103d Congress } COMMITTEE PRINT { S. PRT.
1st Session } { 103–37

FISCAL YEAR 1994 BUDGET RECONCILIATION RECOMMENDATIONS OF THE COMMITTEE ON FINANCE

AS SUBMITTED TO THE COMMITTEE ON THE BUDGET PURSUANT TO H. CON. RES. 64

COMMITTEE ON FINANCE
UNITED STATES SENATE

DANIEL PATRICK MOYNIHAN, *Chairman*

JUNE 1993

Printed for the use of the Committee on Finance by its staff

U.S. GOVERNMENT PRINTING OFFICE
69-501—CC WASHINGTON : 1993

S362-7

For sale by the U.S. Government Printing Office
Superintendent of Documents, Congressional Sales Office, Washington, DC 20402
ISBN 0-16-041091-6

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PREFACE

H.Con.Res. 64 sets forth the congressional budget for the United States Government for fiscal years 1994, 1995, 1996, 1997, and 1998. The resolution also instructs Senate and House committees to develop legislation that achieves the levels of deficit reduction established by the resolution. These "budget reconciliation" recommendations of the various committees are submitted to the Committees on the Budget and assembled into a bill which is considered by each House.

H.Con.Res. 64 instructs the Committee on Finance to report changes in laws within its jurisdiction sufficient to reduce outlays from direct spending programs by $2,346,000,000 in fiscal year 1994 and $35,157,000,000 for the period of fiscal years 1994 through 1998; and to increase revenues $27,293,000,000 in fiscal year 1994 and $272,105,000,000 for the period of fiscal years 1994 through 1998. The Committee on Finance is also instructed to report changes in laws to increase the statutory limit on the public debt to not more than $4,900,000,000,000.

The Congressional Budget Act permits the Committee to alter—within certain limitations—the mix of spending reductions and revenue increases as long as the total deficit reduction of $29,639,000,000 in fiscal year 1994 and $307,262,000,000 for the period of fiscal years 1994 through 1998 is achieved.

On June 18, 1993, the Committee on Finance approved its budget reconciliation recommendations by a vote of 11–9. These recommendations reduce the deficit by $40,293,000,000 in fiscal year 1994 and $310,860,000,000 from fiscal year 1994 to fiscal year 1998 and increase the statutory limit on the public debt to $4,900,000,000,000.

This committee print contains the explanatory report language for titles VII and VIII of the omnibus legislation that was reported by the Senate Budget Committee on June 22, 1993. Titles VII and VIII are the portions of the bill within the jurisdiction of the Committee on Finance.

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TITLE VII—FINANCE COMMITTEE RECONCILIATION PROVISIONS RELATING TO MEDICARE, MEDICAID, AND OTHER PROGRAMS

Subtitle A—Medicare

PART I—PROVISIONS RELATING TO PART A

Payment Updates for Inpatient Hospital Services (Section 7101)

Present Law

(a) *PPS Hospitals.*—Under the prospective payment system, there are different standardized amounts for hospitals located in large urban areas (metropolitan statistical areas with a population over 1 million, or 970,000 in New England), "other urban" areas, and rural areas. Different update factors apply to the urban and rural standardized amounts. The standardized amounts are updated annually effective with discharges occurring on or after October 1 of each year. A sole community hospital is paid based on the higher of the applicable standardized amount or a hospital-specific rate. The hospital-specific rate is updated annually effective with the beginning of the hospital's cost reporting period. The update factors are based on the projected increase in the hospital market basket, an index that measures changes in the prices of goods and services purchased by hospitals. OBRA 90 set the update factors for FY 1994 and FY 1995 as follows:

- The update factor for the urban standardized amount is equal to the estimated percentage increase in the hospital market basket.
- For the rural standardized amount, the FY 1994 update factor is equal to the estimated percentage increase in the hospital market basket plus 1.5 percentage points; for FY 1995, the update factor is to be set at the level necessary to eliminate the difference between the standardized amounts for rural and "other urban" hospitals.
- The update factor for the hospital-specific rate applicable to sole community hospitals is equal to the estimated percentage increase in the hospital market basket.

