affiliated possession corporations that are existing credit claimants, the corporation that survives the merger will not be considered to have added a substantial new line of business by reason of its operation of the existing business of the affiliate that was merged into it.

Special rules for certain possessions

A special rule applies to the Puerto Rico and possession tax credit with respect to operations in Guam, American Samoa, and the Commonwealth of the Northern Mariana Islands. For any taxable year beginning after December 31, 1995, and before January 1, 2006, a corporation that is an existing credit claimant with respect to one of these possessions for such year continues to determine its Puerto Rico and possession tax credit with respect to operations in such possession as under present law.

For taxable years beginning in 2006 and thereafter, both the Puerto Rico and possession tax credit under the income credit method and the credit attributable to QPSII with respect to operations in Guam, American Samoa, and the Commonwealth of the Northern Mariana Islands are eliminated. For taxable years beginning in 2006 and thereafter, a corporation that is an existing credit claimant with respect to one of these possessions continues to be entitled to the wage credit with respect to the operations in such possession. However, for such years, in computing the economic activity limit on the wage credit, the percentage of the taxpayer's qualifying wage and fringe benefit expenses that is taken into ac-

count is reduced from 60 percent to 40 percent. Moreover, for such years, the corporation's possession business income attributable to operations in such possession that is eligible for the wage credit is subject to the cap computed as described above.

Study of wage credit method

The Committee directs the Treasury Department to study the effect on the economy of Puerto Rico of the wage credit (under present law and as amended by the bill), including an analysis of the impact of such credit on unemployment rates and economic growth. The Treasury Department is directed to submit to the House Committee on Ways and Means and the Senate Committee on Finance reports on its findings with respect to the impact of the wage credit within two years of the date of enactment and every four years thereafter.

Effective Date

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

2. *Repeal 50-percent interest income exclusion for financial institution loans to ESOPs (sec. 1602 of the bill and sec. 133 of the Code)*

Present law

A bank, insurance company, regulated investment company, or a corporation actively engaged in the business of lending money may generally exclude from gross income 50 percent of interest received on an ESOP loan (sec. 133). The 50-percent interest exclusion only applies if: (1) immediately after the acquisition of securities with the loan proceeds, the ESOP owns more than 50 percent of the outstanding stock or more than 50 percent of the total value of all outstanding stock of the corporation; (2) the ESOP loan term will not exceed 15 years; and (3) the ESOP provides for full pass-through voting to participants on all allocated shares acquired or transferred in connection with the loan.

Reasons for change

The Committee believes that the 50-percent exclusion for interest with respect to ESOP loans provides an unnecessary tax benefit to financial institutions for loans they would make without regard to the interest exclusion. The Committee finds no evidence that employers that maintain ESOPs have less access to borrowing than other borrowers or that there is a need to provide an incentive to lenders to make money available to ESOPs.

Explanation of provision

The provision repeals the 50-percent interest exclusion with respect to ESOP loans.

Effective date

The provision is effective with respect to loans made after the date of enactment, other than loans made pursuant to a written binding contract in effect before June 10, 1996, and at all times thereafter before such loan is made. The repeal of the 50-percent interest exclusion does not apply to the refinancing of an ESOP loan originally made on or before the date of enactment or pursuant to a binding contract in effect before June 10, 1996, provided: (1) such refinancing loan otherwise meets the requirements of section 133 in effect on the day before the date of enactment; (2) the outstanding principal amount of the loan is not increased; and (3) the term of the refinancing loan does not extend beyond the term of the original ESOP loan.

3. *Taxation of punitive damages received on account of personal injury or sickness (sec. 1603 of the bill and sec. 104(a)(2) of the Code)*

Present law

Under present law, gross income does not include any damages received (whether by suit or agreement and whether as lump sums or as periodic payments) on account of personal injury or sickness (sec. 104(a)(2)).

The exclusion from gross income of damages received on account of personal injury or sickness specifically does not apply to punitive damages received in connection with a case not involving physical injury or sickness. Courts presently differ as to whether the exclusion applies to punitive damages received in connection with a case involving a physical injury or physical sickness.⁷⁸ Certain States provide that, in the case of claims under a wrongful death statute, only punitive damages may be awarded.

Reasons for change

Punitive damages are intended to punish the wrongdoer and are not intended to compensate the claimant (e.g., for lost wages or pain and suffering). Thus, they are a windfall to the taxpayer and appropriately should be included in taxable income.

Explanation of provision

The bill provides that the exclusion from gross income does not apply to any punitive damages received on account of personal injury or sickness whether or not related to a physical injury or physical sickness. Under the bill, present law continues to apply to punitive damages received in a wrongful death action if the applicable State law (as in effect on September 13, 1995 without regard to subsequent modification) provides, or has been construed to provide by a court decision issued on or before such date, that only punitive

⁷⁸The Supreme Court recently agreed to decide whether punitive damages awarded in a physical injury lawsuit are excludable from gross income. *Ogilvie v. U.S.*, 66 F.3d 1550 (10th Cir. 1995), cert. granted, 64 U.S.L.W. 3639 (U.S. March 25, 1996)(No. 95-966). Also, the Tax Court recently held that if punitive damages are not of a compensatory nature, they are not excludable from income, regardless of whether the underlying claim involved a physical injury or physical sickness. *Bagley v. Commissioner*, 105 T.C. No. 27 (1995).

damages may be awarded in a wrongful death action. The Committee intends no inference as to the application of the exclusion to punitive damages prior to the effective date of the bill in connection with a case involving a physical injury or physical sickness.

Effective date

The provision generally is effective with respect to amounts received after June 30, 1996. The provision does not apply to amounts received under a written binding agreement, court decree, or mediation award in effect on (or issued on or before) September 13, 1995.

4. Extension and phaseout of excise tax on luxury automobiles (sec. 1604 of the bill and sec. 4001 of the Code)

Present law

Present law imposes an excise tax on the sale of automobiles whose price exceeds a designated threshold, currently \$34,000. The excise tax is imposed at a rate of 10-percent on the excess of the sales price above the designated threshold. The \$34,000 threshold is indexed for inflation.

The tax generally applies only to the first retail sale after manufacture, production, or importation of an automobile. It does not apply to subsequent sales of taxable automobiles.

The tax applies to sales before January 1, 2000.

Reasons for change

The Committee believes that the expiration date of January 1, 2000, at which time the rate of tax on certain automobiles would fall from ten percent to zero, will create an unacceptable disruption of the automobile market. The Committee believes a more gradual phaseout of the tax will be less disruptive to the market and believes it is appropriate to commence the phaseout this year.

Explanation of provision

The provision extends and phases out the luxury tax on automobiles. The tax rate is reduced by one percentage point per year beginning in 1996. The tax rate for sales (on or after July 1) in 1996 is 9 percent. The tax rate for sales in 1997 is 8 percent. The tax rate for sales in 1998 is 7 percent. The tax rate for sales in 1999 is 6 percent. The tax rate for sales in 2000 is 5 percent. The tax rate for sales in 2001 is 4 percent. The tax rate for sales in 2002 is 3 percent. The tax will expire after December 31, 2002.

Effective date

The provision is effective for sales on or after July 1, 1996.

5. *Allow certain persons engaged in the local furnishing of electricity or gas to elect not to be eligible for future tax-exempt bond financing (sec. 1605 of the amendment and sec. 142 of the Code)*

Present law

Interest on State and local government bonds generally is excluded from income except where the bonds are issued to provide financing for private parties. Present law includes several exceptions, however, that allow tax-exempt bonds to be used to provide financing for certain specifically identified private parties. One such exception allows tax-exempt bonds to be issued to finance facilities for the furnishing of electricity or gas by private parties if the area served by the facilities does not exceed (1) two contiguous counties or (2) a city and a contiguous county (commonly referred to as the “local furnishing” of electricity or gas).

Most private activity tax-exempt bonds are subject to general State private activity bond volume limits of \$50 per resident of the State (\$150 million, if greater) per year. Tax-exempt bonds for facilities used in the local furnishing of electricity or gas are subject to this limit. Like most other private beneficiaries of tax-exempt bonds, borrowers using tax-exempt bonds to finance these facilities are denied interest deductions on the debt underlying the bonds if the facilities cease to be used in qualified local furnishing activities. Additionally, as with all tax-exempt bonds, if the use of facilities financed with the bonds (or the beneficiary of the bonds) changes to a use (or beneficiary) not qualified for tax-exempt financing after the debt is incurred, interest on the bonds becomes taxable unless certain safe harbor standards are satisfied.

Reasons for change

Tax-exempt financing is a Federal tax subsidy which should be subject to careful scrutiny. The Committee is aware that past use of this subsidy during periods when the utility industry was more sheltered from competition may preclude prudent business expansion in certain cases under the current environment, particularly for persons engaged in the local furnishing of electricity or gas. The Committee determined that, in light of these industry changes, a narrow provision allowing for acceleration of the removal of this subsidy and limiting the subsidy to current recipients (and certain successors in interest) is appropriate in view of the current deregulation in these industries.

Explanation of provision

The provision allows persons that have received tax-exempt financing of facilities that currently qualify as used in the local furnishing of electricity or gas to elect to terminate their qualification for this tax-exempt financing and to expand their service areas without incurring the present-law loss of interest deductions and loss of tax-exemption penalties if—

- (1) no additional bonds are issued for facilities of the person making the election (or were issued for any predecessor) after the date of the provision’s enactment;

(2) the expansion of the person's service area is not financed with any tax-exempt bond proceeds; and

(3) all outstanding tax-exempt bonds of the person making the election (and any predecessor) are redeemed no later than six months after the earliest date on which redemption is not prohibited under the terms of the bonds, as issued, (or six months after the election, if later).

Except as described below, the provision further limits the exception allowing tax-exempt bonds to be issued for facilities used in the local furnishing of electricity or gas to bonds for facilities (1) of persons that qualified as engaged in that activity on the date of the provision's enactment and (2) that serve areas served by those persons on that date. The area which is considered to be served on the date of the provision's enactment consists of the geographic area in which service actually is being provided on that date. Service initially provided after the date of enactment to a new customer within that area (e.g., as a result of new construction or of a change in heating fuel type) is not treated as a service area expansion.

For purposes of this requirement, a change in the identity of a person serving an area is disregarded if the change is the result of a corporate reorganization where the area served remains unchanged and there is common ownership of both the predecessor and successor entities. To facilitate compliance with electric and gas industry restructuring now in progress, the provision further permits continued qualification of successor entities under a "step-in-the-shoes" rule without regard to common ownership if the service provided remains unchanged and the area served after the facilities are transferred does not exceed the area served before the transfer. For example, if facilities of a person engaged in local furnishing are sold to another person, the purchaser (when it engages in otherwise qualified local furnishing activities) is eligible for continued tax-exempt financing to the same extent that the seller would have been had the sale not occurred if the service provided and the area served do not change.

Similarly, a purchaser "steps into the shoes" of its seller with regard to eligibility for making the election to terminate its status as engaged in local furnishing without imposition of certain penalties on outstanding tax-exempt bonds. For example, if a person engaged in local furnishing activities on the date of the provision's enactment receives financing from tax-exempt bonds issued after the date of the provision's enactment (and is thereby ineligible to make the election), any purchaser from that person likewise is ineligible.

Effective date

The provision is effective on the date of enactment.

6. *Repeal of financial institution transition rule to interest allocation rules (sec. 1606 of the bill and sec. 1215(c) of the Tax Reform Act of 1986)*

Present law

For foreign tax credit purposes, taxpayers generally are required to allocate and apportion interest expense between U.S. and foreign

source income based on the proportion of the taxpayer's total assets in each location. Such allocation and apportionment is required to be made for affiliated groups (as defined in sec. 864(e)(5)) as a whole rather than on a subsidiary-by-subsidiary basis. However, certain types of financial institutions that are members of an affiliated group are treated as members of a separate affiliated group for purposes of the allocation and apportionment of their interest expense. Section 1215(c)(5) of the Tax Reform Act of 1986 (P.L. 99-514, 100 Stat. 2548) includes a targeted rule which treats a certain corporation as a financial institution for this purpose.

Reasons for change

The Committee believes that it is inappropriate to provide narrowly targeted rules for purposes of allocating and apportioning interest expense under the foreign tax credit rules.

Explanation of provision

The bill repeals the targeted rule of section 1215(c)(5) of the Tax Reform Act of 1986.

Effective date

The provision applies to taxable years beginning after December 31, 1995.

7. *Reinstate Airport and Airway Trust Fund excise taxes (sec. 1607 of the bill and secs. 4041, 4081, 4091, 4261, and 4271 of the Code)*

Present law

Before January 1, 1996, five separate excise taxes were imposed to fund the Federal Airport and Airway Trust Fund (the "Trust Fund") program. These aviation excise taxes were—

- (1) a 10-percent tax on domestic passenger tickets;
- (2) a 6.25-percent tax on domestic freight waybills;
- (3) a \$6-per-person tax on international departures;
- (4) a 17.5-cents-per-gallon tax on jet fuel used in noncommercial aviation; and
- (5) a 15-cents-per-gallon tax on gasoline used in noncommercial aviation.⁷⁹

Current trust fund authorizations extend through September 30, 1996.

During the period that these excise taxes were imposed, an exemption was provided for emergency medical helicopters and helicopters engaged in the exploration and development of hard minerals, oil and gas when the helicopters did not take off from or land at Federally assisted airports or otherwise use Federal aviation facilities or services.

⁷⁹ 14 cents per gallon of this tax continues to be imposed, with the revenues being deposited in the Highway Trust Fund.

Reasons for change

The aviation excise taxes, which expired after December 31, 1995, fund important Federal air transportation services. Their expiration is depleting monies available to finance these services, which Congress is in the process of reauthorizing for the period beginning October 1, 1996. The Committee determined that a short-term extension of those taxes will provide needed revenue while allowing a more complete review of the bases on which the excise taxes are calculated, once the findings of a cost allocation study currently being completed by the Federal Aviation Administration are available.

Explanation of provision

The expired Airport and Airway Trust Fund excise taxes, and transfer of these revenues to the Trust Fund, are reinstated during the period beginning seven days after enactment and ending after December 31, 1996.

The exemption for certain emergency medical helicopters is expanded to include fixed-wing aircraft equipped for and exclusively dedicated to acute care emergency medical transportation. Further, this exemption will no longer be limited to flights that do not take off from or land at Federally assisted airports or otherwise use the Federal air navigation system, but rather will apply to all qualifying flights by emergency medical aircraft.

Clarification is provided that the exemption for helicopters when engaged in exploration for and development of hard minerals, oil, and gas extends to discrete segments of flights that otherwise originate and/or terminate at Federally assisted airports where no Federal air navigation facilities or services are utilized during the segments. That is, a flight segment between intermediate take-offs and landings, neither of which occurs at Federally assisted facilities, is exempt from the aviation excise taxes if no Federal facilities or services are used during that flight segment.

Effective date

The reinstatement of the aviation excise taxes is effective beginning seven days after the date of the provision's enactment; however, the passenger ticket and freight waybill taxes do not apply to any amount paid before that date for transportation occurring during the period when the taxes otherwise are reinstated.

8. *Modify basis adjustment rules under section 1033 (sec. 1608 of the bill and sec. 1033 of the Code)*

Present law

Under section 1033, gain realized by a taxpayer from certain involuntary conversions of property is deferred to the extent the taxpayer purchases property similar or related in service or use to the converted property within a specified replacement period of time. The replacement property may be acquired directly or by acquiring control of a corporation (generally, 80 percent of the stock of the corporation) that owns replacement property. The taxpayer's basis in the replacement property generally is the same as the taxpayer's

basis in the converted property, decreased by the amount of any money or loss recognized on the conversion, and increased by the amount of any gain recognized on the conversion. In cases in which a taxpayer purchases stock as replacement property, the taxpayer generally reduces the basis of the stock, but does not reduce the basis of the underlying assets. Thus, the reduction in the basis of the stock generally does not result in reduced depreciation deductions where the corporation holds depreciable property, and may result in the taxpayer having more aggregate depreciable basis after the acquisition of replacement property than before the involuntary conversion.

Reasons for change

The Committee believes that if a taxpayer elects to defer the recognition of gain with respect to property that is involuntarily converted, the taxpayer should have the same adjusted basis in the acquired property that is similar or related in service or use to the converted property, regardless of whether such property is acquired directly or indirectly through the acquisition of stock of a corporation.

Explanation of provision

The provision provides that where the taxpayer satisfies the replacement property requirement of section 1033 by acquiring stock in a corporation, the corporation generally will reduce its adjusted bases in its assets by the amount by which the taxpayer reduces its basis in the stock. The corporation's adjusted bases in its assets will not be reduced, in the aggregate, below the taxpayer's basis in its stock (determined after the appropriate basis adjustment for the stock). In addition, the basis of any individual asset will not be reduced below zero. The basis reduction first is applied to: (1) property that is similar or related in service or use to the converted property, then (2) to other depreciable property, then (3) to other property.

The application of these rules can be demonstrated by the following examples:

Example 1.—Assume that a taxpayer owned a commercial building with an adjusted basis of \$100,000 that was involuntarily converted, causing the taxpayer to receive \$1 million in insurance proceeds. Further assume that the taxpayer acquires, as replacement property, all of the stock of a corporation, the sole asset of the corporation is a building with a value and an adjusted basis of \$1 million. Under the provision, for section 1033 to apply, the taxpayer would reduce its basis in the stock to \$100,000 (as under present law) and the corporation would reduce its adjusted basis in the building to \$100,000.

Example 2.—Assume the same facts as in Example 1, except that on the date of acquisition, the corporation has an adjusted basis of \$100,000 (rather than \$1 million) in the building. Under the bill, the taxpayer reduces its basis in the stock to \$100,000 (as under present law) and the corporation is not required to reduce its adjusted basis in the building.

Effective date

The provision applies to involuntary conversions occurring after the date of enactment of this Act.

9. *Extension of withholding to certain gambling winnings (sec. 1609 of the bill and sec. 3402(q) of the Code)*

Present law

In general, proceeds from a wagering transaction are subject to withholding at a rate of 28 percent if the proceeds exceed \$5,000 and are at least 300 times as large as the amount wagered. No withholding tax is imposed on winnings from bingo or keno.

Reasons for change

The Committee believes that imposing withholding on winnings from bingo and keno will improve tax compliance.

Explanation of provision

The bill imposes withholding on proceeds from bingo or keno wagering transactions at a rate of 28 percent if such proceeds exceed \$5,000, regardless of the odds of the wager.

Effective date

The provision is effective 30 days after the date of enactment.

10. *Treatment of certain insurance contracts on retired lives (sec. 1610 of the bill and sec. 817(d) of the Code)*

Present law

Life insurance companies are allowed a deduction for any net increase in reserves and are required to include in income any net decrease in reserves. The reserve of a life insurance company for any contract is the greater of the net surrender value of the contract or the reserve determined under Federally prescribed rules. In no event, however, may the amount of the reserve for tax purposes for any contract at any time exceed the amount of the reserve for annual statement purposes.

Special rules are provided in the case of a variable contract. Under these rules, the reserve for a variable contract is adjusted by (1) subtracting any amount that has been added to the reserve by reason of appreciation in the value of assets underlying such contract, and (2) adding any amount that has been subtracted from the reserve by reason of depreciation in the value of assets underlying such contract. In addition, the basis of each asset underlying a variable contract is adjusted for appreciation or depreciation to the extent the reserve is adjusted.

A variable contract generally is defined as any annuity or life insurance contract (1) that provides for the allocation of all or part of the amounts received under the contract to an account that is segregated from the general asset accounts of the company, and (2) under which, in the case of an annuity contract, the amounts paid in, or the amounts paid out, reflect the investment return and the

market value of the segregated asset account, or, in the case of a life insurance contract, the amount of the death benefit (or the period of coverage) is adjusted on the basis of the investment return and the market value of the segregated asset account. A pension plan contract that is not a life, accident, or health, property, casualty, or liability insurance contract is treated as an annuity contract for purposes of this definition.

Reasons for change

The Committee believes that certain contracts which provide insurance on retired lives should be treated as variable contracts in order to simplify the treatment of such contracts and to provide a more accurate measure of the income of life insurance companies with respect to such contracts.

Explanation of provision

The bill provides that a variable contract is to include a contract that provides for the funding of group term life or group accident and health insurance on retired lives if: (1) the contract provides for the allocation of all or part of the amounts received under the contract to an account that is segregated from the general asset account of the company; and (2) the amounts paid in, or the amounts paid out, under the contract reflect the investment return and the market value of the segregated asset account underlying the contract.

Thus, the reserve for such a contract is to be adjusted by (1) subtracting any amount that has been added to the reserve by reason of appreciation in the value of assets underlying such contract, and (2) adding any amount that has been subtracted from the reserve by reason of depreciation in the value of assets underlying such contract. In addition, the basis of each asset underlying the contract is to be adjusted for appreciation or depreciation to the extent that the reserve is adjusted.

Effective date

The provision applies to taxable years beginning after December 31, 1995.

11. Treatment of contributions in aid of construction for water utilities (sec. 1611(a) of the bill and sec. 118 of the Code)

Present and prior law

The gross income of a corporation does not include contributions to its capital. A contribution to the capital of a corporation does not include any contribution in aid of construction or any other contribution as a customer or potential customer.

Prior to the enactment of the Tax Reform Act of 1986 ("1986 Act"), a regulated public utility that provided electric energy, gas, water, or sewage disposal services was allowed to treat any amount of money or property received from any person as a tax-free contribution to its capital so long as such amount: (1) was a contribution in aid of construction and (2) was not included in the taxpayer's rate base for rate-making purposes. A contribution in aid

of construction did not include a connection fee. The basis of any property acquired with a contribution in aid of construction was zero.

If the contribution was in property other than electric energy, gas, steam, water, or sewerage disposal facilities, such contribution was not includible in the utility's gross income so long as: (1) an amount at least equal to the amount of the contribution was expended for the acquisition or construction of tangible property that was used predominantly in the trade or business of furnishing utility services; (2) the expenditure occurred before the end of the second taxable year after the year that the contribution was received; and (3) certain records were kept with respect to the contribution and the expenditure. In addition, the statute of limitations for the assessment of deficiencies was extended in the case of these contributions.

These rules were repealed by the 1986 Act. Thus, after the 1986 Act, the receipt by a utility of a contribution in aid of construction is includible in the gross income of the utility, and the basis of property received or constructed pursuant to the contribution is not reduced.

Reasons for change

The Committee believes that the changes made by the 1986 Act with respect to the treatment of contributions in the aid of construction to water utilities may inhibit the development of certain communities and the modernization of water and sewerage facilities.

Explanation of provision

The provision restores the contributions in aid of construction provisions that were repealed by the 1986 Act for regulated public utilities that provide water or sewerage disposal services.

Effective date

The provision is effective for amounts received after June 12, 1996.

12. *Require water utility property to be depreciated over 25 years (sec. 1611(b) of the bill and sec. 168 of the Code)*

Present law

Property used by a water utility in the gathering, treatment, and commercial distribution of water and municipal sewers are depreciated over a 20-year period for regular tax purposes. The depreciation method generally applicable to property with a recovery period of 20 years is the 150-percent declining balance method (switching to the straight-line method in the year that maximizes the depreciation deduction). The straight-line method applies to property with a recovery period over 20 years.

Reasons for change

The Committee believes that it is appropriate to extend the depreciable life of water utility property given the exception provided by the Committee for contributions in aid of construction of water utility companies and the long useful lives generally exhibited by such property.

Explanation of provision

The provision provides that water utility property will be depreciated using a 25-year recovery period and the straight-line method for regular tax purposes. For this purpose, “water utility property” means (1) property that is an integral part of the gathering, treatment, or commercial distribution of water, and that, without regard to the provision, would have a recovery period of 20 years and (2) any municipal sewer. Such property generally is described in Asset Classes 49.3 and 51 of Revenue Procedure 87–56, 1987–2 C.B. 674. The provision does not change the class lives of water utility property for purposes of the alternative depreciation system of section 168(g).

Effective date

The provision is effective for property placed in service after June 12, 1996, other than property placed in service pursuant to a binding contract in effect before June 10, 1996, and at all times thereafter before the property is placed in service.

13. *Treatment of financial asset securitization investment trusts (“FASITs”) (sec. 1621 of the bill and new secs. 860H, 860J, 860K, and 860L of the Code)*

Present law

An individual can own income-producing assets directly, or indirectly through an entity (i.e., a corporation, partnership, or trust). Where an individual owns assets through an entity (e.g., a corporation), the nature of the interest in the entity (e.g., stock of a corporation) is different than the nature of the assets held by the entity (e.g., assets of the corporation).