For FY 1996 and subsequent years, the update factor for all hospitals subject to the prospective payment system is equal to the estimated increase in the hospital market basket.

Other changes in the prospective payment system are made when the standardized amounts are updated. These include revisions to the hospital wage index, the DRG classification system and relative weights, outlier thresholds, and changes in geographic classification resulting from decisions by the Medicare Geographic Classification Review Board. A hospital that serves a disproportion-

ate share of low income patients receives an additional payment based on the percentage of its patient population that are low income. The payment adjustment factor applicable to urban hospitals with 100 or more beds is to increase effective with discharges occurring in FY 1994. A provision establishing a "regional floor" on payments for hospitals located in a region for which the regional average standardized amount is higher than the national average standardized amount expires September 30, 1993.

(b) *PPS-Excluded Hospitals.*—Hospitals excluded from the prospective payment system (psychiatric, rehabilitation, children's, cancer, and long-term hospitals and psychiatric and rehabilitation distinct part units) are paid on a reasonable cost basis subject to a rate of increase limit on operating costs per discharge. The per discharge limit, or target amount, is updated annually. The update factor for the target amount is equal to the estimated percentage increase in the hospital market basket and is effective for cost reporting periods beginning on or after October 1 of each year.

Committee Proposal

(a) *PPS Hospitals.*—PPS rates would be updated annually effective for discharges occurring on or after January 1 of each year. The payment rates in effect as of September 30, 1993 would continue in effect through December 31, 1993. No changes in the standardized amounts, DRG classification system or relative weights, outlier thresholds, wage index values, or in a hospital's geographic classification would occur until January 1, 1994. The increase in disproportionate share payments for urban hospitals with at least 100 beds would be postponed and would become effective for discharges occurring on or after January 1, 1994. The regional floor would be extended through December 31, 1993.

The standardized amounts would be updated on a calendar year basis as follows:

- 1994: The urban standardized amounts would be updated by the estimated percentage increase in the hospital market basket minus 2.18 percentage points. The rural standardized amounts would be updated by the market basket increase minus .68 percentage points.
- 1995: The urban standardized amounts would be updated by the estimated percentage increase in the hospital market basket minus 2.27 percentage points and the labor and non-labor portions of the standardized amounts would be recomputed based on the labor and non-labor proportions in the national average standardized amount for all hospitals. The rural standardized amount would be updated to equal the standardized amount applicable to hospitals located in "other urban" areas so that there would be a single standardized amount applicable to hospitals located in rural and "other urban" areas.
- 1996: The standardized amounts would be updated by the percentage increase in the hospital market basket minus 2.0 percentage points.
- 1997: The standardized amounts would be updated by the percentage increase in the hospital market basket minus 1.0 percentage point.

• 1998 and thereafter: The standardized amounts would be updated by the percentage increase in the hospital market basket.

The effective date of the update in the hospital-specific rate applicable to a sole community hospital would be changed from the beginning of the hospital's cost reporting period to January 1. The update factor would be based on the average increase in the standardized amounts and would equal the percentage increase in the hospital market basket minus 2.0 percentage points in 1994 (after a 3 month freeze) through 1996 and the percentage increase in the hospital market basket minus 1.0 percentage point in 1997.

The Committee notes that in the proposed rule for FY 1994 Changes to the Hospital Inpatient Prospective Payment Systems that was published May 26, 1993, the Secretary indicated an intention to evaluate the "nearest neighbor" labor market areas recommended by the Prospective Payment Assessment Commission and other alternatives to the labor market area definition currently used to construct the hospital wage index. The Committee expects the Secretary to expedite the appropriate review and analysis so that refined labor market areas will be considered for implementation as soon as possible.