Securitization is the process of converting one type of asset into another and generally involves the use of an entity separate from the underlying assets. In the case of securitization of debt instruments, the instruments created in the securitization typically have different maturities and characteristics than the debt instruments that are securitized.

Entities used in securitization include entities that are subject to tax (e.g., a corporation), conduit entities that generally are not subject to tax (e.g., a partnership, grantor trust, or real estate mortgage investment conduit (“REMIC”)), or partial-conduit entities that generally are subject to tax only to the extent income is not distributed to owners (e.g., a trust, real estate investment trust (“REIT”), or regulated investment company (“RIC”)).

There is no statutory entity that facilitates the securitization of revolving, non-mortgage debt obligations.

Reasons for change

The Committee believes that there are substantial benefits to the economy from increased securitization of assets in the form of debt because securitization of such assets will spread the risk of credit on the debt to others. The Committee believes that the spreading of credit risk will lessen the concentration of such risk in banks and other financial intermediaries which, in turn, will lessen the pressure on Federal deposit insurance. Further, the Committee believes that the spreading of credit risk through securitization will result in lower interest rates for consumers.

The Committee understands that it is difficult to securitize revolving debt (such as credit card receivables) under present law without the imposition of a corporate tax if the sponsor of the securitization does not want to report the securitized assets and the interests therein on his financial reports. Accordingly, the Committee bill would create a new type of entity, known as a "financial asset securitization investment trust" or "FASIT," through which securitizations of all types of debt, including revolving credit debt, can be accomplished without the imposition of a corporate tax even though the securitized debt and the interests in the securitized debt are not reported on the financial statements of the securitization's sponsor.

Basically, the Committee bill achieves its purpose by allowing the FASIT to issue instruments, called "regular interests," which will be treated as debt (and, therefore, payments of the return on such interests would be deductible as interest) even though such instruments might not otherwise be treated as debt for Federal income tax purposes. Nonetheless, in order that there be a corporate tax on returns that approach returns on equity, the bill requires that instruments whose yield is more than five percentage points higher than the yield on U.S. Treasury obligations (called "high-yield interests") be held, directly or indirectly, by domestic, non-exempt corporations and such yield cannot be offset by any net operating loss of its owner. In addition, in order to insure that FASITs are not used for purposes other than securitization, the bill imposes a 100-percent excise tax on any income not related to securitizations (called a "prohibited transaction").

*Explanation of provision**In general*

The bill creates a new type of statutory entity called a "financial asset securitization investment trust" ("FASIT") that facilitates the securitization of debt obligations such as credit card receivables, home equity loans, and auto loans. A FASIT generally will not be taxable; the FASIT's taxable income or net loss will flow through to the owner of the FASIT.

The ownership interest of a FASIT generally will be required to be entirely held by a single domestic C corporation. The Committee expects that the Treasury Department will issue guidance on how this rule would apply to cases in which the entity that owns the FASIT joins in the filing of a consolidated return with other members of the group that wish to hold an ownership interest in the

FASIT. In addition, a FASIT generally may hold only qualified debt obligations, and certain other specified assets, and will be subject to certain restrictions on its activities. An entity that qualifies as a FASIT can issue instruments that meet certain specified requirements and treat those instruments as debt for Federal income tax purposes. Instruments issued by a FASIT bearing yields to maturity over five percentage points above the yield to maturity on specified United States government obligations (i.e., “high-yield interests”) must be held, directly or indirectly, only by domestic C corporations that are not exempt from income tax.

Qualification as a FASIT

In general

To qualify as a FASIT, an entity must: (1) make an election to be treated as a FASIT for the year of the election and all subsequent years; (2) have assets substantially all of which (including assets that the FASIT is treated as owning because they support regular interests) are specified types called “permitted assets;” (3) have non-ownership interests be certain specified types of debt instruments called “regular interests;” (4) have a single ownership interest which is held by an “eligible holder;” and (5) not qualify as a RIC. Any entity, including a corporation, partnership, or trust may be treated as a FASIT. In addition, a segregated pool of assets may qualify as a FASIT.

Election to be a FASIT

Once an election to be a FASIT is made, the election applies from the date specified in the election and all subsequent years until the entity ceases to be a FASIT. The manner of making the election to be a FASIT is to determined by the Secretary of the Treasury. If an election to be a FASIT is made after the initial year of an entity, all of the assets in the entity at the time of the FASIT election are deemed contributed to the FASIT at that time and, accordingly, any gain (but not loss) on such assets will be recognized at that time.⁸⁰

Ceasing to be a FASIT

Once an entity ceases to be a FASIT, it is not a FASIT for that year or any subsequent year. Nonetheless, an entity can continue to be a FASIT where the Treasury Department determines that the entity inadvertently ceases to be a FASIT, steps are taken reasonably soon after it is discovered that the entity ceased being a FASIT so that it again qualifies as a FASIT, and the FASIT and its owner take those steps that the Treasury Department deems necessary. An entity will cease qualifying as a FASIT if the entity’s owner ceases being an eligible corporation. Loss of FASIT status is to be treated as if all of the regular interests of the FASIT were retired and then reissued without the application of the rule which deems regular interests of a FASIT to be debt. The Committee understands that this treatment could result in the creation of cancellation of indebtedness income where the new instruments

⁸⁰The bill provides transitional relief under which gain in pre-effective date entities that make a FASIT election may be deferred.

deemed to be issued are treated as stock under general tax principles.

Permitted assets

In general.—For an entity or arrangement to qualify as a FASIT, substantially all of its assets must consist of the following “permitted assets”: (1) cash and cash equivalents; (2) certain permitted debt instruments; (3) certain foreclosure property; (4) certain instruments or contracts that represent a hedge or guarantee of debt held or issued by the FASIT; (5) contract rights to acquire permitted debt instruments or hedges; and (6) a regular interest in another FASIT. A FASIT must meet the asset test at the 90th day after its formation and at all times thereafter. Permitted assets may be acquired at any time by a FASIT, including any time after its formation.

Permitted debt instruments.—A debt instrument will be a permitted asset only if the instrument is indebtedness for Federal income tax purposes including trade receivables, regular interests in a real estate mortgage investment conduit (REMIC), or regular interests issued by another FASIT and it bears (1) fixed interest or (2) variable interest of a type that relates to qualified variable rate debt (as defined in Treasury regulations prescribed under sec. 860G(a)(1)(B)). Except for cash equivalents, permitted debt obligations cannot be obligations issued, directly or indirectly, by the owner of the FASIT or a related person.

Foreclosure property.—Permitted assets include property acquired on default (or imminent default) of debt instruments, swap contracts, forward contracts, or similar contracts held by the FASIT that would be foreclosure property to a REIT (under sec. 856(e)) if the property that was acquired by foreclosure by the FASIT was real property or would be foreclosure property to a REIT but for certain leases entered into or construction performed (as described in sec. 856(e)(4)) while held by the FASIT.

Hedges.—Permitted assets include interest rate or foreign currency notional principal contracts, letters of credit, insurance, guarantees against payment defaults, notional principal contracts that are “in the money,” or other similar instruments as permitted under Treasury regulations, which are reasonably required to guarantee or hedge against the FASIT’s risks associated with being the obligor of regular interests. An instrument is a hedge if it results in risk reduction as described in Treasury Income Tax Regulations 1.1221-2.

“Regular interests” of a FASIT

Under the bill, “regular interests” of a FASIT, including “high-yield interests,” are treated as debt for Federal income tax purposes regardless of whether instruments with similar terms issued by non-FASITs might be characterized as equity under general tax principles. To be treated as a “regular interest,” an instrument must have fixed terms and must: (1) unconditionally entitle the holder to receive a specified principal amount; (2) pay interest that is based on (a) one or more rates that are fixed, (b) rates that measure contemporaneous variations in the cost of newly borrowed

funds,⁸¹ or (c) to the extent permitted by Treasury regulations, variable rates allowed to regular interests of a REMIC if the FASIT would otherwise qualify as a REMIC; (3) have a term to maturity of no more than 30 years, except as permitted by Treasury regulations; (4) be issued to the public with a premium of not more than 25 percent of its stated principal amount; and (5) have a yield to maturity determined on the date of issue of no more than five percentage points above the applicable Federal rate (AFR) for the calendar month in which the instrument is issued.

A FASIT also may issue high-yield debt instruments, which includes any debt instrument issued by a FASIT that meets the second and third conditions described above, so long as such interests are not held by a disqualified holder. A “disqualified holder” generally is any holder other than (1) a domestic C corporation that does not qualify as a RIC, REIT, REMIC, or cooperative⁸² or (2) a dealer who acquires FASIT debt for resale to customers in the ordinary course of business. An excise tax is imposed at the highest corporate rate on a dealer if there is a change in dealer status or if the holding of the instrument is for investment purposes. A 31-day grace period is granted before ownership of an interest held by a dealer generally could be treated as held by the FASIT owner for investment purposes.

Permitted ownership holder

A permitted holder of the ownership interest in a FASIT generally is a non-exempt domestic C corporation, other than a corporation that qualifies as a RIC, REIT, REMIC, or cooperative.

Transfers to non-permitted holders of high-yield interests

A transfer of a high-yield interest to a disqualified holder is to be ignored for Federal income tax purposes. Thus, such a transferor will continue to be liable for any taxes due with respect to the transferred interest.

Taxation of a FASIT

In general

A FASIT generally is not subject to tax. Instead, all of the FASIT's assets and liabilities are treated as assets and liabilities of the FASIT's owner and any income, gain, deduction or loss of the FASIT is allocable directly to its owner. Accordingly, income tax rules applicable to a FASIT (e.g., related party rules, sec. 871(h), sec. 165(g)(2)) are to be applied in the same manner as they apply to the FASIT's owner. Any securities held by the FASIT that are treated as held by its owner are treated as held for investment. The taxable income of a FASIT is calculated using an accrual method of accounting. The constant yield method and principles that apply for purposes of determining OID accrual on debt obligations whose principal is subject to acceleration apply to all debt ob-

⁸¹Variable interest rates that would meet this standard include variable interest rates described in Treasury Income Tax Regulations 1.860G-1(a)(3).

⁸²The bill treats cooperatives as disqualified holders since cooperatives, like RICs and REITs, are treated as pass-through entities and, also like the owners of RICs and REITs, the cooperative's members and patrons need not be C corporations.

ligations held by a FASIT to calculate the FASIT's interest and discount income and premium deductions or adjustments. For this purpose, a FASIT's income does not include any income subject to the 100-percent penalty excise tax on prohibited transactions.

Income from prohibited transactions

The owner of a FASIT is required to pay a penalty excise tax equal to 100 percent of net income derived from (1) an asset that is not a permitted asset, (2) any disposition of an asset other than a permitted disposition, (3) any income attributable to loans originated by the FASIT, and (4) compensation for services (other than fees for a waiver, amendment, or consent under permitted assets not acquired through foreclosure). A permitted disposition is any disposition of any permitted asset (1) arising from complete liquidation of a class of regular interests (i.e., a qualified liquidation⁸³), (2) incident to the foreclosure, default, or imminent default of the asset, (3) incident to the bankruptcy or insolvency of the FASIT, (4) necessary to avoid a default on any indebtedness of the FASIT attributable to a default (or imminent default) on an asset of the FASIT, (5) to facilitate a clean-up call, (6) to substitute a permitted debt instrument for another such instrument, or (7) in order to reduce over-collateralization where a principal purpose of the disposition was not to avoid recognition of gain arising from an increase in its market value after its acquisition by the FASIT. Notwithstanding this rule, the owner of a FASIT may currently deduct its losses incurred in prohibited transactions in computing its taxable income for the year of the loss.

Taxation of interests in the FASIT

Taxation of holders of regular interests

In general.—A holder of a regular interest, including a high-yield interest, is taxed in the same manner as a holder of any other debt instrument, except that the regular interest holder is required to account for income relating to the interest on an accrual method of accounting, regardless of the method of accounting otherwise used by the holder.⁸⁴

High-yield interests.—Holders of high-yield interests are not allowed to use net operating losses to offset any income derived from the high-yield debt. Any net operating loss carryover shall be computed by disregarding any income arising by reason of the disallowed loss.

In addition, a transfer of a high-yield interest to a disqualified holder is not recognized for Federal income tax purposes such that the transferor will continue to be taxed on the income from the high-yield interest unless the transferee provides the transferor with an affidavit that the transferee is not a disqualified person or the Treasury Secretary determines that the high-yield interest is no longer held by a disqualified person and a corporate tax has been paid on the income from the high-yield interest while it was

⁸³ For this purpose, a "qualified liquidation" has the same meaning as it does purposes of the exemption from the tax on prohibited transactions of a REMIC in section 860F(a)(4).

⁸⁴ Regular interest in a FASIT 95 percent or more of whose assets are real estate mortgages are treated as real estate assets where relevant (e.g., secs. 856, 593, 7701(a)(19)).

held by a disqualified person.⁸⁵ High-yield interests may be held without a corporate tax being imposed on the income from the high-yield interest where the interest is held by a dealer in securities who acquired such high-yield interest for sale in the ordinary course of his business as a securities dealer. In such a case, a corporate tax is imposed on such a dealer if his reason for holding the high-yield interest changes to investment. There is a presumption that the dealer has not changed his intent for holding high-yield instruments to investment for the first 31 days he holds such interests unless such holding is part of a plan to avoid the restriction on holding of high-yield interests by disqualified persons.

Where a pass-through entity (other than a FASIT) issues either debt or equity instruments that are secured by regular interests in a FASIT and such instruments bear a yield to maturity greater than the yield on the regular interests or the applicable Federal rate plus five percentage points (determined on date that the pass-through entity acquires the regular interests in the FASIT) and the pass-through entity issued such debt or equity with a principal purpose of avoiding the rule that high-yield interests be held by corporations, then an excise tax is imposed on the pass-through entity at a rate equal to the highest corporate rate on the income of any holder of such instrument attributable to the regular interests.

Taxation of holder of ownership interest

All of the FASIT's assets and liabilities are treated as assets and liabilities of the holder of a FASIT ownership interest and that owner takes into account all of the FASIT's income, gain, deduction, or loss in computing its taxable income or net loss for the taxable year. The character of the income to the holder of an ownership interest is the same as its character to the FASIT, except tax-exempt interest is taken into income of the holder as ordinary income.⁸⁶

Losses on assets contributed to the FASIT are not allowed upon their contribution, but may be allowed to the FASIT owner upon their disposition by the FASIT. A special rule provides that the holder of a FASIT ownership interest cannot offset income or gain from the FASIT ownership interest with any other losses. Any net operating loss carryover of the FASIT owner shall be computed by disregarding any income arising by reason of a disallowed loss.

For purposes of the alternative minimum tax, the owner's taxable income is determined without regard to the minimum FASIT income. The alternative minimum taxable income of the FASIT owner cannot be less than the FASIT income for that year, and the alternative minimum tax net operating loss deduction is computed without regard to the minimum FASIT income.

Transfers to FASITs

Gain generally is recognized immediately by the owner of the FASIT upon the transfer of assets to a FASIT. Assets that are acquired by the FASIT from someone other than its owner are treat-

⁸⁵ Under this rule, no high-yield interests will be treated as issued where the FASIT directly issues such interests to a disqualified holder.

⁸⁶ Ownership interests in a FASIT 95 percent or more of whose assets are real estate mortgages are treated as real estate assets where relevant (e.g., secs. 856, 593, 7701(a)(19)).

ed as if they were acquired by the owner and then contributed to the FASIT. In addition, any assets of the FASIT owner or a related person that are used to support⁸⁷ FASIT regular interests are treated as contributed to the FASIT and, thus, any gain on any such assets also will be recognized at the earliest date that such assets support any FASIT's regular interests.⁸⁸ To the extent provided by Treasury regulations, gain recognition on the contributed assets may be deferred until such assets support regular interests issued by the FASIT or any indebtedness of the owner or related person. These regulations may adjust other statutory FASIT provisions to the extent such provisions are inconsistent with such regulations. For example, such regulations may disqualify certain assets as permitted assets. The basis of any FASIT asset is increased by the amount of the taxable gain recognized on the contribution of the assets to the FASIT.

Valuation rules

In general, except in the case of debt instruments, the value of FASIT assets is their fair market value. In the case of debt instruments that are traded on an established securities market, then the market price will be used for purposes of determining the amount of gain realized upon contribution of such assets to a FASIT. Nonetheless, the bill contains special rules for valuing other debt instruments for purposes of computing gain on the transfer to a FASIT. Under these rules, the value of such debt instruments is the sum of the present values of the reasonably expected cash flows from such obligations discounted over the weighted average life of such assets. The discount rate is 120 percent of the applicable Federal rate, compounded semiannually, or such other rate that the Treasury Secretary shall prescribe by regulations. For purposes of determining the value of a pool of revolving loan accounts having substantially the same terms, each extension of credit (other than the accrual of interest) is treated as a separate debt instrument and the maturity of the instruments is determined using the reasonably anticipated periodic payment rate at which principal payments will be made as a proportion of their aggregate outstanding principal balances assuming that payments are applied to the earliest credit extensions. The Committee understands that reasonably expected cash flows from loans will reflect nonpayment (i.e., losses), early payments (i.e., prepayments), and reasonable costs of servicing the loans. This value shall be used in determining the amount of gain realized upon the contribution of assets to a FASIT even though that value may be different than the value of such assets would be applying a willing buyer/willing seller standard.

⁸⁷ For this purpose, supporting assets includes any assets that are reasonably expected to directly or indirectly pay regular interests or to otherwise secure or collateralize regular interests. In the case where there is a commitment to make additional contributions to a FASIT, any such assets will not be treated as supporting the FASIT until they are transferred to the FASIT or set aside for such use.

⁸⁸ In the case of a securities dealer which may be an eligible holder, the Committee understands that the mark-to-market rule of section 475 will not apply to an ownership interest in a FASIT or assets held in the FASIT.

Related person

For purposes of the FASIT rules, a person is related to another person if that person bears a relationship to the other person specified in sections 267(b) or 707(b)(1), using a 20-percent ownership test instead of the 50-percent test, or such persons are engaged in trades or businesses under common control as determined under sections 52(a) or (b).

Related amendments

For purposes of the wash sale rule (sec. 1091), an ownership interest of a FASIT is treated as a “security.” In addition, an ownership interest in a FASIT and a residual interest in a pool of debt obligations that are substantially similar to the debt obligations in the FASIT shall be treated as “substantially identical stock or securities”. Finally, the wash sale period begins six months before, and ends six months after, the sale of the ownership interest of the FASIT.

Effective Date

The provision takes effect on the date of enactment. The bill provides a special transition rule for existing entities (e.g., a trust whose interests are taxed like a partnership) that elect to be a FASIT.

14. *Revision of expatriation tax rules (secs. 1631–1633 of the bill and secs. 102, 877, 2107, 2501, and 7701 and new secs. 877A and 6039F of the Code)*

Present Law

Taxation of United States citizens, residents, and nonresidents

Individual income taxation

Income taxation of U.S. citizens and residents

In general.—A United States citizen generally is subject to the U.S. individual income tax on his or her worldwide taxable income. All income earned by a U.S. citizen, from sources inside and outside the United States, is taxable, whether or not the individual lives within the United States. A non-U.S. citizen who resides in the United States generally is taxed in the same manner as a U.S. citizen if the individual meets the definition of a “resident alien,” described below.

The taxable income of a U.S. citizen or resident is equal to the taxpayer’s total income less certain exclusions, exemptions, and deductions. The appropriate tax rates are then applied to a taxpayer’s taxable income to determine his or her individual income tax liability. A taxpayer may reduce his or her income tax liability by any applicable tax credits. When an individual disposes of property, any gain or loss on the disposition is determined by reference to the taxpayer’s cost basis in the property, regardless of whether the property was acquired during the period in which the taxpayer was a citizen or resident of the United States.

If a U.S. citizen or resident earns income from sources outside the United States, and that income is subject to foreign income taxes, the individual generally is permitted a foreign tax credit against his or her U.S. income tax liability to the extent of foreign income taxes paid on that income.⁸⁹ In addition, a United States citizen who lives and works in a foreign country generally is permitted to exclude up to \$70,000 of annual compensation from being subject to U.S. income taxes, and is permitted an exclusion or deduction for certain housing expenses.⁹⁰

Resident aliens.—In general, a non-U.S. citizen is considered a resident of the United States if the individual (1) has entered the United States as a lawful permanent U.S. resident (the “green card test”); or (2) is present in the United States for 31 or more days during the current calendar year and has been present in the United States for a substantial period of time—183 or more days during a 3-year period weighted toward the present year (the “substantial presence test”).⁹¹

If an individual is present in the United States for fewer than 183 days during the calendar year, and if the individual establishes that he or she has a closer connection with a foreign country than with the United States and has a tax home in that country for the year, the individual generally is not subject to U.S. tax as a resident on account of the substantial presence test. If an individual is present for as many as 183 days during a calendar year, this closer connections/tax home exception is not available. An alien who has an application pending to change his or her status to permanent resident or who has taken other steps to apply for status as a lawful permanent U.S. resident is not eligible for the closer connections/tax home exception.

For purposes of applying the substantial presence test, any days that an individual is present as an “exempt individual” are not counted. Exempt individuals include certain foreign government-related individuals, teachers, trainees, students, and professional athletes temporarily in the United States to compete in charitable sports events. In addition, the substantial presence test does not count days of presence of an individual who is physically unable to leave the United States because of a medical condition that arose while he or she was present in the United States, if the individual can establish to the satisfaction of the Secretary of the Treasury that he or she qualifies for this special medical exception.

In some circumstances, an individual who meets the definition of a U.S. resident (as described above) could also be defined as a resident of another country under the internal laws of that country. In order to avoid the double taxation of such individuals, most income tax treaties include a set of “tie-breaker” rules to determine the individual’s country of residence for income tax purposes. In general, a dual resident is deemed to be a resident of the country in which

⁸⁹ See sections 901–907.

⁹⁰ Section 911.

⁹¹ The definitions of resident and nonresident aliens are set forth in section 7701(b). The substantial presence test will compare 183 days to the sum of (1) the days present during the current calendar year, (2) one-third of the days present during the preceding calendar year, and (3) one-sixth of the days present during the second preceding calendar year. Presence for 122 days (or more) per year over the 3-year period would constitute substantial presence under the test.

such person has a permanent home. If the individual has a permanent home available in both countries, the individual's residence is deemed to be the country with which his or her personal and economic relations are closer (i.e., the "center of vital interests.") If the country in which such individual has his or her center of vital interests cannot be determined, or if such individual does not have a permanent home available in either country, he or she is deemed to be a resident of the country in which he or she has an habitual abode. If the individual has an habitual abode in both countries or in neither country, he or she is deemed to be a resident of the country of which he or she is a citizen. If each country considers the person to be its citizen or if he or she is a citizen of neither country, the competent authorities of the countries are to settle the question of residence by mutual agreement.

Income taxation of nonresident aliens

Non-U.S. citizens who do not meet the definition of "resident aliens" are considered to be nonresident aliens for tax purposes. Nonresident aliens are subject to U.S. tax only to the extent their income is from U.S. sources or is effectively connected with the conduct of a trade or business within the United States. Bilateral income tax treaties may modify the U.S. taxation of a nonresident alien.

A nonresident alien is taxed at regular graduated rates on net profits derived from a U.S. business.⁹² Nonresident aliens also are taxed at a flat rate of 30 percent on certain types of passive income derived from U.S. sources, although a lower rate may be provided by treaty (e.g., dividends are frequently taxed at a reduced rate of 15 percent). Such passive income includes interest, dividends, rents, salaries, wages, premiums, annuities, compensations, remunerations, emoluments, and other fixed or determinable annual or periodical gains, profits and income. There is no U.S. tax imposed, however, on interest earned by nonresident aliens with respect to deposits with U.S. banks and certain types of portfolio debt investments.⁹³ Gains on the sale of stocks or securities issued by U.S. persons generally are not taxable to a nonresident alien because they are considered to be foreign source income.⁹⁴

Nonresident aliens are subject to U.S. income taxation on any gain recognized on the disposition of an interest in U.S. real property.⁹⁵ Such gains generally are subject to tax at the same rates that apply to similar income received by U.S. persons. If a U.S. real property interest is acquired from a foreign person, the purchaser

⁹² Section 871.

⁹³ See Sections 871(h) and 871(i)(3).

⁹⁴ Section 865(a).

⁹⁵ Sections 897, 1445, 6039C, and 6652(f), known as the Foreign Investment in Real Property Tax Act ("FIRPTA"). Under the FIRPTA provisions, tax is imposed on gains from the disposition of an interest (other than an interest solely as a creditor) in real property (including an interest in a mine, well, or other natural deposit) located in the United States or the U.S. Virgin Islands. Also included in the definition of a U.S. real property interest is any interest (other than an interest solely as a creditor) in any domestic corporation unless the taxpayer establishes that the corporation was not a U.S. real property holding corporation ("USRPHC") at any time during the five-year period ending on the date of the disposition of the interest (sec. 897(c)(1)(A)(ii)). A USRPHC is any corporation, the fair market value of whose U.S. real property interests equals or exceeds 50 percent of the sum of the fair market values of (1) its U.S. real property interests, (2) its interests in foreign real property, plus (3) any other of its assets which are used or held for use in a trade or business (sec. 897(c)(2)).

generally is required to withhold 10 percent of the amount realized (gross sales price). Alternatively, either party may request that the Internal Revenue Service (“IRS”) determine the transferor’s maximum tax liability and issue a certificate prescribing a reduced amount of withholding (not to exceed the transferor’s maximum tax liability).⁹⁶

Estate and gift taxation

The United States imposes a gift tax on any transfer of property by gift made by a U.S. citizen or resident,⁹⁷ whether made directly or indirectly and whether made in trust or otherwise. Nonresident aliens are subject to the gift tax with respect to transfers of tangible real or personal property where the property is located in the United States at the time of the gift. No gift tax is imposed, however, on gifts made by nonresident aliens of intangible property having a situs within the United States (e.g., stocks and bonds).⁹⁸

The United States also imposes an estate tax on the worldwide “gross estate” of any person who was a citizen or resident of the United States at the time of death, and on certain property belonging to a nonresident of the United States that is located in the United States at the time of death.⁹⁹

Since 1976, the gift tax and the estate tax have been unified so that a single graduated rate schedule applies to cumulative taxable transfers made by a U.S. citizen or resident during his or her lifetime and at death. Under this rate schedule, the unified estate and gift tax rates begin at 18 percent on the first \$10,000 in cumulative taxable transfers and reach 55 percent on cumulative taxable transfers over \$3 million.¹⁰⁰ A unified credit of \$192,800 is available with respect to taxable transfers by gift and at death. The unified credit effectively exempts a total of \$600,000 in cumulative taxable transfers from the estate and gift tax.

Residency for purposes of estate and gift taxation is determined under different rules than those applicable for income tax purposes. In general, an individual is considered to be a resident of the United States for estate and gift tax purposes if the individual is “domiciled” in the United States. An individual is domiciled in the United States if the individual (a) is living in the United States and has the intention to remain in the United States indefinitely; or (b) has lived in the United States with such an intention and has not formed the intention to remain indefinitely in another country. In the case of a U.S. citizen who resided in a U.S. possession at the time of death, if the individual acquired U.S. citizenship solely on account of his or her birth or residence in a U.S. possession, that individual is not treated as a U.S. citizen or resident for estate tax purposes.¹⁰¹

In addition to the estate and gift taxes, a separate transfer tax is imposed on certain “generation-skipping” transfers.

⁹⁶ Section 1445.

⁹⁷ Section 2501.

⁹⁸ Section 2501(a)(2).

⁹⁹ Sections 2001, 2031, 2101, and 2103.

¹⁰⁰ Section 2001(c).

¹⁰¹ Section 2209.

Special tax rules with respect to the movement of persons into or out of the United States

Individuals who relinquish U.S. citizenship with a principal purpose of avoiding U.S. tax

An individual who relinquishes his or her U.S. citizenship with a principal purpose of avoiding U.S. taxes is subject to an alternative method of income taxation for 10 years after expatriation under section 877.¹⁰² Under this provision, if the Treasury Department establishes that it is reasonable to believe that the expatriate's loss of U.S. citizenship would, but for the application of this provision, result in a substantial reduction in U.S. tax based on the expatriate's probable income for the taxable year, then the expatriate has the burden of proving that the loss of citizenship did not have as one of its principal purposes the avoidance of U.S. income, estate or gift taxes. Section 877 does not apply to resident aliens who terminate their U.S. residency.

The alternative method modifies the rules generally applicable to the taxation of nonresident aliens in two ways. First, the expatriate is subject to tax on his or her U.S. source income at the rates applicable to U.S. citizens rather than the rates applicable to other nonresident aliens. (Unlike U.S. citizens, however, individuals subject to section 877 are not taxed on any foreign source income.) Second, the scope of items treated as U.S. source income for section 877 purposes is broader than those items generally considered to be U.S. source income under the Code. For example, gains on the sale of personal property located in the United States, and gains on the sale or exchange of stocks and securities issued by U.S. persons, generally are not considered to be U.S. source income under the Code. However, if an individual is subject to the alternative taxing method of section 877, such gains are treated as U.S. source income with respect to that individual. The alternative method applies only if it results in a higher U.S. tax liability than would otherwise be determined if the individual were taxed as a nonresident alien.

Because section 877 alters the sourcing rules generally used to determine the country having primary taxing jurisdiction over certain items of income, there is an increased potential for such items to be subject to double taxation. For example, a former U.S. citizen subject to the section 877 rules may have capital gains derived from stock in a U.S. corporation. Under section 877, such gains are treated as U.S. source income, and are, therefore, subject to U.S. tax. Under the internal laws of the individual's new country of residence, however, that country may provide that all capital gains realized by a resident of that country are subject to taxation in that country, and thus the individual's gain from the sale of U.S. stock also would be taxable in his or her country of residence. If the individual's new country of residence has an income tax treaty with the

¹⁰²Treasury regulations provide that an individual's citizenship status is governed by the provisions of the Immigration and Nationality Act, specifically referring to the "rules governing loss of citizenship [set forth in] sections 349 to 357, inclusive, of such Act (8 U.S.C. 1481-1489)." Treas. Reg. section 1.1-1(c). Under the Immigration and Nationality Act, an individual is generally considered to lose U.S. citizenship on the date that an expatriating act is committed. The present-law rules governing the loss of citizenship, and a description of the types of expatriating acts that lead to a loss of citizenship, are discussed more fully below.

United States, the treaty may provide for the amelioration of this potential double tax.

Similar rules apply in the context of estate and gift taxation if the transferor relinquished U.S. citizenship with a principal purpose of avoiding U.S. taxes within the 10-year period ending on the date of the transfer. A special rule is applied to the estate tax treatment of any decedent who relinquished his or her U.S. citizenship within 10 years of death, if the decedent's loss of U.S. citizenship had as one of its principal purposes a tax avoidance motive.¹⁰³ Once the Secretary of the Treasury establishes a reasonable belief that the expatriate's loss of U.S. citizenship would result in a substantial reduction in estate, inheritance, legacy and succession taxes, the burden of proving that one of the principal purposes of the loss of U.S. citizenship was not avoidance of U.S. income or estate tax is on the executor of the decedent's estate.

In general, the estates of individuals who have relinquished U.S. citizenship are taxed in accordance with the rules generally applicable to the estates of nonresident aliens (i.e., the gross estate includes all U.S.-situs property held by the decedent at death, is subject to U.S. estate tax at the rates generally applicable to the estates of U.S. citizens, and is allowed a unified credit of \$13,000, as well as credits for State death taxes, gift taxes, and prior transfers). However, a special rule provides that the individual's gross estate also includes his or her pro-rata share of any U.S.-situs property held through a foreign corporation in which the decedent had a 10-percent or greater voting interest, provided that the decedent and related parties together owned more than 50 percent of the voting power of the corporation. Similarly, gifts of intangible property having a situs within the United States (e.g., stocks and bonds) made by a nonresident alien who relinquished his or her U.S. citizenship within the 10-year period ending on the date of transfer are subject to U.S. gift tax, if the loss of U.S. citizenship had as one of its principal purposes a tax avoidance motive.¹⁰⁴

Aliens having a break in residency status

A special rule applies in the case of an individual who has been treated as a resident of the United States for at least three consecutive years, if the individual becomes a nonresident but regains residency status within a three-year period.¹⁰⁵ In such cases, the individual is subject to U.S. tax for all intermediate years under the section 877 rules described above (i.e., the individual is taxed in the same manner as a U.S. citizen who renounced U.S. citizenship with a principal purpose of avoiding U.S. taxes). The special rule for a break in residency status applies regardless of the subjective intent of the individual.

Requirements for United States citizenship, immigration, and visas

United States citizenship

An individual may acquire U.S. citizenship in one of three ways: (1) being born within the geographical boundaries of the United

¹⁰³ Section 2107.

¹⁰⁴ Section 2501(a)(3).

¹⁰⁵ Section 7701(b)(10).

States; (2) being born outside the United States to at least one U.S. citizen parent (as long as that parent had previously been resident in the United States for a requisite period of time); or (3) through the naturalization process. All U.S. citizens are required to pay U.S. income taxes on their worldwide income. The State Department estimates that there are approximately 3 million U.S. citizens living abroad, although thousands of these individuals may not even know that they are U.S. citizens.

A U.S. citizen may voluntarily give up his or her U.S. citizenship at any time by performing one of the following acts (“expatriating acts”) with the intention of relinquishing U.S. nationality: (1) becoming naturalized in another country; (2) formally declaring allegiance to another country; (3) serving in a foreign army; (4) serving in certain types of foreign government employment; (5) making a formal renunciation of nationality before a U.S. diplomatic or consular officer in a foreign country; (6) making a formal renunciation of nationality in the United States during a time of war; or (7) committing an act of treason.¹⁰⁶ An individual who wishes formally to renounce citizenship (item (5), above) must execute an Oath of Renunciation before a consular officer, and the individual’s loss of citizenship is effective on the date the oath is executed. In all other cases, the loss of citizenship is effective on the date that the expatriating act is committed, even though the loss may not be documented until a later date. The State Department generally documents loss in such cases when the individual acknowledges to a consular officer that the act was taken with the requisite intent. In all cases, the consular officer abroad submits a certificate of loss of nationality (“CLN”) to the State Department in Washington, D.C. for approval.¹⁰⁷ Upon approval, a copy of the CLN is issued to the affected individual.

Before a CLN is issued, the State Department reviews the individual’s files to confirm that: (1) the individual was a U.S. citizen; (2) an expatriating act was committed; (3) the act was undertaken voluntarily; and (4) the individual had the intent of relinquishing citizenship when the expatriating act was committed. If the expatriating act involved an action of a foreign government (for example, if the individual was naturalized in a foreign country or joined a foreign army), the State Department will not issue a CLN until it has obtained an official statement from the foreign government confirming the expatriating act. If a CLN is not issued because the State Department does not believe that an expatriating act has occurred (for example, if the requisite intent appears to be lacking), the issue is likely to be resolved through litigation. Whenever the loss of U.S. nationality is put in issue, the burden of proof is on the person or party claiming that a loss of citizenship has occurred to establish, by a preponderance of the evidence, that the loss occurred.¹⁰⁸ Similarly, if a CLN has been issued, but the State Department later discovers that such issuance was improper (for example, because fraudulent documentation was submitted, or the requisite intent appears to be lacking), the State Department could initiate proceedings to revoke the CLN. If the recipient is unable

¹⁰⁶ 8 U.S.C. section 1481.

¹⁰⁷ 8 U.S.C. section 1501.

¹⁰⁸ 8 U.S.C. section 1481(b).

to establish beyond a preponderance of the evidence that citizenship was lost on the date claimed, the CLN would be revoked. To the extent that the IRS believes a CLN was improperly issued, the IRS could present such evidence to the State Department and request that revocation proceedings be commenced. If it is determined that the individual has indeed committed an expatriating act, the date for loss of citizenship will be the date of the expatriating act.

A child under the age of 18 cannot lose U.S. citizenship by naturalizing in a foreign state or by taking an oath of allegiance to a foreign state. A child under 18 can, however, lose U.S. citizenship by serving in a foreign military or by formally renouncing citizenship, but such individuals may regain their citizenship by asserting a claim of citizenship before reaching the age of eighteen years and six months.

A naturalized U.S. citizen can have his or her citizenship involuntarily revoked if a U.S. court determines that the certificate of naturalization was illegally procured, or was procured by concealment of a material fact or by willful misrepresentation. In such cases, the individual's certificate of naturalization is canceled, effective as of the original date of the certificate; in other words, it is as if the individual were never a U.S. citizen at all.

United States immigration and visas

In general, a non-U.S. citizen who enters the United States is required to obtain a visa.¹⁰⁹ An immigrant visa (also known as a "green card") is issued to an individual who intends to relocate to the United States permanently. Various types of nonimmigrant visas are issued to individuals who come to the United States on a temporary basis and intend to return home after a certain period of time. The type of nonimmigrant visa issued to such individuals is dependent upon the purpose of the visit and its duration. An individual holding a nonimmigrant visa is prohibited from engaging in activities that are inconsistent with the purpose of the visa (for example, an individual holding a tourist visa is not permitted to obtain employment in the United States).

Foreign business people and investors often obtain "E" visas to come into the United States. Generally, an "E" visa is initially granted for a one-year period, but it can be routinely extended for additional two-year periods. There is no overall limit on the amount of time an individual may retain an "E" visa. There are two types of "E" visas: an "E-1" visa, for "treaty traders" and an "E-2" visa, for "treaty investors."

Relinquishment of green cards

There are several ways in which a green card can be relinquished. First, an individual who wishes to terminate his or her permanent residency may simply return his or her green card to the INS. Second, an individual may be involuntarily deported from

¹⁰⁹Under the Visa Waiver Pilot Program, nationals of most European countries are not required to obtain a visa to enter the United States if they are coming as tourists and staying a maximum of 90 days. Also, citizens of Canada, Mexico, and certain islands in close proximity to the United States do not need visas to enter the United States, although other types of travel documents may be required.

the United States (through a judicial or administrative proceeding), and the green card must be relinquished at that time. Third, a green card holder who leaves the United States and attempts to re-enter more than a year later may have his or her green card taken away by the INS border examiner, although the individual may appeal to an immigration judge to have the green card reinstated. A green-card holder may permanently leave the United States without relinquishing his or her green card, although such individuals would continue to be taxed as U.S. residents.¹¹⁰

Reasons for change

The Committee has been informed that a small number of very wealthy individuals each year relinquish their U.S. citizenship for the purpose of avoiding U.S. income, estate, and gift taxes. By so doing, such individuals reduce their annual U.S. income tax liability and eliminate their eventual U.S. estate tax liability.

The Committee recognizes that citizens of the United States have a basic right not only physically to leave the United States to live elsewhere, but also to relinquish their U.S. citizenship. The Committee does not believe that the Internal Revenue Code should be used to stop U.S. citizens from expatriating; however, the Committee also does not believe that the Code should provide a tax incentive for expatriating.

The Committee is concerned that present law, which bases the application of the alternative method of taxation under section 877 on proof of a tax-avoidance purpose, is difficult to administer. In addition, the Committee is concerned that the alternative method can be avoided by postponing the realization of U.S. source income for 10 years. The Committee believes that section 877 is largely ineffective in taxing U.S. citizens who expatriate with a principal purpose to avoid tax.

The Committee believes that the alternative tax system of section 877 should be replaced by a tax regime applicable to wealthy expatriates that does not rely on establishing a tax-avoidance motive. Because U.S. citizens who retain their citizenship are subject to income tax on accrued appreciation when they dispose of their assets, as well as estate tax on the full value of assets that are held until death, the Committee believes it fair and equitable to tax expatriates on the appreciation in their assets when they relinquish their U.S. citizenship. The Committee believes that an exception from the expatriation tax should be provided for individuals whose income and net worth are relatively modest.

Explanation of provision

In general

The provision replaces the present-law expatriation income tax rules with rules that generally subject certain U.S. citizens who relinquish their U.S. citizenship and certain long-term U.S. residents

¹¹⁰Section 7701(b)(6)(B) provides that an individual who has obtained the status of residing permanently in the United States as an immigrant (i.e., an individual who has obtained a green card) will continue to be taxed as a lawful permanent resident of the United States until such status is revoked, or is administratively or judicially determined to have been abandoned.

who relinquish their U.S. residency to tax on the net unrealized gain in their property as if such property were sold for fair market value on the expatriation date. The provision also imposes information reporting obligations on U.S. citizens who relinquish their citizenship and long-term residents whose U.S. residency is terminated.

Individuals covered

The provision applies the expatriation tax to certain U.S. citizens and long-term residents who terminate their U.S. citizenship or residency. For this purpose, a long-term resident is any individual who was a lawful permanent resident of the United States for at least 8 out of the 15 taxable years ending with the year in which the termination of residency occurs. In applying this 8-year test, an individual is not considered to be a lawful permanent resident of the United States for any year in which the individual is taxed as a resident of another country under a treaty tie-breaker rule. An individual's U.S. residency is considered to be terminated when either the individual ceases to be a lawful permanent resident pursuant to section 7701(b)(6) (i.e., the individual loses his or her green-card status) or the individual is treated as a resident of another country under a tie-breaker provision of a tax treaty (and the individual does not elect to waive the benefits of such treaty).

The expatriation tax applies only to individuals whose average income tax liability or net worth exceeds specified levels. U.S. citizens who lose their citizenship and long-term residents who terminate U.S. residency are subject to the expatriation tax if they meet either of the following tests: (1) the individual's average annual U.S. Federal income tax liability for the 5 taxable years ending before the date of such loss or termination is greater than \$100,000, or (2) the individual's net worth as of the date of such loss or termination is \$500,000 or more. The dollar amount thresholds contained in these tests are indexed for inflation in the case of a loss of citizenship or termination of residency occurring in any calendar year after 1996.

Exceptions from the expatriation tax are provided for individuals in two situations. The first exception applies to an individual who was born with citizenship both in the United States and in another country, provided that (1) as of the date of relinquishment of U.S. citizenship the individual continues to be a citizen of, and is taxed as a resident of, such other country, and (2) the individual was a resident of the United States for no more than 8 out of the 15 taxable years ending with the year in which the relinquishment of U.S. citizenship occurred. The second exception applies to a U.S. citizen who relinquishes citizenship before reaching age 18½, provided that the individual was a resident of the United States for no more than 5 taxable years before such relinquishment.

Deemed sale of property upon expatriation

Under the provision, individuals who are subject to the expatriation tax generally are treated as having sold all of their property at fair market value immediately prior to the relinquishment of citizenship or termination of residency. Gain or loss from the

deemed sale of property is recognized at that time, generally without regard to provisions of the Code that would otherwise provide nonrecognition treatment. The net gain, if any, on the deemed sale of all such property is subject to U.S. tax at such time to the extent it exceeds \$600,000 (\$1.2 million in the case of married individuals filing a joint return, both of whom expatriate).

The deemed sale rule of the provision generally applies to all property interests held by the individual on the date of relinquishment of citizenship or termination of residency, provided that the gain on such property interest would be includible in the individual's gross income if such property interest were sold for its fair market value on such date. Special rules apply in the case of trust interests (see "Interests in trusts", below). U.S. real property interests, which remain subject to U.S. taxing jurisdiction in the hands of nonresident aliens, generally are excepted from the provision. An exception also applies to interests in qualified retirement plans and, subject to a limit of \$500,000, interests in certain foreign pension plans as prescribed by regulations. The Secretary of the Treasury is authorized to issue regulations exempting other property interests as appropriate. For example, an exclusion could be provided for an interest in a nonqualified compensation plan of a U.S. employer, where payments from such plan to the individual following expatriation would continue to be subject to U.S. withholding tax.

Under the provision, an individual who is subject to the expatriation tax is required to pay a tentative tax equal to the amount of tax that would be due for a hypothetical short tax year ending on the date the individual relinquished citizenship or terminated residency. Thus, the tentative tax is based on all the income, gain, deductions, loss and credits of the individual for the year through such date, including amounts realized from the deemed sale of property. The tentative tax is due on the 90th day after the date of relinquishment of citizenship or termination of residency.

Deferral of payment of tax

Under the provision, an individual is permitted to elect to defer payment of the expatriation tax with respect to the deemed sale of any property. Under this election, the expatriation tax with respect to a particular property, plus interest thereon, is due when the property is subsequently disposed of. For this purpose, except as provided in regulations, the disposition of property in a nonrecognition transaction constitutes a disposition. In addition, if an individual holds property until his or her death, the individual is treated as having disposed of the property immediately before death. In order to elect deferral of the expatriation tax, the individual is required to provide adequate security to ensure that the deferred expatriation tax and interest ultimately will be paid. A bond in the amount of the deferred tax and interest constitutes adequate security. Other security mechanisms also are permitted provided that the individual establishes to the satisfaction of the Secretary of the Treasury that the security is adequate. In the event that the security provided with respect to a particular property subsequently becomes inadequate and the individual fails to correct such situation, the deferred expatriation tax and interest with respect to such property becomes due. As a further condition to making this elec-

tion, the individual is required to consent to the waiver of any treaty rights that would preclude the collection of the expatriation tax.

Interests in trusts

In general

Under the provision, special rules apply to trust interests held by the individual at the time of relinquishment of citizenship or termination of residency. The treatment of trust interests depends upon whether the trust is a qualified trust. For this purpose, a “qualified trust” is a trust that is organized under and governed by U.S. law and that is required by its instruments to have at least one U.S. trustee.

Constructive ownership rules apply to a trust beneficiary that is a corporation, partnership, trust or estate. In such cases, the shareholders, partners or beneficiaries of the entity are deemed to be the direct beneficiaries of the trust for purposes of applying these provisions. In addition, an individual who holds (or who is treated as holding) a trust interest at the time of relinquishment of citizenship or termination of residency is required to disclose on his or her tax return the methodology used to determine his or her interest in the trust, and whether such individual knows (or has reason to know) that any other beneficiary of the trust uses a different method.

Nonqualified trusts

If an individual holds an interest in a trust that is not a qualified trust, a special rule applies for purposes of determining the amount of the expatriation tax due with respect to such trust interest. The individual’s interest in the trust is treated as a separate trust consisting of the trust assets allocable to such interest. Such separate trust is treated as having sold its assets as of the date of relinquishment of citizenship or termination of residency and having distributed all proceeds to the individual, and the individual is treated as having recontributed such proceeds to the trust. The individual is subject to the expatriation tax with respect to any net income or gain arising from the deemed distribution from the trust. The election to defer payment is available for the expatriation tax attributable to a nonqualified trust interest.

A beneficiary’s interest in a nonqualified trust is determined on the basis of all facts and circumstances. These include the terms of the trust instrument itself, any letter of wishes or similar document, historical patterns of trust distributions, and the role of any trust protector or similar advisor.

Qualified trusts

If the individual has an interest in a qualified trust, a different set of rules applies. Under these rules, the amount of unrealized gain allocable to the individual’s trust interest is calculated at the time of expatriation. In determining this amount, all contingencies and discretionary interests are resolved in the individual’s favor (i.e., the individual is allocated the maximum amount that he or she potentially could receive under the terms of the trust instrument). The expatriation tax imposed on such gains generally is col-

lected when the individual receives distributions from the trust, or, if earlier, upon the individual's death. Interest is charged for the period between the date of expatriation and the date on which the tax is paid.

If an individual has an interest in a qualified trust, the individual is subject to expatriation tax upon the receipt of any distribution from the trust. Such distributions may also be subject to U.S. income tax. For any distribution from a qualified trust made to an individual after he or she has expatriated, expatriation tax is imposed in an amount equal to the amount of the distribution multiplied by the highest tax rate generally applicable to trusts and estates, but in no event will the tax imposed exceed the deferred tax amount with respect to such trust interest. The "deferred tax amount" is equal to (1) the tax calculated with respect to the unrealized gain allocable to the trust interest at the time of expatriation, (2) increased by interest thereon, and (3) reduced by the tax imposed under this provision with respect to prior trust distributions to the individual.

If an individual's interest in a trust is vested as of the expatriation date (e.g., if the individual's interest in the trust is non-contingent and non-discretionary), the gain allocable to the individual's trust interest is determined based on the trust assets allocable to his or her trust interest. If the individual's interest in the trust is not vested as of the expatriation date (e.g., if the individual's trust interest is a contingent or discretionary interest), the gain allocable to his or her trust interest is determined based on all of the trust assets that could be allocable to his or her trust interest, determined by resolving all contingencies and discretionary powers in the individual's favor. In the case where more than one trust beneficiary is subject to the expatriation tax with respect to trust interests that are not vested, the rules are intended to apply so that the same unrealized gain with respect to assets in the trust is not taxed to both individuals.