(b) *PPS-Excluded Hospitals.*—Beginning January 1, 1994, the market basket projection would be made on a calendar year basis and would be applicable to cost reporting periods beginning in that calendar year. For cost reporting periods beginning in 1994, an average update factor for the target amount would be determined based on no increase for the first three months of the cost reporting period and an update factor equal to the estimated percentage increase in the hospital market basket minus 1.0 percentage point for the remainder of the cost reporting period. For cost reporting periods beginning in 1995 through 1997, the update factor for the target amount would equal the percentage increase in the hospital market basket minus 1.0 percentage points.

The Committee notes that OBRA 90 required the Secretary to develop a proposal to modify the current payment methodology for hospitals that are excluded from the prospective payment system. The report was to be submitted to Congress by April 1, 1992. The Committee urges that the Secretary submit the report promptly and include recommendations concerning re-basing the target amounts to reflect operating costs incurred in a recent cost reporting period.

Effective Date

Upon enactment.

Payment for Indirect Costs of Medical Education

(Section 7102)

Present Law

Prospective payments to teaching hospitals (hospitals with residents in approved graduate medical education programs) are adjusted to reflect indirect medical education costs, such as the extra demands placed on hospital staff due to teaching activity, the additional tests and procedures ordered by residents, and the higher costs associated with treating more severely ill patients. The pay-

ment adjustment is currently based on a formula that increases the DRG payment by approximately 7.7 percent for each 10 percent increase in the ratio of residents to beds. The increase is calculated on a curvilinear basis (that is, an increase in the resident-to-bed ratio does not result in a proportional increase in payment).

Committee Proposal

The formula used to determine the indirect medical education adjustment factor would be revised to result in a phased reduction in the additional payment for indirect teaching costs. Effective for discharges occurring on or after January 1, 1994 and before January 1, 1996, the DRG payment would be increased by approximately 7.0 percent for each 10 percent increase in the ratio of residents-to-beds. Effective for discharges occurring on or after January 1, 1996, the DRG payment would be increased by approximately 6.5 percent for each 10 percent increase in the ratio of residents-to-beds.

Effective Date

Upon enactment.

Loss of Regional Referral Center Status (Section 7103)

Present Law

Under the prospective payment system, hospitals located in rural areas that meet certain criteria may be classified as regional referral centers. Referral centers are paid standardized amount for "other urban" areas, rather than the standardized amount for rural areas. The Omnibus Budget Reconciliation Act of 1989 (OBRA 89) allowed hospitals that were classified as regional referral centers as of September 30, 1989, to continue in that status through cost reporting periods beginning before October 1, 1992, regardless of whether they continued to meet the criteria for designation as a regional referral center. Beginning on October 1, 1994, the standardized amount for hospitals in rural areas will equal the standardized amount for hospitals in "other urban" areas.

Committee Proposal

Hospitals that were classified as regional referral centers as of September 30, 1992 that were not subsequently reclassified by the Medicare Geographic Classification Review Board would continue to receive the "other urban" standardized amount through portions of cost reporting periods occurring before January 1, 1995, regardless of whether they continue to meet the criteria for designation as a referral center.

The Secretary would be required to make a lump sum payment to any hospital that was determined to not meet the criteria for designation as a referral center as a result of the triennial status review. The payment would be for the additional DRG standard payments (exclusive of outlier payments) that would have been made if the hospital had not lost designation as a regional referral center and had continued to receive payment based on the "other urban" standardized amount. Hospitals that lost rural referral cen-

ter status as a result of a favorable reclassification decision by the Medicare Geographic Reclassification Review Board for fiscal years 1993 or 1994 would have the opportunity to decline the reclassification and retain rural referral center status.

Effective Date

Upon enactment.

Medicare-Dependent, Small Rural Hospital Payment Extension

(Section 7104)

Present Law

OBRA 89 established a special payment provision for "Medicare-dependent small rural hospitals (MDHs)," rural hospitals with 100 or fewer beds that had at least 60 percent Medicare utilization during their cost reporting period beginning in FY 1987. The provision applied only to cost reporting periods beginning on or before April 1, 1990, and ending on or before March 31, 1993. An MDH was paid for operating costs under the same formula as sole community hospitals; that is, an MDH was paid on the basis of its hospital-specific rate (the higher of its FY 1982 or FY 1987 operating costs per discharge, updated for inflation) or the rural standardized amount, whichever is higher.

Committee Proposal

For discharges occurring during cost reporting periods beginning on or after April 1, 1990 and before April 1, 1993, the SCH payment methodology would continue to apply to MDHs. For portions of cost reporting periods beginning on or after April 1, 1993 and before January 1, 1995, an MDH would receive 50 percent of the difference between its payment under the SCH payment rules and the payment regularly provided under the prospective payment system. The Secretary would be required to make a lump sum payment for the additional payments that would have been made if the MDH provision had continued to apply to cost reporting periods ending after March 31, 1993. Hospitals that lost MDH status as a result of a favorable reclassification decision by the Medicare Geographic Reclassification Review Board for fiscal years 1993 or 1994 would be offered the opportunity to decline the reclassification and retain MDH status.

Effective Date

Effective as if included in OBRA 89.

Elimination of Return on Equity for Proprietary Skilled Nursing Facilities

(Section 7105)

Present Law

Proprietary skilled nursing facilities (SNFs) receive, in addition to payments for the costs of providing services, a return on equity payment, which provides the investors in the facility a return on their investment equivalent to what they would have earned if they

had invested the same amount in specified government securities. Return on equity payments for proprietary hospitals were phased out by the Consolidated Omnibus Budget Reconciliation Act of 1985 (COBRA 85). SNFs are the only providers still receiving Medicare return on equity payments.

Committee Proposal

The payment to SNFs for return on equity capital would be eliminated.

Effective Date

Portions of cost reporting periods occurring on or after October 1, 1993.

Extension of 10 Percent Reduction in Payments for Capital-Related Costs of Inpatient Hospital Services

(Section 7106)

Present Law

Until FY 1992, Medicare payments for inpatient hospital capital costs were on a reasonable cost basis, subject to statutory percentage reductions. Since FY 1992, Medicare has instead paid for capital under a prospective payment system. The Omnibus Budget Reconciliation Act of 1990 (OBRA 90) provided that, for portions of cost reporting periods or discharges occurring in FY 1992 through FY 1995, the Secretary is to reduce operating or capital payments, or both, to achieve a 10 percent savings relative to what would have been paid for capital expenses on a reasonable cost basis.

The regulations implementing the capital prospective payment system provide for a ten-year transition from reasonable cost payments to payment based solely on a federal rate. During the transition, each hospital's payment is based on a decreasing proportion of its hospital-specific costs and an increasing proportion of the federal rate for capital. During the transition, hospitals with high capital costs are paid 85 percent of the reasonable costs for capital in patient care use as of December 31, 1990 and certain capital projects that were obligated as of that date. There are special criteria related to obligated capital for hospitals in States with a lengthy certificate-of-need (CON) process.

Committee Proposal

The provision that requires the Secretary to reduce operating or capital payments, or both, to achieve a 10 percent savings relative to what would have been paid for capital expenses on a reasonable cost basis would be extended through FY 1998.

The Committee notes that in the proposed rule for FY 1994 Changes to the Hospital Inpatient Prospective Payment Systems that was published in the Federal Register on May 26, 1993, the Secretary indicated that insufficient information was available to complete a systematic evaluation of the obligated capital criteria for hospitals in States with a lengthy CON process in time to consider appropriate changes during the FY 1994 rulemaking process. The Committee expects the Secretary to complete the assessment in time for consideration in the 1995 rulemaking process and to

evaluate not only the criteria for recognition of obligated capital in States with a lengthy CON process but also whether changes should be made in the payment rules to extend reasonable cost payments for such projects beyond the 10-year transition period.