If the individual disposes of his or her trust interest, the trust ceases to be a qualified trust, or the individual dies, expatriation tax is imposed as of such date. The amount of such tax is equal to the lesser of (1) the tax calculated under the rules for non-qualified trust interests applied as of such date or (2) the deferred tax amount with respect to the trust interest as of such date.

If the individual agrees to waive any treaty rights that would preclude collection of the tax, the tax is imposed under this provision with respect to distributions from a qualified trust to the individual deducted and withheld from distributions. If the individual does not agree to such a waiver of treaty rights, the tax with respect to distributions to the individual is imposed on the trust, the trustee is personally liable therefor, and any other beneficiary of the trust will have a right of contribution against such individual with respect to such tax. Similarly, in the case of the tax imposed in connection with an individual's disposition of a trust interest, the individual's death while holding a trust interest or the individual's holding of an interest in a trust that ceases to be qualified, the tax is imposed on the trust, the trustee is personally liable therefor, and any other beneficiary of the trust will have a right of contribution against such individual with respect to such tax.

Election to be treated as a U.S. citizen

Under the provision, an individual is permitted to make an irrevocable election to continue to be taxed as a U.S. citizen with respect to all property that otherwise is covered by the expatriation tax. This election is an “all-or-nothing” election; an individual is *not* permitted to elect this treatment for some property but not other property. The election, if made, applies to all property that would be subject to the expatriation tax and to any property the basis of which is determined by reference to such property. Under this election, the individual continues to pay U.S. income taxes at the rates applicable to U.S. citizens following expatriation on any income generated by the property and on any gain realized on the disposition of the property, as well as any excise tax imposed with respect to the property (see, e.g., sec. 1491). In addition, the property continues to be subject to U.S. gift, estate, and generation-skipping transfer taxes. However, the amount of any transfer tax so imposed is limited to the amount of income tax that would have been due if the property had been sold for its fair market value immediately before the transfer or death. The \$600,000 exclusion provided with respect to the expatriation tax under the provision is available to reduce the tax imposed by reason of this election. In order to make this election, the taxpayer is required to waive any treaty rights that would preclude the collection of the tax. The individual also is required to provide security to ensure payment of the tax under this election in such form, manner, and amount as the Secretary of the Treasury requires.

Date of relinquishment of citizenship

Under the provision, an individual is treated as having relinquished U.S. citizenship on the date that the individual first makes known to a U.S. government or consular officer his or her intention to relinquish U.S. citizenship. Thus, a U.S. citizen who relinquishes citizenship by formally renouncing his or her U.S. nationality before a diplomatic or consular officer of the United States is treated as having relinquished citizenship on that date, provided that the renunciation is later confirmed by the issuance of a CLN. A U.S. citizen who furnishes to the State Department a signed statement of voluntary relinquishment of U.S. nationality confirming the performance of an expatriating act with the requisite interest to relinquish his or her citizenship is treated as having relinquished his or her citizenship on the date the statement is so furnished (regardless of when the expatriating act was performed), provided that the voluntary relinquishment is later confirmed by the issuance of a CLN. If neither of these circumstances exist, the individual is treated as having relinquished citizenship on the date a CLN is issued or a certificate of naturalization is canceled. The date of relinquishment of citizenship determined under the provision applies for all tax purposes.

Effect on present-law expatriation provisions

Under the provision, the present-law income tax provisions with respect to U.S. citizens who expatriate with a principal purpose of avoiding tax (sec. 877) and certain aliens who have a break in resi-

gency status (sec. 7701(b)(10)) do not apply to U.S. citizens who are treated as relinquishing their citizenship on or after February 6, 1995 or to long-term U.S. residents who terminate their residency on or after such date. The special estate and gift tax provisions with respect to individuals who expatriate with a principal purpose of avoiding tax (secs. 2107 and 2501(a)(3)), however, continue to apply; a credit against the tax imposed solely by reason of such special provisions is allowed for the expatriation tax imposed with respect to the same property.

Treatment of gifts and inheritances from an expatriate

Under the provision, the exclusion from income provided in section 102 does not apply to the value of any property received by gift or inheritance from an individual who was subject to the expatriation tax (i.e., an individual who relinquished citizenship or terminated residency and to whom the expatriation tax was applicable). Accordingly, a U.S. taxpayer who receives a gift or inheritance from such an individual is required to include the value of such gift or inheritance in gross income and is subject to U.S. income tax on such amount.

Required information reporting and sharing

Under the provision, an individual who relinquishes citizenship or terminates residency is required to provide a statement which includes the individual's social security number, forwarding foreign address, new country of residence and citizenship and, in the case of individuals with a net worth of at least \$500,000, a balance sheet. In the case of a former citizen, such statement is due not later than the date the individual's citizenship is treated as relinquished and is provided to the State Department (or other government entity involved in the administration of such relinquishment). The entity to which the statement is provided by former citizens is required to provide to the Secretary of the Treasury copies of all statements received and the names of individuals who refuse to provide such statements. In the case of a former long-term resident, the statement is provided to the Secretary of the Treasury with the individual's tax return for the year in which the individual's U.S. residency is terminated. An individual's failure to provide the statement required under this provision results in the imposition of a penalty for each year the failure continues equal to the greater of (1) 5 percent of the individual's expatriation tax liability for such year or (2) \$1,000.

The provision requires the State Department to provide the Secretary of the Treasury with a copy of each CLN approved by the State Department. Similarly, the provision requires the agency administering the immigration laws to provide the Secretary of the Treasury with the name of each individual whose status as a lawful permanent resident has been revoked or has been determined to have been abandoned.

Further, the provision requires the Secretary of the Treasury to publish in the Federal Register the names of all former U.S. citizens with respect to whom it receives the required statements or

whose names it receives under the foregoing information-sharing provisions.

Treasury report

The provision directs the Treasury Department to undertake a study on the tax compliance of U.S. citizens and green-card holders residing outside the United States and to make recommendations regarding the improvement of such compliance. The findings of such study and such recommendations are required to be reported to the House Committee on Ways and Means and the Senate Committee on Finance within 90 days of the date of enactment.

Effective date

The provision is effective for U.S. citizens whose date of relinquishment of citizenship (as determined under the provision, see “Date of relinquishment of citizenship” above) occurs on or after February 6, 1995. Similarly, the provision is effective for long-term residents who terminate their U.S. residency on or after February 6, 1995.

U.S. citizens who committed an expatriating act with the requisite intent to relinquish their U.S. citizenship prior to February 6, 1995, but whose date of relinquishment of citizenship (as determined under the provision) does not occur until after such date, are subject to the expatriation tax under the provision as of date of relinquishment of citizenship. However, the individual is not subject retroactively to worldwide tax as a U.S. citizen for the period after he or she committed the expatriating act (and therefore ceased being a U.S. citizen for tax purposes under present law). Such an individual continues to be subject to the expatriation tax imposed by present-law section 877 until the individual’s date of relinquishment of citizenship (at which time the individual is subject to the expatriation tax of the provision). The rules described in this paragraph do not apply to an individual who committed an expatriating act prior to February 6, 1995, but did not do so with the requisite intent to relinquish his or her U.S. citizenship.

The tentative tax is not required to be paid, and the reporting requirements are not required to be met, until 90 days after the date of enactment. The reporting provisions apply to all individuals whose date of relinquishment of U.S. citizenship or termination of U.S. residency occurs on or after February 6, 1995.

TAX TECHNICAL CORRECTIONS PROVISIONS

The technical corrections subtitle contains clerical, conforming and clarifying amendments to the provisions enacted by the Revenue Reconciliation Act of 1990, the Revenue Reconciliation Act of 1993, and other recently enacted legislation. All amendments made by this title are meant to carry out the intent of Congress in enacting the original legislation. Therefore, no separate “Reasons for Change” is set forth for each individual amendment. Except as otherwise described, the amendments made by the technical corrections title take effect as if included in the original legislation to which each amendment relates.

A. TECHNICAL CORRECTIONS TO THE REVENUE RECONCILIATION ACT
OF 19901. *Excise tax provisions*

- a. *Application of the 2.5-cents-per-gallon tax on fuel used in rail transportation to States and local governments (sec. 1702(b)(2) of the bill, sec. 11211(b)(4) of the 1990 Act, and sec. 4093 of the Code)*

Present law

The 1990 Act increased the highway and motorboat fuels taxes by 5 cents per gallon, effective on December 1, 1990. The 1990 Act continued the exemption from these taxes for fuels used by States and local governments.

The 1990 Act further imposed a 2.5-cents-per-gallon tax on fuel used in rail transportation, also effective on December 1, 1990. Because of a drafting error, the 2.5-cents-per-gallon tax on fuel used in rail transportation incorrectly applies to fuel used by States and local governments.

Explanation of provision

The bill clarifies that the 2.5-cents-per-gallon tax on fuel used in rail transportation does not apply to such uses by States and local governments.

- b. *Small winery production credit and bonding requirements (secs. 1702(b)(5), (6), and (7) of the bill, sec. 11201 of the 1990 Act, and sec. 5041 of the Code)*

Present law

A 90-cents-per-gallon credit is allowed to wine producers who produce no more than 250,000 gallons of wine in a year. The credit may be claimed against the producers' excise or income taxes.

Wine producers must post a bond in amounts determined by reference to expected excise tax liability as a condition of legally operating.

Explanation of provision

The bill clarifies that wine produced by eligible small wineries may be transferred without payment of tax to bonded warehouses that become liable for payment of the wine excise tax without losing credit eligibility. In such cases, the bonded warehouse will be eligible for the credit to the same extent as the producer otherwise would have been.

The bill further clarifies that the Treasury Department has broad regulatory authority to prevent the benefit of the credit from accruing (directly or indirectly) to wineries producing in excess of 250,000 gallons in a calendar year.

It is intended that the Treasury regulatory authority will extend to all circumstances in which wine production is increased with a purpose of securing indirect credit eligibility for wine produced by such large producers.

The bill also clarifies that the Treasury Department may take the amount of credit expected to be claimed against a producer's wine excise tax liability into account in determining the amount of required bond.

2. Other revenue-increase provisions of the 1990 Act

- a. Deposits of Railroad Retirement Tax Act taxes (sec. 1702(c)(3) of the bill, sec. 11334 of the 1990 Act, and sec. 6302(g) of the Code)*

Present law

Employers must deposit income taxes withheld from employees' wages and FICA taxes that are equal to or greater than \$100,000 by the close of the next banking day. Under the Railroad Retirement Solvency Act of 1983, the deposit rules for withheld income taxes and FICA taxes automatically apply to Railroad Retirement Tax Act taxes (sec. 226 of P.L. 98-76).

Explanation of provision

The bill conforms the Internal Revenue Code to the Railroad Retirement Solvency Act of 1983 by stating in the Code that these deposit rules for withheld income taxes and FICA taxes apply to Railroad Retirement Tax Act taxes.

- b. Treatment of salvage and subrogation of property and casualty insurance companies (sec. 1702(c)(4) of the bill and sec. 11305 of the 1990 Act)*

Present law

For taxable years beginning after December 31, 1989, property and casualty insurance companies are required to reduce the deduction allowed for losses incurred (both paid and unpaid) by estimated recoveries of salvage and subrogation attributable to such losses. In the case of any property and casualty insurance company that took into account estimated salvage and subrogation recoverable in determining losses incurred for its last taxable year beginning before January 1, 1990, 87 percent of the discounted amount of the estimated salvage and subrogation recoverable as of the close of the last taxable year beginning before January 1, 1990, is allowed as a deduction ratably over the first 4 taxable years beginning after December 31, 1989. This special deduction was enacted in order to provide such property and casualty insurance companies with substantially the same Federal income tax treatment as that provided to those property and casualty insurance companies that prior to the Revenue Reconciliation Act of 1990 did not take into account estimated salvage and subrogation recoverable in determining losses incurred.

Explanation of provision

The bill provides that the earnings and profits of any property and casualty insurance company that took into account estimated salvage and subrogation recoverable in determining losses incurred for its last taxable year beginning before January 1, 1990, is to be

determined without regard to the special deduction that is allowed over the first 4 taxable years beginning after December 31, 1989. The special deduction is to be taken into account, however, in determining earnings and profits for purposes of applying sections 56, 902, and subpart F of part III of subchapter N of chapter 1 of the Internal Revenue Code of 1986. This provision is considered necessary in order to provide those property and casualty insurance companies that took into account estimated salvage and subrogation recoverable in determining losses incurred with substantially the same Federal income tax treatment as that provided to those property and casualty insurance companies that prior to the 1990 Act did not take into account estimated salvage and subrogation recoverable in determining losses incurred.

c. Information with respect to certain foreign-owned or foreign corporations: Suspension of the statute of limitations during certain judicial proceedings (sec. 1702(c)(5) of the bill, secs. 11314 and 11315 of the 1990 Act, and secs. 6038A and 6038C of the Code)

Present law

Any domestic corporation that is 25-percent owned by one foreign person is subject to certain information reporting and record-keeping requirements with respect to transactions carried out directly or indirectly with certain foreign persons treated as related to the domestic corporation ("reportable transactions") (sec. 6038A(a)). In addition, the Code provides procedures whereby an IRS examination request or summons with respect to reportable transactions can be served on foreign related persons through the domestic corporation (sec. 6038A(e)). Similar provisions apply to any foreign corporation engaged in a trade or business within the United States, with respect to information, records, examination requests, and summonses pertaining to the computation of its liability for tax in the United States (sec. 6038C). Certain noncompliance rules may be applied by the Internal Revenue Service in the case of the failure by a domestic corporation to comply with a summons pertaining to a reportable transaction (a "6038A summons") (sec. 6038A(e)), or the failure by a foreign corporation engaged in a U.S. trade or business to comply with a summons issued for purposes of determining the foreign corporation's liability for tax in the United States (a "6038C summons") (sec. 6038C(d)).

Any corporation that is subject to the provisions of section 6038A or 6038C has the right to petition a Federal district court to quash a 6038A or 6038C summons, or to review a determination by the IRS that the corporation did not substantially comply in a timely manner with the 6038A or 6038C summons (sec. 6038A(e)(4)(A) and (B); sec. 6038C(d)(4)). During the period that either such judicial proceeding is pending (including appeals), and for up to 90 days thereafter, the statute of limitations is suspended with respect to any transaction (or item, in the case of a foreign corporation) to which the summons relates (secs. 6038A(e)(4)(D), 6038C(d)(4)).

The legislative history of the 1989 Act amendments to section 6038A states that the suspension of the statute of limitations ap-

plies to “the taxable year(s) at issue.”¹¹¹ The legislative history of the 1990 Act, which added section 6038C to the Code, uses the same language.¹¹²

Explanation of provision

The bill modifies the provisions in sections 6038A and 6038C that suspend the statute of limitations to clarify that the suspension applies to any taxable year the determination of the amount of tax imposed for which is affected by the transaction or item to which the summons relates.

It is intended that, under the provision, a transaction or item would affect the determination of the amount of tax imposed for the taxable year directly at issue, as well as for any taxable year indirectly affected through, for example, net operating loss carrybacks or carryforwards. It is not intended that, under the provision, a transaction or item would affect the determination of the amount of tax imposed for any taxable year other than the taxable year directly at issue solely by reason of any similarity of issues involved. Similarly, it is not intended that, under the provision, a transaction or item would affect the determination of the amount of tax imposed on any taxpayer unrelated to the taxpayer to whom the summons is directed.

d. Rate of interest for large corporate underpayments (secs. 1702(c)(6) and (7) of the bill, sec. 11341 of the 1990 Act, and sec. 6621(c) of the Code)

Present law

The rate of interest otherwise applicable to underpayments of tax is increased by two percent in the case of large corporate underpayments (generally defined to exceed \$100,000), applicable to periods after the 30th day following the earlier of a notice of proposed deficiency, the furnishing of a statutory notice of deficiency, or an assessment notice issued in connection with a nondeficiency procedure.

Explanation of provision

The bill provides that an IRS notice that is later withdrawn because it was issued in error does not trigger the higher rate of interest. The bill also corrects an incorrect reference to “this subtitle”.

¹¹¹H. Rept. No. 247, 101st Cong., 1st Sess. 1301 (1989); “Explanation of Provisions Approved by the Committee on October 3, 1989,” Senate Finance Committee Print, 101st Cong., 1st Sess. 118 (October 12, 1989).

¹¹²“Legislative History of Ways and Means Democratic Alternative,” House Ways and Means Committee Print (WMCP: 101-37), 101st Cong., 2nd Sess. 58 (October 15, 1990); Report language submitted by the Senate Finance Committee to the Senate Budget Committee on S. 3299, 136 Cong. Rec. S 15629, S 15700 (1990).

3. *Research credit provision: Effective date for repeal of special proration rule (sec. 1702(d)(1) of the bill and sec. 11402 of the 1990 Act)*

Present law

The Omnibus Budget Reconciliation Act of 1989 (“1989 Act”) effectively extended the research credit for nine months by prorating certain qualified research expenses incurred before January 1, 1991. The special rule to prorate qualified research expenses applied in the case of any taxable year which began before October 1, 1990, and ended after September 30, 1990. Under this special proration rule, the amount of qualified research expenses incurred by a taxpayer prior to January 1, 1991, was multiplied by the ratio that the number of days in that taxable year before October 1, 1990, bears to the total number of days in such taxable year before January 1, 1991. The amendments made by the 1989 Act to the research credit (including the new method for calculating a taxpayer’s base amount) generally were effective for taxable years beginning after December 31, 1989. However, this effective date did not apply to the special proration rule (which applied to any taxable year which began prior to October 1, 1990—including some years which began before December 31, 1989—if such taxable year ended after September 30, 1990).

Section 11402 of the Revenue Reconciliation Act of 1990 (“1990 Act”) extended the research credit through December 31, 1991, and repealed the special proration rule provided for by the 1989 Act. Section 11402 of the 1990 Act was effective for taxable years beginning after December 31, 1989. Thus, in the case of taxable years beginning before December 31, 1989, and ending after September 30, 1990 (e.g., a taxable year of November 1, 1989 through October 31, 1990), the special proration rule provided by the 1989 Act would continue to apply.

Explanation of provision

The bill repeals for all taxable years ending after December 31, 1989, the special proration rule provided for by the 1989 Act.

4. *Energy tax provision: Alternative minimum tax adjustment based on energy preferences (secs. 1702(e)(1) and (4) of the bill, sec. 11531(a) of the 1990 Act, and former sec. 56(h) of the Code)*

Present law

In computing alternative minimum taxable income (and the adjusted current earnings (ACE) adjustment of the alternative minimum tax), certain adjustments are made to the taxpayer’s regular tax treatment for intangible drilling costs (IDCs) and depletion. For certain taxable years, a special energy deduction is also allowed. The special energy deduction is initially determined by determining the taxpayer’s (1) intangible drilling cost preference and (2) the marginal production depletion preference. The intangible drilling cost preference is the amount by which the taxpayer’s alternative minimum taxable income would be reduced if it were computed without regard to the adjustments for IDCs. The marginal produc-

tion depletion preference is the amount by which the taxpayer's alternative minimum taxable income would be reduced if it were computed without regard to depletion adjustments attributable to marginal production. The intangible drilling cost preference is then apportioned between (1) the portion of the preference related to qualified exploratory costs and (2) the remaining portion of the preference. The portion of the preference related to qualified exploratory costs is multiplied by 75 percent and the remaining portion is multiplied by 15 percent. The marginal production depletion preference is multiplied by 50 percent. The three products described above are added together to arrive at the taxpayer's special energy deduction (subject to certain limitations).

The special energy deduction is not allowed to the extent that it exceeds 40 percent of alternative minimum taxable income determined without regard to either this special energy deduction or the alternative tax net operating loss deduction. Any special energy deduction amount limited by the 40-percent threshold may not be carried to another taxable year. 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.

The special energy deduction was repealed for taxable years beginning after December 31, 1992.

Explanation of provision

Interaction of special energy deduction with net operating loss and investment tax credit

The bill clarifies that the amount of alternative tax net operating loss that is utilized in any taxable year is to be appropriately adjusted to take into account the amount of special energy deduction claimed for that year. This operates to preserve a portion of the alternative tax net operating loss carryover by reducing the amount of net operating loss utilized to the extent of the special energy deduction claimed, which if unused, could not be carried forward.

In addition, the bill contains a similar provision which clarifies that the limitation on the utilization of the investment tax credit for purposes of the alternative minimum tax is to be determined without regard to the special energy deduction.

Interaction of special energy deduction with adjustment based on adjusted current earnings

The bill provides that the ACE adjustment for taxable years beginning in 1991 and 1992 is to be computed without regard to the special energy deduction. Thus, the bill specifies that the ACE adjustment is equal to 75 percent of the excess of a corporation's adjusted current earnings over its alternative minimum taxable income computed without regard to either the ACE adjustment, the alternative tax net operating loss deduction, or the special energy deduction.

5. *Estate tax freezes (sec. 1702(f) of the bill, sec. 11602 of the 1990 Act, and secs. 2701–2704 of the Code)*

Present law

Generally

The value of property transferred by gift or includible in the decedent's gross estate is its fair market value. Fair market value generally is the price at which the property would change hands between a willing buyer and willing seller, neither being under any compulsion to buy or sell and both having reasonable knowledge of relevant facts (Treas. Reg. sec. 20.2031). Chapter 14 contains rules that supersede the willing buyer, willing seller standard (Code secs. 2701–2704).

Preferred interests in corporations and partnerships

Valuation of retained interests

Scope.—Section 2701 provides special rules for valuing certain rights retained in conjunction with the transfer to a family member of an interest in a corporation or partnership. These rules apply to any applicable retained interest held by the transferor or an applicable family member immediately after the transfer of an interest in such entity. An “applicable family member” is, with respect to any transferor, the transferor's spouse, ancestors of the transferor and the spouse, and spouses of such ancestors.

An applicable retained interest is an interest with respect to which there is one of two types of rights (“affected rights”). The first type of affected right is a liquidation, put, call, or conversion right, generally defined as any liquidation, put, call, or conversion right, or similar right, the exercise or nonexercise of which affects the value of the transferred interest. The second type of affected right is a distribution right¹¹³ in an entity in which the transferor and applicable family members hold control immediately before the transfer. In determining control, an individual is treated as holding any interest held by the individual's brothers, sisters and lineal descendants. A distribution right does not include any right with respect to a junior equity interest.

Valuation.—Section 2701 contains two rules for valuing applicable retained interests. Under the first rule, an affected right other than a right to qualified payments is valued at zero. Under the second rule, any retained interest that confers (1) a liquidation, put, call or conversion right and (2) a distribution right that consists of the right to receive a qualified payment is valued on the assumption that each right is exercised in a manner resulting in the lowest value for all such rights (the “lowest value rule”). There is no statutory rule governing the treatment of an applicable retained interest that confers a right to receive a qualified payment, but with respect to which there is no liquidation, put, call or conversion right.

¹¹³ Distribution right generally is a right to a distribution from a corporation with respect to its stock, or from a partnership with respect to a partner's interest in the partnership.

A qualified payment is a dividend payable on a periodic basis and at a fixed rate under cumulative preferred stock (or a comparable payment under a partnership agreement). A transferor or applicable family member may elect not to treat such a dividend (or comparable payment) as a qualified payment. A transferor or applicable family member also may elect to treat any other distribution right as a qualified payment to be paid in the amounts and at the times specified in the election.

Inclusion in transfer tax base.—Failure to make a qualified payment valued under the lowest value rule within four years of its due date generally results in an inclusion in the transfer tax base equal to the difference between the compounded value of the scheduled payments over the compounded value of the payments actually made. The Treasury Department has regulatory authority to make subsequent transfer tax adjustments in the transfer of an applicable retained interest to reflect the increase in a prior taxable gift by reason of section 2701.

Generally, this inclusion occurs if the holder transfers by sale or gift the applicable retained interest during life or at death. In addition, the taxpayer may, by election, treat the payment of the qualified payment as giving rise to an inclusion with respect to prior periods.

The inclusion continues to apply if the applicable retained interest is transferred to an applicable family member. There is no inclusion on a transfer of an applicable retained interest to a spouse for consideration or in a transaction qualifying for the marital deduction, but subsequent transfers by the spouse are subject to the inclusion. Other transfers to applicable family members result in an immediate inclusion as well as subjecting the transferee to subsequent inclusions.