Effective Date

Upon enactment.

Skilled Nursing Facility Cost Limits (Section 7107)

Present Law

Medicare payment for skilled nursing facility services is made on a reasonable cost basis subject to a limit on routine costs per diem. The limit is based on 112 percent of the mean per diem routine service costs for freestanding facilities. There is an add-on to the limit for hospital-based facilities equal to 50 percent of the difference between 112 percent of the mean per diem routine costs for freestanding facilities and 112 percent of the mean per diem costs for hospital-based facilities.

The labor-related portion of the limits are to be adjusted by an appropriate wage index. The Secretary currently uses a wage index based on wage data collected from hospitals. In its March 1, 1992 Report and Recommendations to the Congress, the Prospective Payment Assessment Commission recommended that the Secretary collect data on employee compensation and paid hours of employment for nursing facilities for the purpose of implementing a nursing facility wage index to adjust the cost limits. The limits are to be updated every two years.

Committee Proposal

The cost limit would be lowered to 110 percent of the median per diem routine service costs for freestanding facilities. The add-on for hospital-based facilities would equal 50 percent of the difference between 110 percent of the median per diem routine costs for freestanding facilities and 110 percent of the median per diem routine costs for hospital-based facilities. The Secretary would be required to begin collecting the data necessary to compute a wage index based on wages specific to skilled nursing facilities within 1 year of enactment. The Prospective Payment Assessment Commission would be required to study and report by March 31, 1994 on the impact of applying the limits on routine per diem costs on a regional basis.

Effective Date

The lower cost limits would be effective for cost reporting periods beginning on or after October 1, 1993. The other requirements would be effective upon the date of enactment.

Payments for Hospice Care
(Section 7108)

Present Law

Payment for routine home care and other services included in hospice care are updated annually each October 1 based on the percentage increase in the hospital market basket.

Committee Proposal

The annual payment update would be moved to January 1. Payment rates in effect as of September 30, 1993 would continue in effect until January 1, 1994. Effective January 1, 1994, the annual update through 1998 would equal the percentage increase in the hospital market basket minus one percentage point.

Effective Date

Upon enactment.

PART II—PROVISIONS RELATING TO PART B

Subpart A—Physicians' Services

Reduction in the Physician Fee Update
(Section 7201)

Present Law

The law contains a default formula for updating the Medicare physician fee schedule if Congress does not act to set the update. The *default update* is the Medicare Economic Index (MEI—an inflation index) for the year plus or minus the difference between the Medicare volume performance standard rate of increase and actual expenditures for the second previous fiscal year (i.e. FY 1992 expenditures are used in determining the update for 1994).

The law also specifies a lower limit on the update. The update in 1994 and 1995 can be no lower than the MEI minus 2.5 percentage points. In subsequent years, the update can be no lower than the MEI minus 3 percentage points.

The *volume performance standard* specifies a maximum rate at which expenditures for physicians' services should increase. Separate volume performance standards were established for surgical services and all other services for FY 1992. The surgical volume performance standard (VPS) rate of increase was 6.5 percent in 1992; the non-surgical VPS was 11.2 percent; and the VPS for all services was 10.0 percent.

In 1992, actual expenditures for surgical services decreased by 3.3 percent; non-surgical services increased by 7.0 percent; and all services increased by 4.3 percent. The estimated MEI for 1994 is 2.4 percent. Using the default formula, the estimated updates for 1994 are as follows. For surgical services, the estimated default update is 12.2%. For non-surgical services, the estimated default update is 6.6%. The estimated default update for all services is 8.1%.

Committee Proposal

The committee proposal would reduce the default formula updates by 8.0 percent for surgical services and 4.4 percent for non-surgical services, except for primary care, which would receive the default update. Under the committee's provision, the estimated updates for 1994 are 4.2% for surgical services; 2.2 percent for all other services (except primary care; and 6.6 percent for primary care services.

Effective Date

Upon enactment.

Reduce Default Medicare Volume Performance Standard and Update

(Section 7202)

Present Law

The default Medicare Volume Performance Standard (VPS) establishes a standard for the rate of growth in Medicare physician expenditures if Congress does not act to establish a VPS. The purpose of the standard is to encourage physicians to restrain the rate of growth in spending so that actual expenditures for a given year do not exceed the VPS for that year.

The default VPS is calculated as the sum of the following four factors, from which a performance standard factor is subtracted: (1) the Secretary's estimate of the weighted average percentage increase in Medicare physician fees; (2) the Secretary's estimate of the percentage increase or decrease in Medicare beneficiaries for that year; (3) the Secretary's estimate of the average annual growth in volume and intensity of physicians' services for the preceding five fiscal years; and (4) the Secretary's estimate of the percentage increase or decrease in Medicare physician expenditures due to changes in law or regulation. This sum is reduced by a performance standard factor. In 1993 and succeeding years, the performance standard factor is 2 percentage points.

Separate VPSs are established for surgical services and all other services. Separate VPSs were established for surgical services and non-surgical services for the first time in FY 1991. The surgical volume performance standard (VPS) rate of increase for FY 1992 was 6.5 percent; the non-surgical VPS was 11.2 percent; and the VPS for all services was 10.0 percent.

The law contains a default formula for updating the Medicare physician fee schedule if Congress does not act to set the update. The default update is the Medicare Economic Index (MEI) plus or minus the difference between the Medicare volume performance standard rate of increase and actual expenditures for the second previous year (i.e. 1992 expenditures are used in determining the update for 1994).

The law also specifies a lower limit on the update. The update in 1994 and 1995 can be no lower than the MEI minus 2.5 percentage points. In subsequent years, the update can be no lower than the MEI minus 3 percentage points.

Committee Proposal

The committee provision would reduce the default volume performance standard by increasing the performance standard factor to 3.5% in 1994 and 4% in each succeeding year for all services except primary care. The committee provision would establish a new volume performance standard for primary care services and set the performance standard factor for primary care services at zero percentage points. The provision would also decrease the lower limit on the update by lowering it to the MEI minus to 5 percentage points, beginning in 1995.

Effective Date

Changes to the volume performance standards apply beginning in fiscal year 1994. Creation of a separate category of primary care services is effective upon enactment. The conversion factor updates and the lower limit on the default update apply beginning in 1996.

Resource Based Practice Expense Phase-In (Section 7203)

Present Law

Practice expenses are defined as all expenses for furnishing physicians' services, such as office rent and wages of personnel employed by physicians. It excludes malpractice expenses, physician compensation and other physician fringe benefits.

Relative values for practice expenses are based on historical charges. The average percentage division of resources among work, practice expense and malpractice expense were determined for each medical specialty based on a 1989 survey of office-based physicians and, for specialties not included in the survey, from data supplied by national specialty societies. Second, the proportion of each service performed by each specialty was determined from Part B claims data. Using this information, an average practice expense percentage was computed for each service. Then the average practice expense percentage is multiplied by the base allowed charge for a service, which was computed by estimating the 1991 national allowed charge for a service.

Committee Proposal

The committee provision requires the Secretary to develop a methodology for implementing resource-based practice expense relative value units in 1997. The Secretary would be required to transmit a report on the proposed methodology to the House Ways and Means Committee, the Energy and Commerce Committee and the Senate Finance Committee by June 30, 1996. The report would include a presentation of data used in developing the methodology and an explanation of the methodology.