Minimum value of residual interest

Section 2701 also establishes a minimum value for a junior equity interest in a corporation or partnership. For partnerships, a junior equity interest is an interest under which the rights to income and capital are junior to the rights of all other classes of equity interests.

Trusts and term interests in property

The value of a transfer in trust is the value of the entire property less the value of rights in the property retained by the grantor. Section 2702 provides that in determining the extent to which a transfer of an interest in trust to a member of the transferor's family is a gift, the value of an interest retained by the transferor or an applicable family member is zero unless such interest takes certain prescribed forms.

For a transfer with respect to a specified portion of property, section 2702 applies only to such portion. The section does not apply to the extent that the transfer is incomplete.

Options and buy-sell agreements

A restriction upon the sale or transfer of property may reduce its fair market value. Treasury regulations provide that a restriction

is to be disregarded unless the agreement represents a bona fide business arrangement and not a device to pass the decedent's shares to the natural objects of his bounty for less than full and adequate consideration (Treas. Reg. sec. 20.2031-2(h)).

Section 2703 provides, that for transfer tax purposes, the value of property is determined without regard to any option, agreement or other right to acquire or use the property at less than fair market value or any restriction on the right to sell or use such property. Certain options are excepted from this rule. To fall within the exception, the option, agreement, right or restriction must (1) be a bona fide business arrangement, (2) not be a device to transfer such property to members of the decedent's family for less than full and adequate consideration in money or money's worth, and (3) have terms comparable to similar arrangements entered into by persons in an arm's length transaction.

Explanation of provision

Preferred interests in corporations and partnerships

Valuation

The bill provides that an applicable retained interest conferring a distribution right to qualified payments with respect to which there is no liquidation, put, call, or conversion right is valued without regard to section 2701. The bill also provides that the retention of such right gives rise to potential inclusion in the transfer tax base. In making these changes, it is understood that Treasury regulations could provide, in appropriate circumstances, that a right to receive amounts on liquidation of the corporation or partnership constitutes a liquidation right within the meaning of section 2701 if the transferor, alone or with others, holds the right to cause liquidation.

The bill modifies the definition of junior equity interest by granting regulatory authority to treat a partnership interest with rights that are junior with respect to either income or capital as a junior equity interest. The bill also modifies the definition of distribution right by replacing the junior equity interest exception with an exception for a right under an interest that is junior to the rights of the transferred interest. As a result, section 2701 does not affect the valuation of a transferred interest that is senior to the retained interest, even if the retained interest is not a junior equity interest.

The bill modifies the rules for electing into or out of qualified payment treatment. A dividend payable on a periodic basis and at a fixed rate under a cumulative preferred stock held by the transferor is treated as a qualified payment unless the transferor elects otherwise. If held by an applicable family member, such stock is not treated as a qualified payment unless the holder so elects.¹¹⁴ In addition, a transferor or applicable family member holding any other distribution right may treat such right as a qualified payment to be paid in the amounts and at the times specified in the election.

¹¹⁴With respect to gifts made prior to the date of enactment, the provision provides that this election may be made by the due date (including extensions) of the transferor's gift tax return due for the first calendar year after the date of enactment.

Prior technical corrections bills also included a provision to provide a special definition of “applicable family member” for purposes of determining control under section 2701. The bill does not include this provision.

Inclusion in transfer tax base

The bill grants the Treasury Department regulatory authority to make subsequent transfer tax adjustments to reflect the inclusion of unpaid amounts with respect to a qualified payment. This authority, for example, would permit the Treasury Department to eliminate the double taxation that might occur if, with respect to a transfer, both the inclusion and the value of qualified payment arrearages were included in the transfer tax base. It also would permit elimination of the double taxation that might result from a transfer to a spouse, who, under the statute, is both an applicable family member and a member of the transferor’s family.

The bill treats a transfer to a spouse falling under the annual exclusion the same as a transfer qualifying for the marital deduction. Thus, no inclusion would occur upon the transfer of an applicable retained interest to a spouse, but subsequent transfers by the spouse would be subject to inclusion. The bill also clarifies that the inclusion continues to apply if an applicable family member transfers a right to qualified payments to the transferor.

The provision clarifies the consequences of electing to treat a distribution as giving rise to an inclusion. Under the bill, the election gives rise to an inclusion only with respect to the payment for which the election is made. The inclusion with respect to other payments is unaffected.

Trust and term interests in property

The bill conforms section 2702 to existing regulatory terminology by substituting the term “incomplete gift” for “incomplete transfer.” In addition, the bill limits the exception for incomplete gifts to instances in which the entire gift is incomplete. The Treasury Department is granted regulatory authority, however, to create additional exceptions not inconsistent with the purposes of the section. This authority, for example, could be used to except a charitable remainder trust that meets the requirements of section 664 and that does not otherwise create an opportunity for transferring property to a family member free of transfer tax.

6. Miscellaneous provisions

- a. Conforming amendments to the repeal of the General Utilities doctrine (secs. 1702(g)(1) and (2) of the bill, sec. 11702(e)(2) of the 1990 Act, and secs. 897(f) and 1248 of the Code)*

Present law

As a result of changes made by recent tax legislation, gain is generally recognized on the distribution of appreciated property by a corporation to its shareholders. The Technical Corrections subtitle of the 1990 Act and technical correction provisions in prior acts made various conforming amendments arising out of these

changes. For example, the 1990 Act made a conforming change to section 355(c) to state the treatment of distributions in section 355 transactions in the affirmative rather than by reference to the provisions of section 311. In addition, the Technical and Miscellaneous Revenue Act of 1988 (“1988 Act”) made a conforming change to section 1248(f) to update the references to the nonrecognition provisions contained in that subsection. One of the changes was to change the reference to “section 311(a)” from “section 311”.

Explanation of provision

The bill makes three conforming changes to the Code with respect to the repeal of the *General Utilities* doctrine.

First, section 1248(f) is amended to add a reference to section 355(c)(1), which provides generally for the nonrecognition of gain or loss on the distribution of stock or securities in certain subsidiary corporations. This retains the substance of the law as it existed before the conforming change to section 355(c) made by the 1990 Act. This provision is not intended to affect the authority of the Secretary of the Treasury to issue regulations under section 1248(f) providing exceptions to the rule recognizing gain in certain distributions (cf. Notice 87-64, 1987-2 C.B. 375).

Second, section 1248 is amended to clarify that, notwithstanding the conforming changes made by the 1988 Act, with respect to any transaction in which a U.S. person is treated as realizing gain from the sale or exchange of stock of a controlled foreign corporation, the U.S. person shall be treated as having sold or exchanged the stock for purposes of applying section 1248. Thus, if a U.S. person distributes appreciated stock of a controlled foreign corporation to its shareholders in a transaction in which gain is recognized under section 311(b), section 1248 shall be applied as if the stock had been sold or exchanged at its fair market value. Under section 1248(a), part or all of the gain may be treated as a dividend. Under the bill, the rule treating the distribution for purposes of section 1248 as a sale or exchange also applies where the U.S. person is deemed to distribute the stock under the provisions of section 1248(i). Under section 1248(i), gain will be recognized only to the extent of the amount treated as a dividend under section 1248.

Third, section 897(f), relating to the basis in a United States real property interest distributed to a foreign person, is repealed as deadwood. The basis of the distributed property is its fair market value in accordance with section 301(d).

b. Prohibited transaction rules (sec. 1702(g)(3) of the bill, sec. 11701(m) of the 1990 Act, and sec. 4975 of the Code)

Present law

The Code and title I of the Employee Retirement Income Security Act of 1974 (ERISA) prohibit certain transactions between an employee benefit plan and certain persons related to such plan. An exemption to the prohibited transaction rules of title I of ERISA is provided in the case of sales of employer securities the plan is required to dispose of under the Pension Protection Act of 1987 (ERISA sec. 408(b)(12)). The 1990 Act amended the Code to provide that certain transactions that are exempt from the prohibited

transaction rules of ERISA are automatically exempt from the prohibited transaction rules of the Code. The 1990 Act change was intended to be limited to transactions exempt under section 408(b)(12) of ERISA.

Explanation of provision

The bill conforms the statutory language to legislative intent by providing that transactions that are exempt from the prohibited transaction rules of ERISA by reason of ERISA section 408(b)(12) are also exempt from the prohibited transaction rules of the Code.

c. Effective date of LIFO adjustment for purposes of computing adjusted current earnings (sec. 1702(g)(4) of the bill, sec. 11701 of the 1990 Act, sec. 7611(b) of the 1989 Act, and sec. 56(g) of the Code)

present law

For purposes of computing the adjusted current earnings (ACE) component of the corporate alternative minimum tax, taxpayers are required to make the LIFO inventory adjustments provided in section 312(n)(4) of the Code. Section 312(n)(4) generally is applicable for purposes of computing earnings and profits in taxable years beginning after September 30, 1984. The ACE adjustment generally is applicable to taxable years beginning after December 31, 1989.

Explanation of provision

The bill clarifies that the LIFO inventory adjustment required for ACE purposes shall be computed by applying the rules of section 312(n)(4) only with respect to taxable years beginning after December 31, 1989. The effective date applicable to the determination of earnings and profits (September 30, 1984) is inapplicable for purposes of the ACE LIFO inventory adjustment. Thus, the ACE LIFO adjustment shall be computed with reference to increases (and decreases, to the extent provided in Treasury regulations) in the ACE LIFO reserve in taxable years beginning after December 31, 1989.

d. Low-income housing credit (sec. 1702(g)(5) of the bill, sec. 11701(a)(11) of the 1990 Act, and sec. 42 of the Code)

Present law

The amendments to the low-income housing tax credit contained in the Omnibus Budget Reconciliation Act of 1989 ("1989 Act") generally were effective for buildings placed in service after December 31, 1989, to the extent the buildings were financed by tax-exempt bonds ("bond-financed buildings"). This rule applied regardless of when the bonds were issued.

A technical correction enacted in the Revenue Reconciliation Act of 1990 ("1990 Act") limited this effective date to buildings financed with bonds issued after December 31, 1989. Thus, the technical correction applied pre-1989 Act law to bond-financed buildings placed in service after December 31, 1989, if the bonds were issued before January 1, 1990.

Explanation of provision

The bill repeals the 1990 technical correction. The bill provides, however, that pre-1989 Act law will apply to a bond-financed building if the owner of the building establishes to the satisfaction of the Secretary of the Treasury reasonable reliance upon the 1990 technical correction. In the case of buildings placed in service before the date of the bill's enactment, reasonable reliance may be established by a showing of compliance with the law as in effect for those buildings before enactment of the amendments made by the bill.

7. *Expired or obsolete provisions ("deadwood provisions") (secs. 1702(h)(1)–(18) of the bill and secs. 11801–1816 of the 1990 Act)*

Present law

The 1990 Act repealed and amended numerous sections of the Code by deleting obsolete provisions ("deadwood"). These amendments were not intended to make substantive changes to the tax law.

Explanation of provision

The bill makes several amendments to restore the substance of prior law which was inadvertently changed by the deadwood provisions of the 1990 Act. These amendments include (1) a provision that clarifies that solar or wind property owned by a public utility may qualify as 5-year MACRS property (sec. 168(e)(3)(B)(vi)); (2) a provision restoring the prior-law rule providing that if any member of an affiliated group of corporations elects the credit under section 901 for foreign taxes paid or accrued, then all members of the group paying or accruing such taxes must elect the credit in order for any dividend paid by a member of the group to qualify for the 100-percent dividends received deduction (sec. 243(b)); and (3) a provision that denies section 179 expensing for property described in section 50(b) and air conditioning and heating units.

The bill also makes several nonsubstantive clerical amendments to conform the Code to the amendments made by the deadwood provisions. None of these amendments is intended to change the substance of pre-1990 law.

B. TECHNICAL CORRECTIONS TO THE REVENUE RECONCILIATION ACT
OF 1993

1. *Treatment of full-time students under the low-income housing credit (sec. 1703(b)(1) of the bill, sec. 13142 of the 1993 Act and sec. 42 of the Code).*

Present law

The Revenue Reconciliation Act of 1993 ("1993 Act") codified prior law rules relating to the treatment of married students filing joint returns. Further, it provided that a housing 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.

Explanation of provision

The bill provides that the full-time student provision is effective on the date of enactment of the 1993 Act.

2. *Indexation of threshold applicable to excise tax on luxury automobiles (sec. 1703(c) of the bill, sec. 13161 of the 1993 Act, and sec. 4001(e)(1) of the Code)*

Present law

The 1993 Act indexed the threshold above which the excise tax on luxury automobiles is to apply.

Explanation of provision

The bill corrects the application of the indexing adjustment so that the adjustment calculated for a given calendar year applies for that calendar year rather than in the subsequent calendar year. This conforms the indexation to that described in the conference report to the 1993 Act.¹¹⁵ The intent of Congress, as reflected in the conference report, was that current year indexation be effective on the date of enactment of the 1993 Act. Under the bill, the provision would, however, be effective on the date of enactment, to alleviate the difficulties that both taxpayers and the Treasury would experience in administering a retroactive refund effective to August 10, 1993.

3. *Indexation of the limitation based on modified adjusted gross income for income from United States Savings bonds used to pay higher education tuition and fees (sec. 1703(d) of the bill, sec. 13201 of the 1993 Act, and sec. 135(b)(2)(B) of the Code)*

Present law

A taxpayer may exclude from gross income the proceeds from the redemption of qualified United States savings bonds if the proceeds are used to pay qualified higher education expenses and the taxpayer's modified adjusted gross income is equal to or less than \$60,000 (\$40,000 in the case of a single return). The exclusion is phased out for incomes above these thresholds. The \$60,000 (\$40,000) threshold is indexed for inflation occurring after 1992.

Explanation of provision

The bill corrects the indexing of the \$60,000 (\$40,000) threshold to provide that the thresholds be indexed for inflation after 1989, as was provided prior to the 1993 Act.

4. *Reporting and notification requirements for lobbying and political expenditures of tax-exempt organizations (sec. 1703(g) of the bill, sec. 13222 of the 1993 Act and sec. 6033(e) of the Code)*

Present law

Tax-exempt organizations which incur political expenditures are subject to tax under Code section 527(f). The tax is calculated by

¹¹⁵ See, H. Rept. 103-213, August 4, 1993, p. 558.

applying the highest corporate rate to the lesser of (a) the net investment income of the organization, or (b) the amount of political expenditures incurred by the organization during the taxable year. Expenditures covered by Code section 527(f) are those expended for “influencing or attempting to influence the selection, nomination, election, or appointment of any individual to any Federal, State, or local public office or office in a political organization, or the election of Presidential or Vice-Presidential electors, whether or not such individual or electors are selected, nominated, elected, or appointed.”

Code section 162(e), as amended by the 1993 Act, provides a separate set of rules regarding the tax treatment of lobbying and political expenditures. Political expenditures include amounts paid or incurred in connection with “participation in, or intervention in, any political campaign on behalf of (or in opposition to) any candidate for public office.” Taxpayers may not deduct the portion of dues or similar amounts paid to a tax-exempt organization which the organization notifies the taxpayer are allocable to lobbying or political expenditures.

Code section 6033(e) sets forth reporting and notification requirements applicable to tax-exempt organizations (other than charities) that incur lobbying or political expenditures within the meaning of Code section 162(e). First, the organization must report on its annual tax return both the total amount of its lobbying and political expenditures, and the total amount of dues (or similar payments) allocable to such expenditures. Second, the organization must either provide notice to its members of the portion of dues allocable to lobbying and political expenditures (so that such amounts are not deductible by members), or may elect to pay a proxy tax (at the highest corporate rate) on its lobbying and political expenditures, up to the amount of dues receipts.

Explanation of provision

The bill amends Code section 6033(e) to clarify that any political expenditures on which tax is paid pursuant to Code section 527(f) are not subject to the reporting and notification requirements of Code section 6033(e). In addition, the bill clarifies that the reporting and notification requirements of Code section 6033(e) apply to organizations exempt from tax under Code section 501(a), other than charities described in section 501(c)(3).

5. *Estimated tax rules for certain tax-exempt organizations (sec. 1703(h) of the bill, sec. 13225 of the 1993 Act and sec. 6655(g)(3) of the Code)*

Present law

A tax-exempt organization is generally subject to an addition to tax for any underpayment of estimated tax on its unrelated business taxable income or its net investment income (as the case may be). Under the 1993 Act, for years beginning after December 31, 1993, a corporation or tax-exempt organization does not have an underpayment of estimated tax if it makes four timely estimated tax payments that total at least 100 percent of the tax liability shown on its return for the current taxable year. A corporation or tax-exempt organization may estimate its current year tax liability

prior to year-end by annualizing its income. The 1993 Act also changed the method by which a corporation annualizes its current year tax liability.

Explanation of provision

The bill clarifies that the 1993 Act did not change the method by which a tax-exempt organization annualizes its current year tax liability.

6. *Current taxation of certain earnings of controlled foreign corporations—application of foreign tax credit limitation (sec. 1703(i)(1) of the bill, sec. 13231(b) of the 1993 Act, and sec. 904(d) of the Code)*

Present law

Present law requires U.S. shareholders of a controlled foreign corporation to include in income the corporation's subpart F income, certain earnings invested in U.S. property, and, as modified by the 1993 Act, certain earnings invested in excess passive assets. A U.S. shareholder's tax liability attributable to the inclusion may be offset by foreign tax credits for certain foreign taxes paid or deemed paid by the shareholder.

The foreign tax credit limitation applies separately to several categories of income. The separate limitations apply to a dividend from a controlled foreign corporation to a U.S. shareholder of that controlled foreign corporation by reference to the character of the earnings and profits of the distributing corporation.

An inclusion of a controlled foreign corporation's earnings invested in U.S. property is treated like a dividend for purposes of the foreign tax credit limitation. Although the 1993 Act provided that inclusions of earnings invested in excess passive assets generally are determined in the same manner as inclusions of earnings invested in U.S. property, the 1993 Act did not specify how the separate limitations of the foreign tax credit should apply to inclusions of earnings invested in excess passive assets.

Some have argued that the separate limitations of the foreign tax credit do not apply to an inclusion of a controlled foreign corporation's earnings invested in excess passive assets; rather, that such an inclusion is allocated entirely to the general foreign tax credit limitation, without regard to the character of the underlying earnings and profits of the controlled foreign corporation.

Explanation of provision

The bill clarifies that a U.S. shareholder's inclusion of a controlled foreign corporation's earnings invested in excess passive assets is treated like a dividend for purposes of the foreign tax credit limitation. Thus, the inclusion is characterized by reference to the underlying earnings and profits of the controlled foreign corporation. This treatment is consistent with present law's application of the separate limitations of the foreign tax credit to other amounts included in income with respect to a controlled foreign corporation.

7. *Current taxation of certain earnings of controlled foreign corporations—measurement of accumulated earnings (sec. 1703(i)(2) of the bill, sec. 13231(b) of the 1993 Act, and sec. 956A(b) of the Code)*

Present law

Present law, as modified by the 1993 Act, limits the availability of deferral of U.S. tax on certain earnings of controlled foreign corporations by requiring U.S. shareholders of a controlled foreign corporation to include in income the corporation's accumulated¹¹⁶ or current earnings invested in excess passive assets. Some have argued that the Code's definition of earnings subject to this treatment permits an accumulated deficit in earnings to eliminate positive current earnings, resulting in no income inclusion in a case where an actual distribution would be treated as a dividend out of current earnings. In addition, some have argued that the Code's definition of earnings subject to this treatment takes current-year earnings into account more than once.

Explanation of provision

The bill clarifies that the accumulated earnings and profits of a controlled foreign corporation taken into account for purposes of determining the foreign corporation's earnings invested in excess passive assets do not include any deficit in accumulated earnings and profits,¹¹⁷ and do not include current earnings (which are taken into account separately).

8. *Current taxation of certain earnings of controlled foreign corporations—aggregation and look-through rules (sec. 1703(i)(3) of the bill, sec. 13231(b) of the 1993 Act, and sec. 956A(f) of the Code)*

Present law

Present law, as modified by the 1993 Act, provides certain aggregation and look-through rules in connection with requiring U.S. shareholders of a controlled foreign corporation to include in income certain of the corporation's earnings invested in excess passive assets. Under the aggregation rule, certain groups of controlled foreign corporations that are linked by stock ownership of more than 50 percent (CFC groups) are treated as a single corporation for purposes of determining their earnings invested in excess passive assets. Look-through treatment applies to certain corporations whose stock is owned at least 25 percent by a controlled foreign corporation. Some have argued that these rules permit the assets of one foreign corporation to be taken into account more than once through a combination of CFC group treatment and look-through treatment. In addition, some have argued that these rules permit the assets of one foreign corporation to be taken into account more than once through membership of the foreign corporation in more than one CFC group.

¹¹⁶ Accumulated earnings and profits are taken into account only to the extent that they were accumulated in taxable years beginning after September 30, 1993.

¹¹⁷ Incurred in taxable years beginning after September 30, 1993.

Explanation of provision

The bill clarifies that, within the regulatory authority provided to the Secretary of the Treasury under the 1993 Act, regulations are specifically authorized to coordinate the CFC group treatment and look-through treatment applicable for purposes of determining a foreign corporation's earnings invested in excess passive assets. Pending the promulgation of guidance by the Secretary, it is intended that taxpayers be permitted to coordinate such treatment using any reasonable method for taking assets into account only once, so long as the method is consistently applied to all controlled foreign corporations (whether or not members of any CFC group) in all taxable years.

9. *Treatment of certain leased assets for PFIC purposes (sec. 1703(i)(5) of the bill, sec. 13231(d)(4) of the 1993 Act, and sec. 1297(d) of the Code)*

Present law

Under present law, as modified by the 1993 Act, certain property leased by a foreign corporation may be treated as an asset actually owned by the foreign corporation in measuring the assets of the foreign corporation for purposes of the passive foreign investment company ("PFIC") asset test of section 1296(a)(2). The 1993 Act provided a special measurement rule, under which the adjusted basis of the leased asset for this purpose is determined by reference to the unamortized portion of the present value of the payments under the lease for the use of the property. Some have argued, however, that the special measurement rule does not apply to PFICs that are permitted to measure their assets by fair market value, rather than by adjusted basis. Under this argument, the entire fair market value of the leased asset might be treated as owned by the foreign corporation.

Explanation of provision

The bill clarifies that, in the case of any item of property leased by a foreign corporation and treated as an asset actually owned by the foreign corporation in measuring the assets of the foreign corporation for purposes of the PFIC asset test, the amount taken into account with respect to the leased property is the amount determined under the 1993 Act's special measurement rule, which is based on the unamortized portion of the present value of the payments under the lease for the use of the property. That is, the provision clarifies that the special measurement rule of the 1993 Act applies to all PFICs, regardless of whether they are generally permitted to measure their assets by fair market value rather than adjusted basis.

10. *Expiration date of special ethanol blender refund (sec. 1703(k) of the bill and sec. 6427 of the Code)*

Present law

A 54-cents-per-gallon blender income tax credit is provided for ethanol used as a motor fuel. This credit applies to ethanol which is blended with gasoline (“gasohol”).

Gasoline is subject to an 18.3-cents-per-gallon excise tax. As an alternative to claiming the income tax credit, gasohol blenders may claim the benefit of the ethanol income tax credit against their gasoline excise tax liability. The benefit may be claimed against excise tax liability in either of two ways: (1) by purchasing gasoline destined for blending with ethanol at a reduced excise tax rate, or (2) before October 1, 1995, by claiming expedited refunds of the excise tax paid on gasoline purchased at the full excise tax rate, after that gasoline is blended with ethanol. In general, the gasoline (including gasohol) excise tax provisions associated with the Highway Trust Fund expire after September 30, 1999.

Explanation of provision

The bill corrects a 1990 drafting error by conforming the expiration date for the excise tax expedited refund provision for gasohol blenders to that for gasoline tax provisions generally. Thus, these refunds will be permitted through September 30, 1999.

11. *Amortization of goodwill and certain other intangibles (sec. 1703(l) of the bill, sec. 13261(g) of the 1993 Act and sec. 197 of the Code)*

Present law

The 1993 Act allows amortization deductions to certain intangible assets acquired after the 1993 Act’s effective date that were not amortizable under prior law. The 1993 Act contains “antichurning” rules that deny amortization to intangible assets that were not amortizable under prior law if such assets are acquired by the taxpayer after the effective date from certain related parties.

The 1993 Act also contains an election under which a taxpayer and certain related parties may elect to treat all acquisitions after July 25, 1991 as subject to the provisions of the 1993 Act.

Explanation of provision

The bill clarifies that when a taxpayer and its related parties have made an election to apply the 1993 Act to all acquisitions after July 25, 1991, the antichurning rules will not apply when property acquired from an unrelated party after July 25, 1991 (and not subject to the antichurning rules in the hands of the acquirer) is transferred to a taxpayer related to the acquirer after the date of enactment of the 1993 Act.

12. *Empowerment zones and eligibility of small farms for tax incentives (sec. 1703(m) of the bill, sec. 13301 of the 1993 Act and sec. 1397B(d)(5)(B) of the Code)*

Present law

Pursuant to the 1993 Act, on December 21, 1994, six empowerment zones and 65 enterprise communities were designated in eligible urban areas, and three empowerment zones and 30 enterprise communities were designated in rural areas. Special tax incentives (i.e., a wage credit, additional section 179 expensing, and expanded tax-exempt financing) are available for certain business activities conducted in urban and rural empowerment zones. Expanded tax-exempt financing benefits are available for certain facilities located in urban and rural enterprise communities.

The empowerment zone wage credit is not available with respect to any individual employed by a trade or business the principal activity of which is farming (within the meaning of subparagraphs (A) and (B) of section 2032A(e)(5)) if, as of the close of the current taxable year, the sum of the aggregate unadjusted bases (or, if greater, the fair market value) of assets of the farm exceed \$500,000 (sec. 1396(d)(2)(E)). In contrast, the additional section 179 expensing (available in empowerment zones) and expanded tax-exempt financing benefits (available in both empowerment zones and enterprise communities) are not allowed for any trade or business the principal activity of which is farming if, as of the close of the preceding taxable year, the sum of the aggregate bases (or, if greater, the fair market value) of the assets of the farm exceed \$500,000 (sec. 1397B(d)(5)).

Explanation of provision

The bill provides that the \$500,000 asset test for determining whether a farm is eligible for additional section 179 expensing (in an empowerment zone) and expanded tax-exempt financing benefits (in an empowerment zone or enterprise community) is applied based on the assets of the farm at the end of the current taxable year. Thus, the \$500,000 asset test for determining farm eligibility is based on the same taxable period (i.e., the current taxable year) for purposes of all tax incentives available in empowerment zones and enterprise communities.

C. OTHER TAX TECHNICAL CORRECTIONS

1. *Hedge bonds (sec. 1704(b) of the bill, sec. 11701 of the 1989 Act, and sec. 149(g) of the Code)*

Present law

The 1989 Act provided generally that interest on hedge bonds is not tax-exempt unless prescribed minimum percentages of the proceeds are reasonably expected to be spent at set intervals during the five-year period after issuance of the bonds (sec. 149(g)). A hedge bond is defined generally as a bond (1) at least 85 percent of the proceeds of which is not reasonably expected to be spent within three years following issuance and (2) more than 50 percent

of the proceeds of which is invested at substantially guaranteed yields for four years or more.

This restriction does not apply, however, if at least 95 percent of the bond proceeds is invested in other tax-exempt bonds (not subject to the alternative minimum tax). The 95-percent investment requirement is not violated if investment earnings exceeding five percent of the proceeds are temporarily invested for up to 30 days pending reinvestment in taxable (including alternative minimum taxable) investments.

This provision is effective as if included in the Omnibus Budget Reconciliation Act of 1989.

Explanation of provision

The bill clarifies that the 30-day exception for temporary investments of investment earnings applies to amounts (i.e., principal and earnings thereon) temporarily invested during the 30-day period immediately preceding redemption of the bonds as well as such periods preceding reinvestment of the proceeds.

2. *Withholding on distributions from U.S. real property holding companies (sec. 1704(c) of the bill, sec. 129 of the Deficit Reduction Act of 1984, and sec. 1445 of the Code)*

Present law

In general

Under the Foreign Investment in Real Property Tax Act of 1980 ("FIRPTA"), a foreign investor that disposes of a U.S. real property interest generally is required to pay tax on any gain on the disposition. For this purpose a U.S. real property interest generally includes stock in a domestic corporation that is a U.S. real property holding corporation ("USRPHC"), or was a USRPHC at any time during the previous five years.

A sale or exchange of stock in a USRPHC is an example of a disposition of a U.S. real property interest. In addition, provisions of subchapter C of the Code treat amounts received in certain corporate distributions as amounts received in sales or exchanges, giving rise to tax liability under the FIRPTA rules when a foreign person receives such a distribution from a present or former USRPHC. Thus, amounts received by a foreign shareholder in a USRPHC in a distribution in complete liquidation of the USRPHC are treated as in full payment in exchange for the USRPHC stock, and are therefore subject to tax under FIRPTA (sec. 331; Treas. Reg. sec. 1.897-5T(b)(2)(iii)). Similarly, amounts received by a foreign shareholder in a USRPHC upon redemption of the USRPHC stock are treated as a distribution in part or full payment in exchange for the stock, and are therefore subject to tax under FIRPTA (sec. 302(a); Treas. Reg. sec. 1.897-5T(b)(2)(ii)). Third, amounts received by a foreign shareholder in a USRPHC, in a section 301 distribution from the USRPHC that exceeds the available earnings and profits of the USRPHC, are treated as gain from the sale or exchange of the shareholder's USRPHC stock to the extent that they exceed the shareholder's adjusted basis in the stock; such amounts

are therefore also subject to tax under FIRPTA (sec. 301(c)(3); Treas. Reg. sec. 1.897-5T(b)(2)(i)).

FIRPTA withholding

The Deficit Reduction Act of 1984 established a withholding system to enforce the FIRPTA tax. Unless an exception applies, a transferee of a U.S. real property interest from a foreign person generally is required to withhold the lesser of 10 percent of the amount realized (purchase price), or the maximum tax liability on disposition (as determined by the IRS) (sec. 1445). Such withholding may be reduced or eliminated pursuant to a withholding certificate issued by the Internal Revenue Service (Treas. Reg. sec. 1.1445-3).

Although the FIRPTA withholding requirement by its terms generally applies to all dispositions of U.S. real property interests, and subchapter C treats amounts received in certain distributions as amounts received in sales or exchanges, the FIRPTA withholding provisions also provide express rules for withholding on certain distributions treated as sales or exchanges. Generally, distributions in a transaction to which section 302 (redemptions) or part II of subchapter C (liquidations) applies are subject to 10-percent withholding.¹¹⁸ Although a section 301 distribution in excess of earnings and profits is also treated as a disposition for purposes of computing the FIRPTA liability of a foreign recipient of the distribution, there is no corresponding withholding provision expressly addressed to the payor of such a distribution.

Explanation of provision

The bill clarifies that FIRPTA withholding requirements apply to any section 301 distribution to a foreign person by a domestic corporation that is or was a USRPHC, which distribution is not made out of the corporation's earnings and profits and is therefore treated as an amount received in a sale or exchange of a U.S. real property interest. (The bill does not alter the withholding treatment of section 301 distributions by such a corporation that are out of earnings and profits.) Under the bill, the FIRPTA withholding requirements that apply to a section 301 distribution not out of earnings and profits are similar to the requirements applicable to redemption or liquidation distributions to a foreign person by such a corporation. It is anticipated that withholding certificates will be available to taxpayers that expect to receive section 301 distributions not out of earnings and profits.

The provision is effective for distributions made after the date of enactment of the bill. No inference is intended to be drawn from the provision as to the FIRPTA withholding requirements applicable to such a distribution under present law.

¹¹⁸Under other rules, dividend distributions (i.e., distributions to which sec. 301(c)(1) applies) to foreign persons by U.S. corporations, including USRPHCs, are subject to 30-percent withholding under the Code. Under treaties, the withholding on a dividend may be reduced to as little as 5 or 15 percent.

3. *Treatment of credits attributable to working interests in oil and gas properties (sec. 1704(d) of the bill, sec. 501 of the Tax Reform Act of 1986, and sec. 469 of the Code)*

Present law

Under present law, a working interest in an oil and gas property which does not limit the liability of the taxpayer is not a “passive activity” for purposes of the passive loss rules (sec. 469). However, if any loss from an activity is treated as not being a passive loss by reason of being from a working interest, any net income from the activity in subsequent years is not treated as income from a passive activity, notwithstanding that the activity may otherwise have become passive with respect to the taxpayer.

Explanation of provision

The bill clarifies that any credit attributable to a working interest in an oil and gas property, in a taxable year in which the activity is no longer treated as not being a passive activity, will not be treated as attributable to a passive activity to the extent of any tax allocable to the net income from the activity for the taxable year. Any credits from the activity in excess of this amount of tax will continue to be treated as arising from a passive activity and will be treated under the rules generally applicable to the passive activity credit. The provision applies to taxable years beginning after December 31, 1986.

4. *Clarification of passive loss disposition rule (sec. 1704(e) of the bill, sec. 501 of the Tax Reform Act of 1986, sec. 1005(a)(2)(A) of the Technical and Miscellaneous Revenue Act of 1988, and sec. 469(g)(1)(A) of the Code)*

Present law

The Tax Reform Act of 1986 (“1986 Act”) provided that if a passive activity is disposed of in a transaction in which all gain or loss is recognized, any overall loss from the activity in the year of disposition is recognized and allowed against income (whether active or passive income).¹¹⁹ The language of the 1986 Act provided that any loss was allowable, first, against income or gain from the passive activity, second, against income or gain from all passive activities, and finally, against any other income or gain. This rule was rewritten by the technical corrections portion of the Technical and Miscellaneous Revenue Act of 1988 (“1988 Act”). The statutory language (as amended by the 1988 Act) providing for the computation of the overall loss for the taxable year of disposition is not entirely clear where the activity is disposed of at a gain.

Explanation of provision

The bill clarifies the rule relating to the computation of the overall loss allowed upon the disposition of a passive activity. The bill provides that, in a transaction in which all gain or loss is recognized on the disposition of a passive activity, any loss from the ac-

¹¹⁹ See S. Rept. 99-313, p. 725.

tivity for the taxable year (taking into account all income, gain, and loss, including gain or loss recognized on the disposition) in excess of any net income or gain from other passive activities for the taxable year is treated as a loss which is not from a passive activity. The provision applies to taxable years beginning after December 31, 1986.

5. *Estate tax unified credit allowed nonresident aliens under treaty (sec. 1704(f)(1) of the bill, sec. 5032(b)(2) of the Technical and Miscellaneous Revenue Act of 1988, and sec. 2102(c)(3)(A) of the Code)*

Present law

Amount subject to tax

For U.S. citizens and residents, the amount subject to Federal estate and gift tax is determined by reference to all property, wherever situated. For nonresident aliens, the Code provides that the amount subject to Federal estate and gift tax is determined only by reference to property situated in the United States.

The United States has entered into bilateral treaties designed to avoid double transfer taxation. Early treaties typically did this by providing rules for determining situs and requiring that the State of domicile allow a credit for taxes paid to the situs country.¹²⁰ In contrast, treaties signed in the 1980s, and the U.S. and OECD model treaties, exempt most property, wherever situated, from taxation outside the State of domicile.¹²¹

Specific exemption and unified credit

Prior to the Tax Reform Act of 1976 ("1976 Act"), the Code allowed a "specific exemption" against the estate tax. The estate of a U.S. citizen or resident was allowed an exemption of \$60,000, while the estate of a nonresident alien was allowed a lesser amount. A number of U.S. estate tax treaties ratified in the 1950s allowed a nonresident alien a "specific exemption" equal to the exemption allowed a U.S. citizen or resident multiplied by the percentage of the gross estate subject to U.S. estate tax (the "pro rata exemption").¹²²

The 1976 Act replaced the specific exemption with a unified credit of \$47,000 for the estate of U.S. citizen or resident and \$3,600 for the estate of a nonresident alien. After 1976, two courts interpreted the pro rata exemption allowed in the 1950s treaties as applying to the unified credit, i.e., as allowing a unified credit no less than the unified credit allowed a U.S. citizen or resident multiplied by the percentage of the gross estate situated in the United States (and therefore subject to U.S. estate tax under those treaties).¹²³

¹²⁰ See Staff of the Joint Committee on Taxation, 98th Cong., 2d Sess., *Explanation of Proposed Estate and Gift Tax Treaty Between the United States and Sweden* 8 (1984).

¹²¹ See, e.g., U.S. Treasury Model Estate and Gift Tax Treaty (1980), Article 7, paragraph 1: "Transfers and deemed transfers by an individual domiciled in a Contracting State of property other than property referred to in Article 5 (Real Property) and 6 (Business Property of a Permanent Establishment and Asset Pertaining to a Fixed Base Used for the Performance of Independent Personal Services) shall be taxable only in that State."

¹²² See Rev. Rul. 81-303, 1981-2 C.B. 255.

¹²³ See *Mudry v. United States*, 11 Cl. Ct. 207 (1986) (Swiss treaty); *Burghardt v. Commissioner*, 80 T.C. 705 (1983), aff'd., 734 F.2d 3 (3d Cir. 1984) (Italian treaty).

The Technical and Miscellaneous Revenue Act of 1988 (“1988 Act”) increased the unified credit allowed an estate of a non-resident alien to \$13,000. In so doing, the 1988 Act provided that, “to the extent required by any treaty,” the estate of a nonresident alien is allowed a unified credit equal to the unified credit allowed a U.S. citizen or resident multiplied by the percentage of the gross estate situated in the United States (Code sec. 2102(c)(3)(A)). Thus, the 1988 Act did not override the “specific exemption” language of the 1950s treaties, as interpreted by the two courts, and could be interpreted as encouraging the negotiation of pro rata unified credits in future treaties.

Explanation of provision

The bill clarifies that in determining the pro rata unified credit required by treaty, property exempted by the treaty from U.S. estate tax is not treated as situated in the United States. Under this rule, a treaty granting a pro rata unified credit would allow a non-resident alien the unified credit allowed a U.S. citizen or resident multiplied by the percentage of the gross estate subject to U.S. estate tax, as modified by treaty.

The provision is not intended to affect existing treaties that contain pro rata exemptions pursuant to which the assets reserved for situs taxation by the non-domiciliary country are specifically described. In the case of a treaty that contains a pro rata exemption but does not provide rules for determining the situs for property (e.g., the treaty with Canada), the bill clarifies that property exempted by the treaty from U.S. estate tax is not treated as situated in the United States. The Senate Foreign Relations Committee Report with respect to the revised protocol amending the tax convention with Canada anticipated the enactment of this provision (Sen. Exec. Rep. No. 104–9, 104th Cong., 1st Sess. at 15). For future treaties, it is intended that any pro rata unified credit negotiated not exceed the proportion of the gross worldwide estate subject to U.S. estate and gift tax, as modified by treaty.

The provision is effective upon the date of its enactment.

6. *Limitation on deduction for certain interest paid by corporation to related persons (sec. 1704(f)(2)(A) of the bill, sec. 7210(a) of the 1989 Act, and sec. 163(j) of the Code)*

Present law

Subject to certain limitations, a taxpayer may deduct interest paid or accrued on indebtedness within a taxable year (sec. 163(a)). The 1989 Act added a so-called “earnings stripping” limitation on interest deductibility with respect to certain interest paid by corporations to related persons (sec. 163(j)). If the provision applies to a corporation for a taxable year, it disallows deductions for certain amounts of “disqualified interest” paid or accrued by the corporation during that year. If in a taxable year a deduction is disallowed, under the provision, for an amount of interest paid or accrued in that year, the disallowed amount is treated under the

earnings stripping provision as disqualified interest paid or accrued in the succeeding taxable year.¹²⁴

In order for the earnings stripping provision to apply to a corporation for a taxable year, two thresholds must be exceeded. To exceed the first threshold, the corporation must have “excess interest expense” as that term is defined in the Code for this purpose. To exceed the second threshold, the corporation must have a ratio of debt to equity as of the close of the taxable year in question (or on any other day prescribed by the Secretary in regulations) that exceeds 1.5 to 1. Excess interest expense is the excess (if any) of the corporation’s net interest expense over the sum of 50 percent of the adjusted taxable income of the corporation plus any excess limitation carryforward from a prior year. Excess limitation is the excess (if any) of 50 percent of adjusted taxable income over net interest expense.

Explanation of provision

The bill provides that the debt-equity threshold does not apply for purposes of applying the earnings stripping provision to a carryover of excess interest expense from a prior taxable year. Thus, the bill clarifies that excess interest carried forward from a year in which the debt-equity ratio threshold is exceeded may be deducted in a subsequent year in which that threshold is not exceeded, but only to the extent that such interest would not otherwise be treated as excess interest expense in the carryforward year.

For example, assume that in year 1 \$20 of a corporation’s interest expense is nondeductible due to the operation of the earnings stripping provision. The corporation carries forward the \$20 of interest deduction that it could not use in year 1. Assume that in year 2 the corporation has a debt-equity ratio of 1 to 1 and \$50 of current net and gross interest expense, all of which is disqualified interest, and that it earns \$400 of adjusted taxable income. The provision is intended to clarify that the \$20 of interest carried forward from year 1 is deductible in year 2. This is because \$70, the sum of the current net interest expense for year 2 (\$50) plus the interest expense carried over from year 1 (\$20), does not exceed one-half of adjusted taxable income in year 2.

As another example, assume that in year 2 the corporation has a debt-equity ratio of 1 to 1 and \$50 of current net and gross interest expense, all of which is disqualified interest, and that it earns \$80 of adjusted taxable income. The provision is intended to clarify that the \$20 of interest carried forward from year 1 is not deductible in year 2. This is because the current net interest expense for year 2 (\$50) exceeds by \$10 one-half of adjusted taxable income in year 2 (\$80 divided by 2, or \$40). Therefore, treating the year 1 carryover as an interest expense in year 2 causes the corporation to have excess interest expense equal to \$30. But for the debt-equity safe harbor, the corporation would have a \$30 interest expense disallowance in year 2 if the carried over amount were treated as having been paid in year 2. Under the bill, no actual year 2 inter-

¹²⁴ Disqualified interest is interest paid by a corporation to related persons that are not subject to U.S. tax on the interest received. (If, in accordance with a U.S. income tax treaty, interest income of a related person is subject to a reduced rate of U.S. tax, a portion of the interest paid to the related person is deemed to be interest on which no tax is imposed.)

est can be disallowed. However, under these facts, none of the interest carried over from year 1 can be deducted in year 2. Instead, the interest carried over from year 1 is carried forward for potential deduction (subject to the same rules that applied to the carryforward in year 2) in a year subsequent to year 2.

As a third example, assume that in year 2 the corporation has a debt-equity ratio of 1 to 1 and \$50 of current net and gross interest expense, all of which is disqualified interest, and that it earns \$110 of adjusted taxable income. The provision is intended to clarify that \$5 of interest carried forward from year 1 is deductible in year 2, and the other \$15 of interest carried forward from year 1 is not deductible in year 2. This is because the current net interest expense for year 2 (\$50) is \$5 less than one-half of adjusted taxable income in year 2 (one-half of \$110, or \$55). Therefore, even if the debt-equity safe harbor had not been met in year 2, the corporation would have had \$5 of excess limitation in year 2 had there been no carryover amount from year 1. On the other hand, treating the year 1 carryover as an interest expense in year 2 causes the corporation to have excess interest expense equal to \$15. This \$15 may be carried forward to a subsequent year.

The provision is effective as if included in the amendments made by section 7210(a) of the Revenue Reconciliation Act of 1989.

7. Interaction between passive activity loss rules and earnings stripping rules (sec. 1704(f)(2)(B) and (C) of the bill, sec. 7210(a) of the 1989 Act, and sec. 163(j) of the Code)

Present law

The passive loss rules limit deductions and credits from passive trade or business activities (sec. 469). 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. Deductions and credits that are suspended are carried forward and treated as deductions and credits from passive activities in the next year. 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 any taxpayer that is an individual, estate, trust, closely held C corporation, or personal service corporation. In determining passive activity deductions, Treasury regulations provide that "an item of deduction arises in the taxable year in which the item would be allowable as a deduction under the taxpayer's method of accounting if taxable income for all taxable years were determined without regard to sections 469, 613A(d) and 1211" (Treas. Reg. sec. 1.469-2(d)(8)). Thus, these regulations effectively require other limitations to be applied before applying the passive loss rules.

The at-risk rules limit deductible losses from an activity to the amount that the taxpayer has at risk, in the case of an individual or a closely-held corporation (sec. 465). The amount at risk is generally the sum of (1) cash contributions, (2) the adjusted basis of contributed property, and (3) amounts borrowed for use in the activity with respect to which the taxpayer has personal liability or

has pledged as security property not used in the activity. The amount at risk is increased by income from the activity and decreased by losses and withdrawals.

A taxpayer generally may deduct interest paid or accrued on indebtedness within a taxable year (sec. 163(a)). The Revenue Reconciliation Act of 1989 (the “1989 Act”) added an “earnings stripping” limitation on interest deductibility with respect to certain interest paid by corporations to related persons (sec. 163(j)). If the provision applies to a corporation for a taxable year, it disallows deductions for certain amounts of “disqualified interest” paid or accrued by the corporation during that year. Disqualified interest is interest paid by a corporation to related persons that are not subject to U.S. tax on the interest received. The disallowed amount is treated under the earnings stripping provision as disqualified interest paid or accrued in the succeeding taxable year. Proposed Treasury regulations would provide that “sections 465 and 469 shall be applied before applying section 163(j)” (Prop. Treas. Reg. sec. 1.163(j)-7(b)(3)).

Explanation of provision

The provision modifies section 163(j) of the Code to clarify that the earnings stripping rules apply before the passive loss rules and the at-risk rules.

The provision is effective as if included in the 1989 Act.

8. *Branch-level interest tax (sec. 1704(f)(3) of the bill, sec. 1241 of the 1986 Act, and sec. 884 of the Code)*

Present law

Interest paid (or treated as if paid) by a U.S. trade or business (i.e., a U.S. branch) of a foreign corporation is treated as if paid by a U.S. corporation and, hence, is U.S. source and subject to U.S. withholding tax of 30 percent, unless the tax is reduced or eliminated by a specific Code or treaty provision. The Treasury has regulatory authority to limit U.S. sourcing, and hence U.S. withholding, to the amount of interest reasonably expected to be deducted in arriving at the U.S. branch’s effectively connected taxable income.

To the extent a U.S. branch of a foreign corporation has allocated to it under Treasury Regulation section 1.882-5 an interest deduction in excess of the interest actually paid by the branch (this generally occurs where the indebtedness of the U.S. branch is disproportionately small compared to the total indebtedness of the foreign corporation), the excess is treated as if it were interest paid on a notional loan to a U.S. subsidiary (the U.S. branch, in actuality) from its foreign corporate parent (the home office). This excess is subject to the 30-percent tax, absent a specific Code exemption or treaty reduction (sec. 884(f)(1)(B)).

These branch-level interest taxes, along with the branch profits tax, were intended to reflect the view that a foreign corporation doing business in the United States generally should be subject to the same substantive tax rules that apply to a foreign corporation

operating in the United States through a U.S. subsidiary.¹²⁵ Where a U.S. corporation pays interest to its foreign corporate parent, that interest, like the interest deducted by a U.S. branch of a foreign corporation, is also generally subject to a 30-percent U.S. withholding tax unless the tax is reduced by treaty. In the case of a U.S. subsidiary of a foreign parent corporation, the withholding tax applies without regard to whether the interest payment is currently deductible by the U.S. subsidiary. For example, deductions for interest may be delayed or denied under section 163, 263, 263A, 266, 267, or 469, but it is still subject (or not subject) to withholding when paid without regard to the operation of those provisions.

Explanation of provision

The bill provides that the branch level interest tax on interest not actually paid by the branch applies to any interest which is allocable to income which is effectively connected with the conduct of a trade or business in the United States. Similarly, in the case of interest paid by the U.S. branch, the bill provides regulatory authority to limit U.S. sourcing, and hence U.S. withholding, to the amount of interest reasonably expected to be allocable to income which is effectively connected with the conduct of a trade or business in the United States. Thus, where an interest expense of a foreign corporation is allocable to U.S. effectively connected income, but that interest expense would not have been fully deductible for tax purposes under another Code provision had it been paid by a U.S. corporation, the bill clarifies that such interest is nonetheless treated for branch level interest tax purposes like a payment by a U.S. corporation to a foreign corporate parent. Similarly, with regard to the Treasury's regulatory authority to treat an interest payment by a foreign corporation's U.S. branch as though not paid by a U.S. person for source and withholding purposes, the bill clarifies that the authority extends to interest payments in excess of those reasonably expected to be allocable to U.S. effectively connected income of the foreign corporation.