In the interim, the committee provision would reduce practice expense relative value units considered to be overvalued. Practice expense relative value units which are greater than 110 percent of physician work relative value units would be subject to reductions. The reduction in 1994 would equal 25 percent of the difference between the practice expense relative value units and the work rel-

ative value units. In 1995 and 1996, the reduction would equal an additional 25 percent of the remainder. Practice expense relative value units could not be reduced below 110 percent of the work relative value units for that service. Services that have no physician work component and consist only of a practice expense component would not be subject to these reductions. Services which the Secretary determines are performed in an office setting at least 75 percent of the time would be exempt from these reductions.

It is the committee's understanding that this policy will be applied to professional component billings and not to global billings.

Effective Date

Upon enactment.

Cap on Payments to the Anesthesia Care Team (Section 7204)

Present Law

Both anesthesiologists and certified registered nurse anesthetists (CRNAs) are paid on the basis of a fee schedule derived from a uniform relative value guide that is unique to anesthesia services. Payment is equal to the sum of the total number of base units (which measure complexity of a service) and the number of time units (which measure actual time used, with each 15 minute interval equal to one full time unit during the delivery of a service) multiplied by a dollar conversion factor.

CRNAs may practice alone or under medical direction. When CRNAs practice without medical supervision, payment is the same as would be paid to anesthesiologists. When CRNAs practice under medical direction as part of an anesthesia care team, payments to CRNAs are reduced; the conversion factor is set at a specific dollar amount ($11.00 in 1993). When this conversion factor was established in the Omnibus Budget Reconciliation Act of 1990, it was projected to equal 70 percent of the conversion factor that would be paid to anesthesiologists practicing alone.

When an anesthesiologist medically directs a CRNA, the base units used in calculating payment are reduced by 10 percent, 25 percent, and 40 percent for the concurrent direction of two, three, or four CRNAs. Time units are based on 30 minute intervals, instead of 15 minute time increments. An anesthesiologist may not concurrently direct more than four CRNAs.

Committee Proposal

Payments to an anesthesia care team would be capped at 120 percent of the amount paid to an anesthesiologist practicing alone in 1994. The cap would be reduced by 5 percent in each succeeding year, so that payments to an anesthesia care team would equal 100 percent of the amount paid to a solo anesthesiologist by 1998. The reduction in the number of base units paid to anesthesiologists medically directing CRNAs would be repealed, as would requirements that anesthesiologists medically directing CRNAs report certain information on claims forms. The fee schedule amount paid to CRNAs practicing in an anesthesia care team would be one half the total payment.

Effective Date

Applies to physician services furnished on or after January 1, 1994.

Reinstating Separate Payment for Interpretation of Electrocardiograms (EKGs)

(Section 7205)

Present Law

OBRA 90 eliminated separate payments for interpretation of EKGs performed or ordered to be performed as part of, or in conjunction with, a medical visit or consultation, effective January 1, 1992.

Committee Proposal

The committee provision repeals the OBRA 90 prohibition on separate payments for interpretation of EKGs.. Separate fee schedule payment amounts for interpreting EKGs in all settings would be established.

The committee provision provides for several adjustments to the fee schedule in order to comply with budget neutrality rules. First, HCFA would subtract the relative value units for EKG interpretation that were bundled into medical visit and consultation relative values for 1992 and 1993.

The committee provision requires HCFA to make across-the-board adjustments to the relative values for all services to account for the shortfall of relative value units that were bundled into medical visits and consults in 1992 and 1993. The Secretary is required to reduce the relative value for all services (except anesthesia services) by the percentage the Secretary determines necessary so that beginning in 1996 expenditures under the fee schedule would not exceed those which would have been made in the absence of this provision. For anesthesia services, the appropriate adjustment is made to the conversion factor.

The committee provision also requires HCFA to make an adjustment to the historical payment basis in the fee schedule to account for the fact that more EKG interpretations would be paid at the full fee schedule amount than medical visits and consultations during the transition. No reduction would be made for services already at the full fee schedule amount. The Secretary is to make appropriate budget neutrality adjustments in the historical payment portion of the 1994 transition payment which applies in 1994 and 1995.