These provisions are effective as if they were made by the Tax Reform Act of 1986.

9. *Determination of source in case of sales of inventory property (sec. 1704(f)(4) of the bill, sec. 211 of the 1986 Act, and sec. 865(b) of the Code)*

Present law

Prior to the 1986 Act, the source of income derived from the sale of personal property generally was determined by the place of sale (commonly referred to as the "title passage" rule) (see, e.g., Treas. Reg. sec. 1.861-7, T.D. 6258, 1957-2 C.B. 368). While the 1986 Act generally replaced the place-of-sale rule for sales of personal property with a residence-of-the-seller rule (sec. 865(a)), the Act did not change the place-of-sale rule for most sales of inventory property (sec. 865(b)).

¹²⁵Staff of the Joint Committee on Taxation, 100th Cong., 1st Sess., *General Explanation of the Tax Reform Act of 1986* at 1036 (1987).

Before and after the 1986 Act, statutory rules for sourcing income from inventory sales have included those covering income from (1) purchasing inventory property outside the United States (other than within a U.S. possession) and selling it in the United States (sec. 861(a)(6)); (2) purchasing inventory property in the United States and selling it outside the United States (sec. 862(a)(6)); (3) selling outside the United States inventory property which has been produced by the taxpayer in the United States (or selling in the United States inventory property which has been produced by the taxpayer outside the United States) (sec. 863(b)(2)); and (4) purchasing inventory property in a U.S. possession and selling it in the United States (sec. 863(b)(3)). Prior to the 1986 Act, these provisions were not limited in application to income from sales of inventory property, but rather covered sales of personal property generally.

In addition to statutory rules for sourcing items of income from transactions involving inventory property specified in the Code, such as those listed above, the Code both before and after the 1986 Act has contained other sourcing rules that do not make specific reference to property sales, and includes general regulatory authority to allocate and apportion between U.S. and foreign sources items of gross income, expenses, losses, and deductions other than those specified in sections 861(a) and 862(a) (sec. 863(a)). In carving income from the sale of inventory property out of the general residence-of-the-seller rule of section 865, section 865(b) makes reference to the above statutory rules making specific reference to inventory property, but not to the general grant of regulatory authority in section 863(a).

Explanation of provision

The bill modifies the general provision relating to the sourcing of income from the sale of personal property (sec. 865) so that the cross-reference to sourcing rules applicable to inventory property includes a reference to all of section 863, rather than simply to section 863(b). The bill thus clarifies that, to the extent that the Secretary of the Treasury had general regulatory authority to provide rules for the sourcing of income from the sales of personal property prior to the 1986 Act, the Secretary of the Treasury retains that authority under present law with respect to inventory property.

The bill is not intended to increase the Treasury Secretary's regulatory authority under section 863(a) beyond the authority that he had under the law in effect prior to the enactment of the 1986 Act. It is intended that no inference be drawn from this provision either as to the correctness of, or as to the post-1986 Act implications of, any judicial decision interpreting the scope of that pre-1986 Act authority.

The provision is effective as if it were included in the Tax Reform Act of 1986.

10. *Repeal of obsolete provisions (sec. 1704(f)(5) of the bill, sec. 10202 of the Revenue Act of 1987, and secs. 6038(a)(1)(F) and 6038A(b)(4) of the Code)*

Present law

A U.S. person who controls a foreign corporation must report certain information related to that foreign corporation as may be required by the Treasury Secretary (sec. 6038). Information reporting is also required with respect to certain foreign-owned domestic corporations (sec. 6038A). Included under each of these information reporting provisions is a requirement to report such information as the Treasury Secretary may require for purposes of carrying out the provisions of section 453C. Section 453C, relating to certain indebtedness treated as payment on installment obligations (the so-called “proportional disallowance rule”), was repealed in the Revenue Act of 1987.

Explanation of provision

The bill repeals as obsolete the information reporting requirements of sections 6038 and 6038A relating to section 453C. The provision is effective upon the date of its enactment.

11. *Clarification of a certain stadium bond transition rule in Tax Reform Act of 1986 (sec. 1704(g) of the bill and sec. 1317(3)(A) of the Tax Reform Act of 1986)*

Present law

The Tax Reform Act of 1986 included a transition rule authorizing tax-exempt bonds not exceeding \$200 million to be issued by or on behalf of the City of Cleveland, Ohio, to finance a stadium. The bonds were required to be issued before January 1, 1991 (and were so issued). As enacted, the rule required Cleveland to retain a residual interest in the stadium following planned private business use.

Explanation of provision

The bill permits the residual interest in the stadium currently held by the City of Cleveland to be assigned to Cuyahoga County, Ohio (the county in which both Cleveland and the stadium are located) because of a change in Ohio State law prior to issuance of the bonds. The bill does not extend the time for issuing the bonds or otherwise affect the amount of bonds or the location or design of the stadium.

This provision is effective as if included in the Tax Reform Act of 1986.

12. *Health care continuation rules (sec. 1704(h) of the bill, sec. 7862(c)(5) of the 1989 Act, sec. 4980B(f)(2)(B)(i) of the Code, sec. 602(2)(A) of ERISA, and sec. 2202(2)(A) of the Public Health Service Act)*

Present law

The Revenue Reconciliation Act of 1989 (“1989 Act”) amended the health care continuation rules to provide that if a covered employee is entitled to Medicare and within 18 months of such entitlement separates from service or has a reduction in hours, the duration of continuation coverage for the spouse and dependents is 36 months from the date the covered employee became entitled to Medicare. One possible interpretation of the statutory language, however, would permit continuation coverage for up to 54 months. This extension of the coverage period was not intended.

Explanation of provision

The bill amends the Code (sec. 4980B), title I of the Employee Retirement Income Security Act (sec. 602), and the Public Health Service Act (sec. 2202(2)(A)) to limit the continuation coverage in such cases to no more than 36 months. The provision is effective for plan years beginning after December 31, 1989.

13. *Taxation of excess inclusions of a residual interest in a REMIC for taxpayers subject to alternative minimum tax with net operating losses (sec. 1704(i) of the bill and sec. 860E(a)(6) of the Code)*

Present law

Residual interests in a REMIC

A real estate mortgage investment conduit (“REMIC”) is an entity that holds real estate mortgages. All interests in a REMIC must be “regular interests” or “residual interests.” A regular interest is an interest the terms of which are fixed on the start-up day, which unconditionally entitles the holder to receive a specified principal amount, and which provides that interest amounts are payable based on a fixed rate (or a variable rate to the extent provided in the Treasury regulations). A residual interest is any interest that is so designated and that is not a regular interest in a REMIC.

Generally, the holder of a residual interest in a REMIC takes into account his daily portion of the taxable income or net loss of such REMIC for each day during which he held such interest. The taxable income of any holder of a residual interest in a REMIC for any taxable year cannot be less than the excess inclusion for the year (sec. 860E). Thus, in general, income from excess inclusions cannot be offset by a net operating loss (or net operating loss carryover) in computing the taxpayer’s regular tax.

Alternative minimum tax

Taxpayers are subject to an alternative minimum tax which is payable, in addition to all other tax liabilities, to the extent it ex-

ceeds the taxpayer's regular tax. The tax is imposed at rates of 26 and 28 percent (20 percent in the case of a corporation) on alternative minimum taxable income in excess of an exemption amount. Alternative minimum taxable income generally is the taxpayer's taxable income, as increased or decreased by certain adjustments and preferences. A taxpayer may offset no more than ninety percent of its alternative minimum taxable income with its alternative tax net operating loss carryover.

Because the determination of a taxpayer's alternative minimum taxable income begins with taxable income, a holder of a residual interest in a REMIC may have positive alternative minimum taxable income even where the taxpayer has a net operating loss for the year.

Explanation of provision

The bill provides that three rules for determining the alternative minimum taxable income of a taxpayer that is not a thrift institution that holds residual interests in a REMIC.

First, the alternative minimum taxable income of such a taxpayer is computed without regard to the REMIC rule that taxable income cannot be less than the amount of excess inclusions. This provision prevents a taxpayer from having to include in alternative minimum taxable income preference items for which it received no tax benefit.

Second, the alternative minimum taxable income of such a taxpayer for a taxable year cannot be less than the excess inclusions of the residual interests for that year. In effect, this provision prevents nonrefundable credits from reducing the taxpayer's income tax below an amount equal to what the tentative minimum tax would be if computed only on excess inclusions.

Third, the amount of any alternative minimum tax net operating loss deduction of such a taxpayer is computed without regard to any excess inclusions. This provision insures that the net operating losses will not reduce any income attributable to any excess inclusions. Thus, all such taxpayers subject to the alternative minimum tax will pay a tax on excess inclusions at the alternative minimum tax rate, regardless of whether the taxpayer has a net operating loss.

The provision is effective for all taxable years beginning after December 31, 1986, unless the taxpayer elects to apply the rules of the bill only to taxable years beginning after the date of enactment.

14. Application of harbor maintenance tax to Alaska and Hawaii ship passengers (sec. 1704(j) of the bill and sec. 4462(b) of the Code)

Present law

A harbor maintenance excise tax ("harbor tax") of 0.125 percent of value applies generally to commercial cargo (including passenger fares) loaded or unloaded at U.S. ports (sec. 4461). The harbor tax does not apply to commercial cargo (other than crude oil with respect to Alaska) loaded or unloaded in Alaska, Hawaii, and U.S. possessions where such cargo is transported to or from the U.S. mainland (for domestic use) or where such cargo is loaded and un-

loaded in the same State (Alaska or Hawaii) or possession (sec. 4462(b)).

Explanation of provision

The bill clarifies that the harbor tax does not apply to passenger fares where the passengers are transported on U.S. flag vessels operating solely within the State waters of Alaska or Hawaii and adjacent international waters (i.e., leaving and returning to a port in the same State without stopping elsewhere).

The provision applies as if included in the Harbor Maintenance Revenue Act of 1986 (April 1, 1987).

15. *Modify effective date provision relating to the Energy Policy Act of 1992 (sec. 1704(k) of the bill and secs. 53 and 30 of the Code)*

Present law

The nonconventional fuels production credit (sec. 29) cannot reduce the taxpayer's tax liability to less than the amount of the tentative minimum tax. The credit for prior year minimum tax liability (sec. 53) is increased by the amount of the nonconventional fuels credit not allowed for the taxable year solely by reason of the limitation based on the taxpayer's tentative minimum tax.

Explanation of provision

The bill corrects a cross reference to section 29(b)(6)(B) contained in section 53(d)(1)(B)(iv), and clarifies that the correction applies to taxable years beginning after December 31, 1990. In addition, section 1702(e)(5) of the bill clarifies that a correction made in the Energy Policy Act of 1992 to a similar cross reference in section 53(d)(1)(B)(iii) applies to taxable years beginning after December 31, 1990.

The bill also clarifies the relationship between the basis adjustment rules for the electric vehicle credit (sec. 30(d)(1)) and the alternative minimum tax.

16. *Treat qualified football coaches plan as multiemployer pension plan for purposes of the Internal Revenue Code (sec. 1704(l) of the bill and sec. 1022 of ERISA)*

Present law

Section 3(37) of the Employee Retirement Income Security Act of 1974 ("ERISA"), as amended by Public Law 100-202 (Continuing Appropriations for Fiscal Year 1988), provides that, for purposes of Title I of ERISA, a qualified football coaches plan generally is treated as a multiemployer plan and may include a qualified cash or deferred arrangement. Under section 3(37) of ERISA, a qualified football coaches plan is defined as any defined contribution plan established and maintained by an organization described in section 501(c) of the Internal Revenue Code (the "Code"), the membership of which consists entirely of individuals who primarily coach football as full-time employees of 4-year colleges or universities, if the organization was in existence on September 18, 1986. This defini-

tion is generally intended to apply to the American Football Coaches Association.

However, section 9343(a) of the Omnibus Budget Reconciliation Act of 1987 (P.L. 100-203) provides that Titles I and IV of ERISA are not applicable in interpreting Title II of ERISA (the Code provisions relating to qualified plans), except to the extent specifically provided in the Code or as determined by the Secretary of the Treasury.

Explanation of provision

The bill amends Title II of ERISA to provide that, for purposes of determining the qualified plan status of a qualified football coaches plan, section 3(37) of ERISA is treated as part of Title II of ERISA and a qualified football coaches plan is treated as a multiemployer collectively bargained plan.

The provision is effective for years beginning after December 22, 1987 (the date of enactment of P.L. 100-202).

17. Determination of unrecovered investment in annuity contract (sec. 1704(m) of the bill and sec. 72 (b) and (c) of the Code)

Present law

An exclusion is provided for amounts received as an annuity under an annuity, endowment, or life insurance contract, as determined under a statutory exclusion ratio (sec. 72(b)). The exclusion ratio is determined as the ratio of (1) the taxpayer's investment in the contract (as of the annuity starting date) to (2) the expected return under the contract (as of such date). In the case of a contract with a refund feature, the amount of a taxpayer's investment in the contract is reduced by the value of the refund feature (sec.72(c)).

This exclusion was modified by the Tax Reform Act of 1986 to limit the excludable amount to the taxpayer's unrecovered investment in the contract, and to provide a deduction for the unrecovered investment in the contract if payments as an annuity under the contract cease by reason of the death of an annuitant. In the case of a contract with a refund feature, the 1986 Act modifications reduce the exclusion ratio so that it is possible that less than the entire investment in the contract can be recovered tax-free.

Explanation of provision

The bill modifies the definition of the unrecovered investment in the contract, in the case of a contract with a refund feature, so that the entire investment in the contract can be recovered tax-free.

The provision is effective as if enacted in the Tax Reform Act of 1986.

18. *Election by parent to claim unearned income of certain children on parent's return (sec. 1704(n) of the bill and secs. 1 and 59(j) of the Code)*

Present law

The net unearned income of a child under 14 years of age is taxed to the child at the parent's statutory rate. Net unearned income means unearned income less the sum of \$650 (for 1995) and the greater of: (1) \$650 (for 1995) or, (2) if the child itemizes deductions, the amount of allowable deductions directly connected with the production of the unearned income. The dollar amounts are adjusted for inflation.

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 \$650 (for 1995) 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 \$650 amount is adjusted for inflation but the \$1,000 amount is not.

Explanation of provision

The bill adjusts for inflation 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.

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

19. *Treatment of certain veterans' reemployment rights (sec. 1704(o) of the bill and new sec. 414(u) of the Code)*

Present law

Under the Uniformed Services Employment and Reemployment Rights Act of 1994 ("USERRA"), Pub. L. No. 103-353, 38 U.S.C. §§ 4301, ff., which revised and restated the Federal law protecting veterans' reemployment rights, an employee who leaves a civilian job for qualified military service generally is entitled to be reemployed by the civilian employer if the individual returns to employment within a specified time period. In addition to reemployment rights, a returning veteran also is entitled to the restoration of certain pension, profit sharing and similar benefits that would have accrued, but for the employee's absence due to the qualified military service.

USERRA generally provides that for a reemployed veteran service in the uniformed services is considered service with the employer for retirement plan benefit accrual purposes, and the em-

ployer that reemploys the returning veteran is liable for funding any resulting obligation. USERRA also provides that the reemployed veteran is entitled to any accrued benefits that are contingent on the making of, or derived from, employee contributions or elective deferrals only to the extent the reemployed veteran makes payment to the plan with respect to such contributions or deferrals. No such payment may exceed the amount the reemployed veteran would have been permitted or required to contribute had the person remained continuously employed by the employer throughout the period of uniformed service. Under USERRA, any such payment to the plan must be made during the period beginning with the date of reemployment and whose duration is three times the reemployed veteran's period of uniform service, not to exceed five years.

Under the Internal Revenue Code, overall limits are provided on contributions and benefits under certain retirement plans. For example, the maximum amount of elective deferrals that can be made by an individual into a qualified cash or deferred arrangement in any taxable year is limited to \$9,500 for 1996 (sec. 402(g)). Annual additions with respect to each participant under a qualified defined contribution plan generally are limited to the lesser of \$30,000 (for 1996) or 25 percent of compensation (sec. 415(c)). Annual deferrals with respect to each participant under an eligible deferred compensation plan (sec. 457) generally are limited to the lesser of \$7,500 or 33 $\frac{1}{3}$ percent of includible compensation. There is no provision under present law that permits contributions or deferrals to exceed these and other annual limits in the case of contributions with respect to a reemployed veteran.

Other requirements for which there is no special provision for contributions with respect to a reemployed veteran include the limit on deductible contributions and the qualified plan non-discrimination, coverage, minimum participation, and top heavy rules.

Explanation of provision

The bill provides special rules in the case of certain contributions ("make-up contributions") with respect to a reemployed veteran that are required or authorized under USERRA. The bill applies to contributions made by an employer or employee to an individual account plan or to contributions made by an employee to a defined benefit plan that provides for employee contributions.

Under the bill, if any make-up contribution is made by an employer or employee with respect to a reemployed veteran, then such contributions are not subject to the generally applicable plan contribution limits (i.e., secs. 402(g), 402(h), 403(b), 408, 415, or 457) or the limit on deductible contributions (i.e., secs. 404(a) or 404(h)) as applied with respect to the year in which the contribution is made. In addition, the make-up contributions are not taken into account in applying the plan contribution or deductible contribution limits to any other contribution made during the year. However, the amount of any make-up contribution could not exceed the aggregate amount of contributions that would have been permitted under the plan contribution and deductible contribution limits for the year to which the contribution relates had the individual con-

tinued to be employed by the employer during the period of uniformed service.

Under the bill, a plan to which a make-up contribution is made on account of a reemployed veteran is not treated as failing to meet the qualified plan nondiscrimination, coverage, minimum participation, and top heavy rules (i.e., secs. 401(a)(4), 401(a)(26), 401(k)(3), 401(k)(11), 401(k)(12), 401(m), 403(b)(12), 408(k)(3), 408(k)(6), 408(p), 410(b), or 416) by reason of the making of such contribution. Consequently, for purposes of applying the requirements and tests associated with these rules, make-up contributions are not taken into account either for the year in which they are made or for the year to which they relate.

Under the bill, a special rule applies in the case of make-up contributions of salary reduction, employer matching, and after-tax employee amounts. A plan that provides for elective deferrals or employee contributions is treated as meeting the requirements of USERRA if the employer permits reemployed veterans to make additional elective deferrals or employee contributions under the plan during the period which begins on the date of reemployment and has the same length as the lesser of (1) the period of the individual's absence due to uniformed service multiplied by three or (2) five years.

The employer is required to match any additional elective deferrals or employee contributions at the same rate that would have been required had the deferrals or contributions actually been made during the period of uniformed service. Additional elective deferrals, employer matching contributions, and employee contributions is treated as make-up contributions for purposes of the rule exempting such contributions from qualified plan nondiscrimination, coverage, minimum participation, and top heavy rules as described above.

The bill clarifies that USERRA does not require (1) any earnings to be credited to an employee with respect to any contribution before such contribution is actually made or (2) any make-up allocation of any forfeiture that occurred during the period of uniformed service.

The bill also provides that the plan loan, plan qualification, and prohibited transaction rules will not be violated merely because a plan suspends the repayment of a plan loan during a period of uniformed service.

The bill also defines compensation to be used for purposes of determining make-up contributions and would conform the rules contained in the Code with certain rights of reemployed veterans contained in USERRA pertaining to employee benefit plans.

The provision is effective as of December 12, 1994, the effective date of the benefits-related provisions of USERRA.

20. Reporting of real estate transactions (sec. 1704(p) of the bill and sec. 6045(e)(3) of the Code)

Present law

It is unlawful for any real estate reporting person to charge separately any customer for complying with the information reporting requirements with respect to real estate transactions.

Explanation of provision

The bill clarifies that real estate reporting persons may take into account the cost of complying with the reporting requirements of Code section 6045 in establishing charges for their services, so long as a separately listed charge for such costs is not made.

The provision is effective on November 11, 1988 (as if originally enacted as part of the amendment to the Code relating to separate charges).

21. *Clarification of denial of deductions for stock redemption expenses (sec. 1704(q) of the bill and sec. 162(k)(2) of the Code)*

Present law

Section 162(k), added by the Tax Reform Act of 1986, denies a deduction for any amount paid or incurred by a corporation in connection with the redemption of its stock. An exception is provided for any deduction allowable under section 163 (relating to interest). The Internal Revenue Service has taken the position that costs properly allocable to a borrowing the interest on which is deductible under the exception may not be amortized over the period of the loan, due to section 162(k). Different courts have reached differing conclusions when taxpayers have litigated the question.¹²⁶

Explanation of provision

The bill clarifies that amounts properly allocable to indebtedness on which interest is deductible and properly amortized over the term of that indebtedness are not subject to the provision of section 162(k) denying a deduction for any amount paid or incurred by a corporation in connection with the redemption of its stock.

In addition, the bill clarifies that the rules of section 162(k) apply to any acquisition of its stock by a corporation or by a party that has a relationship to the corporation described in section 465(b)(3)(C) (which applies a more than 10 percent relationship test in certain cases).

Thus, for example, it is clarified that the denial of a deduction applies to any reacquisition (i.e., any transaction that is in effect an acquisition of previously outstanding stock) regardless of whether the transaction is treated as a redemption for purposes of subchapter C of the Code, regardless of whether it is treated for tax purposes as a sale of the stock or as a dividend, and regardless of whether the transaction is a reorganization or other transaction.

Apart from the clarification relating to amounts properly allocable to indebtedness, it is not intended that application of the 1986 Act deduction denial to any amount or transaction be limited under the bill.

The provision clarifying that amounts properly allocable to indebtedness and amortized over the term of that indebtedness are not subject to the denial under section 162(k), is effective as if included in the Tax Reform Act of 1986.

¹²⁶ See, e.g., *Fort Howard Corp. v. Commissioner* 103 T.C. 345 (1994) upholding the IRS position; compare *U.S. v. Kroy (Europe) Limited*, 27 F.3d 367 (9th Cir. 1994) (to the contrary).

The other clarifications apply to amounts paid or incurred after September 13, 1995. No inference is intended that any amounts described in these other clarifications are deductible under present law.

22. *Definition of passive income in determining passive foreign investment company status (sec. 1704(s) of the bill, sec. 1235 of the 1986 Act and sec. 1296(b)(2) of the Code)*

Present law

Under the export trade corporation (ETC) provisions, a controlled foreign corporation (CFC) that qualifies as an ETC is not subject to current U.S. tax on certain export trade income. In 1971, the ETC provisions were replaced by rules applicable to domestic international sales corporations (DISCs). Only those ETCs in existence at that time are allowed to continue operating as ETCs. In 1984, the DISC provisions were largely replaced by the rules applicable to foreign sales corporations (FSCs). Certain foreign trade income of a FSC is exempt from U.S. income tax. In addition, a domestic corporation is allowed a 100-percent dividends-received deduction for dividends distributed from the FSC out of earnings attributable to certain foreign trade income.

The Tax Reform Act of 1986 established an anti-deferral regime for passive foreign investment companies (PFICs). A foreign corporation is a PFIC 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 amount of its assets consists of assets that produce, or are held for the production of passive income. Passive income for this purpose generally means income that satisfies the definition of foreign personal holding company income under subpart F. Foreign personal holding company income generally includes interest, dividends, and annuities; certain 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. In determining whether a foreign corporation is a PFIC, passive income does not include certain active-business banking, insurance, or (in the case of the U.S. shareholders of a CFC) securities 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).

Explanation of provision

The bill clarifies that foreign trade income of a FSC and export trade income of an ETC do not constitute passive income for purposes of the PFIC definition.

The provision is effective as if it were included in the Tax Reform Act of 1986.

23. *Exclusion from income for combat zone compensation (sec. 1704(t)(4) of the bill and sec. 112 of the Code)*

Present law

The Code provides that gross income does not include compensation received by a taxpayer for active service in the Armed Forces

of the United States for any month during any part of which the taxpayer served in a combat zone (or was hospitalized as a result of injuries, wounds or disease incurred while serving in a combat zone) (limited to \$500 per month for commissioned officers). The heading refers to “combat pay,” although that term is no longer used to refer to special pay provisions for members of the Armed Forces, nor is the exclusion limited to those special pay provisions (hazardous duty pay (37 U.S.C. sec. 301) and hostile fire or imminent danger pay (37 U.S.C. sec. 310)).

Explanation of provision

The bill modifies the heading of Code section 112 to refer to “combat zone compensation” instead of “combat pay.” The bill also makes conforming changes to cross-references elsewhere in the Code. This provision is effective on the date of enactment.

III. BUDGET EFFECTS OF THE BILL

A. COMMITTEE ESTIMATES

In accordance with paragraph 11(a) of rule XXVI of the Standing Rules of the Senate, the following statement is made concerning the estimated budget effects of the committee amendment to Title I of the bill.

The revenue provisions of Title I are estimated to have the following effects on the budget for fiscal years 1996–2005:

Provision	Effective	1986	1987	1989	1990	2000	2001	2002	2003	2004	2005	1995-00	2001-05	1995-05
5. Authority to void certain invalid elections.....	YbA 12/31/82	---	[2]	[2]	[2]	[2]	[2]	[2]	[2]	[2]	[2]	[2]	[2]	[2]
6. Excess contributions paid and amended	YbA 12/31/96	---	[2]	[2]	[2]	[2]	[2]	[2]	[2]	[2]	[2]	[2]	[2]	[2]
7. Excess contributions paid and amended	YbA 12/31/96	---	[2]	[2]	[2]	[2]	[2]	[2]	[2]	[2]	[2]	[2]	[2]	[2]
8. S corporations permitted to hold S or C subsidiaries.....	YbA 12/31/86	---	[5]	-9	-11	-13	-15	-17	-20	-23	-26	-39	-101	-139
9. Treatment of distributions during loss years.....	YbA 12/31/86	---	[2]	[2]	[2]	[2]	[2]	[2]	[2]	[2]	[2]	[2]	[2]	[2]
10. Treatment of S corporations as shareholders in C corporations.....	YbA 12/31/96	---	[3]	[3]	[3]	[3]	[3]	[3]	[3]	[3]	[3]	[3]	[4]	[6]
11. Elimination of certain earnings and profits of S corporations.....	YbA 12/31/96	---	[3]	[3]	[3]	[3]	[3]	[3]	[3]	[3]	[3]	[3]	[4]	[6]
12. Treatment of certain losses carried over under at-risk rules.....	YbA 12/31/96	---	[3]	[3]	[3]	[3]	[3]	[3]	[3]	[3]	[3]	[3]	[4]	[6]
13. Adjustments to basis in S stock.....	YbA 12/31/96	---	[7]	[7]	[7]	[7]	[7]	[7]	[7]	[7]	[7]	[7]	[7]	[7]
14. Treatment of certain real estate held by an S corporation.....	YbA 12/31/86	---	[3]	[3]	[3]	[3]	[3]	[3]	[3]	[3]	[3]	[3]	[4]	[6]
15. Transition rule for elections after termination.....	YbA 12/31/86	---	[3]	[3]	[3]	[3]	[3]	[3]	[3]	[3]	[3]	[3]	[4]	[6]
16. Treat financial institutions that do not use the reserve method as eligible corporations.....	YbA 12/31/96	---	[3]	[3]	[3]	[3]	[3]	[3]	[3]	[3]	[3]	[3]	[4]	[6]
17. Permit tax-exempts to be subchapter S shareholders with UBTI inclusion and ESOP benefit restriction.....	YbA 12/31/96	---	[3]	[3]	[3]	[3]	[3]	[3]	[3]	[3]	[3]	[3]	[4]	[6]
18. Interaction of subchapter S changes.....	YbA 12/31/97	---	[3]	[3]	[3]	[3]	[3]	[3]	[3]	[3]	[3]	[3]	[4]	[6]
Subtotal of Provisions Relating to S Corporations.....		---	-32	-73	-82	-106	-115	-125	-136	-147	-157	-303	-460	-697
II. Pension Simplification Provisions														
A. Simplification Rules														
1. Rollover Rules														
2. Rollover Rules														
3. Simplified method for taxing annuity distributions under certain employer plans.....	YbA 12/31/89	---	74	77	108	78	70	44	17	15	---	337	145	482
4. Minimum required distributions.....	dOs DOE	---	28	49	52	54	55	55	56	57	57	183	280	463
B. Increased Access to Retirement Savings Plans - 1. Establish SIMPLE pension plan as modified, but not as reduced SEP.....	asOs dOs DOE	---	22	28	28	29	29	29	30	30	31	107	149	256
2. Increase availability of spousal IRAs.....	YbA 12/31/96	---	-1	-4	-4	-4	-4	-4	-4	-4	-4	-13	-20	-33
3. Increase availability of spousal IRAs.....	YbA 12/31/96	---	-50	-76	-79	-81	-84	-87	-91	-94	-97	-285	-453	-735
C. Nondiscrimination Provisions														
1. Simplified definition of highly compensated employees [8].....	YbA 12/31/96	---	8	22	24	25	26	28	29	30	31	70	144	233
2. Repeal of family aggregation rules [9].....	YbA 12/31/96	---	57	168	184	185	208	210	233	248	264	604	1,170	1,774
3. Modification of additional participation requirements.....	YbA 12/31/96	---	[9]	[9]	[9]	[9]	[9]	[9]	[9]	[9]	[9]	[9]	[9]	[9]
4. Surveys, nondiscrimination rules for qualified cash contributions [11].....	YbA 12/31/96	---	[10]	[10]	[10]	[10]	[10]	[10]	[10]	[10]	[10]	[10]	[10]	[10]
5. Definition of compensation for section 415 purposes.....	YbA 12/31/97	---	---	---	-39	-155	-160	-164	-169	-174	-179	-195	-847	-1,042
Subtotal of Provisions Relating to Pension Simplification Provisions.....		---	---	---	-1	-2	-2	-2	-2	-2	-3	-4	-11	-15

--- Negligible Revenue Effect

--- Considered in Other Provisions

--- Negligible Revenue Effect

Provision	Effective	1995	1997	1998	1999	2000	2001	2002	2003	2004	2005	1996-00	2001-05	1996-05	
2. Application of common paymaster rules to universities [1].....	ras 12/31/06		-1	-2	-2	-2	-2	-2	-2	-2	-2	-2	-7	-10	-17
3. Exempt imported recycled halons from ozone-depleting chemicals tax.....	das 12/31/96		-1	-1	-1	-1	-1	-1	-1	-1	-1	-1	-4	-5	-9
4. Authorize tax-exempt bonds for purchase of Alaska Power Authority.....	ba DOE		-1	-1	-1	-1	-1	-1	-1	-1	-1	-1	-4	-5	-9
5. Clarify the income tax treatment of common trust funds to avoid double taxation.....	ta 12/31/05	-4	-9	-8	-8	-8	-8	-8	-8	-8	-8	-8	-37	-43	-80
6. Clarify that State prepayment rules are tax-exempt entities; clarify OID rules.....	ya 12/31/95														
7. Suspend excise tax on ozone depleting chemicals used in related dose inhalers.....	DOE x 7 days		-12	-8	-8	-2									
Subtotal of Miscellaneous Provisions.....		[2]	-25	-31	-31	-15	-13	-13	-14	-14	-14	-14	-45	-48	-151
B. Additional Revenue Offsets															
1. Modify basis adjustment rules under section 1033; repeal exemption for withholding on gambling winnings from bingo and keno where proceeds exceed \$5,000.....	DOE		1	5	9	14	20	29	37	46	56	66	20	188	217
2. Repeal exemption for withholding on gambling winnings from bingo and keno where proceeds exceed \$5,000.....	DOE x 30 days	3	12	6	6	6	7	7	7	7	7	8	33	38	69
3. Treatment of certain insurance on related lives.....	ya 12/31/96		-2	1	-2	5	2	[2]	10	-5	2	6	8	14	14
Subtotal of Additional Revenue Offsets.....		3	15	12	13	25	29	35	54	49	66	66	232	300	300
SUBTOTAL OF PART VI.....		3	-10	-9	-9	10	18	23	40	34	52	-17	168	148	148
NET TOTAL.....		258	407	-373	-179	-75	-395	-304	-61	207	571	47	13	58	58

Joint Committee on Taxation

NOTE: Details may not add to totals due to rounding.

Legend for "Effective" column: ara = amounts received after
 asla = annuity starting date after
 ba = bonds issued after
 ca = contracts purchased after
 caba/sa = contracts purchased before, on, or after
 cda = decedents dying after
 dda = decedents declared after
 dda = deferrals on or after
 doe = date of enactment
 dpa = date of payment after
 fba = household improvements disposed of after
 fba = loans made after
 fba = limitation years beginning after

ppis/a/b = property placed in service on, after, or before
 ppsa = prohibited transactions occurring after
 ppsa = plan years beginning after
 ppsa = prohibited transactions after
 rna = sales made after
 spa = services performed after
 ta = transfers after
 ya = taxable years beginning after
 ya/da DOE = tickets purchased 7 days after date of enactment for travel 7 days after date of enactment
 ya/da DOE = taxable years beginning before, on, or after
 ya/da DOE = taxable years beginning after, on, or after
 ya/da DOE = 90 days after date of enactment

[Footnotes for Revenue Table appear on the following page]

B. BUDGET AUTHORITY AND TAX EXPENDITURES

Budget authority

In accordance with section 308(a)(1) of the Budget Act, the Committee states that the committee amendment to Title I involves no new or increased budget authority.

Tax expenditures

In accordance with section 308(a)(2) of the Budget Act, the Committee states that the revenue-reducing income tax provisions of the committee amendment to Title I generally involve increased tax expenditures and that the revenue-increasing income tax provisions generally involve decreased tax expenditures (other than the revision of expatriation tax rules). Excise tax and estate and gift tax provisions are not classified as tax expenditures under the Budget Act. (See the revenue table in Part III.A., above, for specific income tax provisions.)

C. CONSULTATION WITH CONGRESSIONAL BUDGET OFFICE

In accordance with section 403 of the Budget Act, the Committee advises that the Congressional Budget Office has submitted the following statement on the budget effects of the committee amendment to Title I of the bill:

U.S. CONGRESS,
CONGRESSIONAL BUDGET OFFICE,
Washington, DC, June 18, 1996.

Hon. WILLIAM V. ROTH, Jr.,
Chairman, Committee on Finance,
U.S. Senate, Washington, DC.

DEAR MR. CHAIRMAN: The Congressional Budget Office and the Joint Committee on Taxation (JCT) have reviewed H.R. 3448, the "Small Business Job Protection Act of 1996," as ordered reported by the Senate Committee on Finance on June 12, 1996. The JCT estimates that this bill would increase governmental receipts by \$258 million in fiscal year 1996 and by \$72 million over fiscal years 1996 through 2005. CBO concurs with this estimate.

H.R. 3448 would increase the expensing limitation for small businesses, extend certain expiring provisions, simplify pension and foreign asset provisions, modify the tax treatment of Subchapter S corporations and make technical corrections. In addition, the bill would reinstate the Airport and Airway Trust Fund excise taxes through December 31, 1996, modify the possessions tax credit, repeal the 50 percent interest income exclusion for financial institution loans to ESOPs, and make other changes that would increase taxes on corporations and other businesses. The revenue effects of H.R. 3448 are summarized in the table below. Please refer to the enclosed table for a more detailed estimate of the bill.

Revenue Effects of H.R. 3448
[By fiscal years, in billions of dollars]

	1996	1997	1998	1999	2000	2001–2005
Projected revenues: Under current law ¹	1,417.583	1,475.572	1,547.285	1,619.979	1,699,866	9,999.271
Proposed changes	0.258	0.405	-0.375	-0.179	-0.072	0.029
Projected revenues: Under H.R. 3074	1,417.841	1,475.977	1,546.910	1,619.800	1,699.794	9,999.300

¹Includes the revenue effects of P.L. 104–7 (H.R. 831), P.L. 104–104 (S. 652), P.L. 104–117 (H.R. 2778), P.L. 104–121 (H.R. 3136), P.L. 104–132 (S. 735), and P.L. 104–134 (H.R. 3019).

In accordance with the requirements of Public Law 104–4, the Unfunded Mandates Reform Act of 1995, JCT has determined that the bill contains one intergovernmental mandate. The provision to reinstate the Airport and Airway Trust Fund excise taxes through December 31, 1996, imposes a Federal intergovernmental mandate because State, local, and tribal governments will be required to pay the requisite taxes for commercial air travel by their employees. JCT estimates that the direct costs of complying with this Federal intergovernmental mandate will not exceed \$50 million in any of the first five fiscal years.

In addition, JCT has determined that the bill contains several Federal private sector mandates. The JCT estimates the direct mandate costs of tax increases in H.R. 3448 would total \$655 million in 1996, and about \$6.914 billion over the 1996–2000 period, as shown below:

FEDERAL PRIVATE SECTOR MANDATES
[By fiscal years, in millions of dollars]

	1996	1997	1998	1999	2000
Direct cost of tax increases	655	2,568	1,129	1,273	1,289

Please refer to the enclosed letter for a more detailed account of these provisions.

In addition to these Federal private sector mandates, the bill also provides for reductions in taxes. At this point, it is unclear to CBO whether these tax reductions should be viewed as offsets to the direct costs of the mandates in the bill. JCT estimates that the savings to the private sector associated with the tax reductions in H.R. 3448 would total \$397 million in 1996, and about \$6.051 billion over the 1996–2000 period, as shown below:

FEDERAL PRIVATE SECTOR SAVINGS
[By fiscal years, in millions of dollars]

	1996	1997	1998	1999	2000
Reductions in taxes	-397	-1,865	-1,281	-1,170	-1,228

Section 252 of the Balanced Budget and Emergency Deficit Control Act of 1985 sets up pay-as-you-go procedures for legislation affecting receipts or direct spending through 1998. Because the bill would affect receipts, pay-as-you-go procedures would apply to the bill. These effects are summarized in the table below.

PAY-AS-YOU-GO CONSIDERATIONS

[By fiscal years in millions of dollars]

	1996	1997	1998
Changes in receipts	258	405	-375
Changes in outlays	N.A.	N.A.	N.A.

Not Applicable.

If you wish further details, please free to contact me or your staff may wish to contact Stephanie Weiner.

Sincerely,

JUNE E. O'NEILL,
Director.

U.S. CONGRESS,
JOINT COMMITTEE ON TAXATION,
Washington, DC, June 18, 1996.

Mrs. JUNE O'NEILL,
Director, Congressional Budget Office
U.S. Congress, Washington, DC.

DEAR MRS. O'NEILL: We have reviewed H.R. 3448, the "Small Business Job Protection Act," as amended and ordered to be reported by the Senate Committee on Finance on June 12, 1996. In accordance with the requirements of Public Law 104-4, the Unfunded Mandates Reform Act of 1995 (the "Unfunded Mandates Act"). We have determined that the following revenue provisions of the bill contain Federal private sector mandates: (1) the provision relating to adjustments to basis of inherited S corporation stock; (2) the provision to repeal 5-year averaging for lump-sum distributions from qualified pension plans; (3) the provision to repeal the \$5,000 exclusion for employee death benefits; (4) the provision that would provide a simplified method for taxing annuity distributions under qualified pension plans; (5) the provision to modify the section 936 credit; (6) the provision to repeal the 50-percent interest income exclusion for financial institution loans to ESOPs; (7) the provision to provide that punitive damages are not excludable from income; (8) the provision to phase out and extend the luxury automobile excise tax; (9) the provision to modify the two county tax-exempt bond rule for local furnishers of electricity or gas and to prohibit new local furnishers; (10) the provision to eliminate the interest allocation exception for certain nonfinancial corporations; (11) the provision to reinstate the Airport and Airway Trust Fund excise taxes through December 31, 1996; (12) the provision to change the depreciation rules for water utilities; (13) the provision to revise the expatriation tax rules; (14) the provision to modify the basis adjustment rules under section 1033; (15) the provision to repeal the exemption from withholding for gambling winnings from bingo and keno; and (16) and the provision relating to the treatment of retired lives reserves. The attached revenue table (items I.B.13., II.A.I., 2., and 3., and IV.1-3., 5-8., and 10., and VI.B. I-3.) generally reflects amounts that are no greater than the aggregate estimated amounts that the private sector will be required to spend in order to comply with these Federal private sector mandates. In the case of the provision modifying the depreciation rules for water utilities, the staff of the Joint Committee on Taxation estimates

that the amounts that the private sector will be required to spend to comply with the Federal private sector mandate will not exceed \$6 million in fiscal year 1997, \$20 million in fiscal year 1998, \$34 million in fiscal year 1999, \$47 million in fiscal year 2000, and \$59 million in fiscal year 2001.

The provision to reinstate the Airport and Airway Trust Fund excise taxes through December 31, 1996, imposes a Federal intergovernmental mandate because State, local, and tribal governments will be required to pay the requisite taxes for commercial air travel by State, local, and tribal government employees. The staff of the Joint Committee on Taxation estimates that the direct costs of complying with this Federal intergovernmental mandate will not exceed \$50,000,000 in either the first fiscal year or in any of the 4 fiscal years following the first fiscal year.

If you would like to discuss this matter in further detail, please feel free to contact me. Thank you for your cooperation in this matter.

Sincerely,

KENNETH J. KIES,
Chief of Staff.

IV. VOTES OF THE COMMITTEE

In accordance with paragraph 7(b) of rule XXVI of the Standing Rules of the Senate, the following statement is made concerning the votes taken on the committee amendment to Title I of the bill.

Motion to approve committee amendment

The Committee approved the Chairman's amendment, as amended, by unanimous voice vote, a quorum being present. The committee amendment is a substitute for Title I of H.R. 3448 (revenue provisions).

Amendment to the Chairman's proposed amendment

The Committee approved an en bloc amendment by Senator Moynihan to the Chairman's proposed committee amendment by unanimous voice vote, a quorum being present.

V. REGULATORY IMPACT AND OTHER MATTERS

A. REGULATORY IMPACT

In accordance with 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 committee amendment to Title I of the bill.

Impact on individuals and businesses

Subtitle A of Title I provides tax relief benefiting small businesses. Subtitle B contains temporary extensions of certain expiring or expiring tax provisions. Subtitle C provides modifications benefiting S corporations. Subtitle D provides pension simplification provisions. Subtitle E contains certain revenue offsets to pay for the revenue-reducing provisions of the committee amendment. Sub-

title F contains technical corrections to recent tax legislation. Subtitle G includes miscellaneous revenue measures.

The revenue-increasing provisions will result in increased tax payments by the affected taxpayers, and will require such taxpayers to make the necessary calculations to comply with the provisions.

Impact on personal privacy and paperwork

The committee amendment to Title I of the bill will have little impact on personal privacy. Certain of the tax provisions will involve revised calculations by taxpayers in order to correctly compute their tax liability.

B. INFORMATION RELATING TO UNFUNDED MANDATES

This information is provided in accordance with section 423 of the Unfunded Mandates Act of 1995 (P.L. 104-4).

The Committee has determined that the following provisions of the bill contain Federal mandates on the private sector: (1) the provision relating to adjustments to basis of inherited S corporation stock; (2) the provision to repeal 5-year averaging for lump-sum distributions from qualified pension plans; (3) the provision to repeal the \$5,000 exclusion for employee death benefits; (4) the provision that would provide a simplified method for taxing annuity distributions under qualified pension plans; (5) the provision to modify the section 936 credit; (6) the provision to repeal the 50-percent interest income exclusion for financial institution loans to ESOPs; (7) the provision to provide that punitive damages are not excludable from income; (8) the provision to phase out and extend the luxury automobile excise tax; (9) the provision to modify the two county tax-exempt bond rule for local furnishers or electricity or gas to prohibit new local furnishers; (10) the provision to eliminate the interest allocation exception for certain nonfinancial corporations; (11) the provision to reinstate the Airport and Airway Trust Fund excise taxes through December 31, 1996; (12) the provision to change the depreciation rules for water utilities; (13) the provision to revise the expatriation tax rules, (14) the provision to modify the basis adjustment rules under section 1033; (15) the provision to repeal the exemption from withholding for gambling winnings from bingo and keno; and (16) and the provision relating to the treatment of retired lives reserves.

The costs required to comply with each Federal private sector mandate generally is no greater than the revenue estimate for the provision. Benefits from the provisions include improved administration of the Federal income tax laws, simplification for individual taxpayers, and a more accurate measurement of gross income for Federal income tax purposes. The Committee believes the benefits of the bill are greater than the costs required to comply with the Federal private sector mandates contained in the bill.

The provision to repeal five-year averaging for lump-sum distributions from qualified pension plans results in a better measurement of gross income for Federal income tax purposes and encourages taxpayers to take qualified pension plan distributions in a form other than a lump-sum distribution. The provision to repeal

the \$5,000 exclusion for employee death benefits results in a better measurement of gross income for Federal income tax purposes. The provision to provide a simplified method for taxing annuity distributions under qualified pension plans generally adopts an alternative method for taxing such distributions contained in Treasury regulations as the sole method for taxing such distributions and, thereby, simplifies the determination for individual taxpayers.

The provision relating to the adjustment to basis of inherited S corporation stock provides that a person acquiring stock in an S corporation from a decedent will treat as income in respect of a decedent ("IRD") his or her pro rata share of any item of income of the corporation that would have been IRD if that item had been acquired directly from the decedent, thereby improving the measurement of income for tax purposes.

The provision to modify the section 936 credit with transition rules for companies that have existing operations in the possessions will result in the better measurement of gross income for Federal income tax purposes by generally eliminating a tax benefit enjoyed by only a small number of U.S. corporations operating in possessions.

The provision to repeal the 50-percent interest income exclusion for financial institution loans to ESOPs will result in a better measurement of the income of such financial institutions.

The provision to repeal the exclusion for punitive damages will result in a better measurement of income for Federal tax purposes.

The provision to phase out and extend the luxury automobile excise tax will result in a more gradual phase out of the excise tax, which will result in less disruption of the automobile market.

The provision to modify the two county tax-exempt bond rule for local furnishers of electricity or gas and to prohibit new local furnishers eliminates a Federal tax subsidy for certain persons engaged in the local furnishing of electricity or gas and should result in a more accurate measure of income for Federal tax purposes.

The provision to eliminate the interest allocation exception for certain nonfinancial corporations eliminates a narrowly targeted rule for allocating and apportioning interest expense under the foreign tax credit rules and should result in a more accurate measure of income for Federal tax purposes.

The provision to reinstate the Airport and Airway Trust Fund excise taxes through December 31, 1996, funds important air transportation services.

The provision to change the depreciation rules for water utilities should result in a more accurate measure of income for Federal tax purposes given the long useful lives generally exhibited by water utility property.

The provision to revise the expatriation rules helps to ensure that the Federal tax laws do not provide individuals with an incentive to expatriate.

The provision to modify the basis adjustment rules under section 1033 should result in a more accurate measure of income for Federal tax purposes.

The provision to repeal the exemption from withholding for gambling winnings from bingo and keno will improve tax compliance and administration.

The provision relating to the treatment of retired reserves will simplify the treatment of such contracts and result in a better measurement of income for Federal tax purposes.

The revenue-raising provisions of the bill are used to offset the cost of certain small business initiatives (including increased expensing, extension of the FICA tip credit to certain delivery persons, and pension and S corporation simplification provisions) and the extension of certain expiring provisions. These provisions are generally designed to relieve the burdens of Federal income taxation on individuals and small business and the revenue-raising provisions of the bill are critical to achieving these goals.

The provision to reinstate the Airport and Airway Trust Fund taxes through December 31, 1996, imposes a Federal intergovernmental mandate because State, local, and tribal governments will be required to pay the requisite taxes for commercial air travel by State, local, and tribal government employees. The staff of the Joint Committee on Taxation estimates that the direct costs of complying with this Federal intergovernmental mandate will be less than \$50,000,000 in either the first fiscal year or in any one of the 4 fiscal years following the first fiscal year. The Committee intends that the Federal intergovernmental mandate be unfunded because the Airport and Airway Trust Fund excise taxes are intended to fund the maintenance of U.S. airports and airways and the Committee believes that it is appropriate for State, local, and tribal governments to bear their allocable share of the responsibility for such funding.

The revenue provisions of the bill generally affect activities that are only engaged in by the private sector. The provision reinstating the Airport and Airway Trust Fund excise taxes are imposed both on the private sector and on State, local, and tribal governments and, thus, do not affect the competitive balance between such governments and the private sector.

VI. CHANGES IN EXISTING LAW MADE BY THE BILL, AS REPORTED

In the opinion of the Committee, it is necessary in order to expedite the business of the Senate, to dispense with the requirements of paragraph 12 of the 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).