Effective Date

Applies to services furnished on or after January 1, 1994.

Payments for New Physicians and Practitioners

(Section 7206)

Present Law

New physicians and practitioners receive reduced payments during their first four years of practice. These reductions were imposed

on the first two years of practice by OBRA 87 and extended to the third and fourth years of practice in OBRA 90. Payments are 80 percent of the amount otherwise recognized during the first year of practice, 85 percent during the second year, 90 percent during the third year, and 95 percent during the fourth year. These reductions apply to payments under the fee schedule, prevailing charges, or other fee schedule payment amounts.

Committee Proposal

The committee provision repeals reductions in payments to new physicians and practitioners and requires that payments under Section 1848 be no greater or less than they would be in the absence of the repeal. The Secretary is required to reduce the following values and amounts for 1994 (to be applied for that year and subsequent years) so that physician expenditures would not exceed the amount of expenditures that would have been made in the absence of this provision. The specified values and amounts are: (i) the relative values for services (except for anesthesia services, where the reduction is to the conversion factor); (ii) the historical payment portion of the 1994 transition payment; and (iii) the prevailing charge or fee schedule amounts to be applied for services of a health care practitioner (as that term was defined before enactment of this Act).

Effective Date

Applies with respect to physicians' services furnished on or after January 1, 1994.

Extra Billing
(Section 7207)

Present Law

(a) Limitations on beneficiary liability.—OBRA '89 established limits on the amount above the Medicare approved payment amount nonparticipating physicians may charge Medicare beneficiaries. OBRA 89 permitted the Secretary to impose sanctions on physicians who knowingly and willfully bill above the limiting charge on a repeated basis. However, it did not specifically prohibit physicians from billing beneficiaries more than the limiting charge. OBRA 89 also did not require physicians to make refunds to beneficiaries when they billed above the limiting charge and did not absolve beneficiaries from liability for amounts they are billed above the medicare limiting charge.

(b) Pre-Payment Screening of Claims.—Carriers are not currently required by law to screen unassigned claims submitted by nonparticipating physicians prior to payment in order to determine whether the amount billed exceeds the limiting charge.

(c) Information Regarding Limiting Charges.—There is currently no requirement that beneficiaries be given information on the explanation of Medicare benefits (EOMB) form if physicians have charged beneficiaries in excess of the limiting charge.

(d) Applying the Limiting Charge to Nonphysician Services Provided Under the Physician Fee Schedule.—The five percent differential in payments to nonparticipating physicians and suppliers

does not apply to nonphysician services furnished under the Medicare physician fee schedule. These services generally consist of the technical components of services, such as services rendered by free-standing radiology centers or independent physiological laboratories.

(e) Clarification of Mandatory Assignment Rules for Certain Practitioners.—There is some ambiguity in current law regarding the application of mandatory assignment rules for certain nonphysician practitioners.

Committee Proposal

(a) Limitations on Beneficiary Liability.—The committee provision prohibits nonparticipating physicians from billing or collecting from any person an actual charge in excess of the Medicare limiting charge. The provision would specify that no person is liable for payment of any amount billed in excess of the limiting charge. It would also require physicians who bill, but who do not collect the excess charge to reduce the actual charge billed for the service to the amount approved by Medicare. Physicians who collect amounts exceeding the limiting charge would be required to refund, on a timely basis, the amount collected in excess of the limiting charge. The amount of the refund is reduced to the extent the individual has an outstanding balance owed to the physician. A correction of a bill for an excess charge or refund of an excess charge is considered to be made on a timely basis if it is made within 30 days of the date the physician, supplier or other person is notified of the excess charge by the carrier.

The committee provision specifies that in the case of a physician (1) knowingly and willfully bills in excess of the limiting charge; (2) collects charges exceeding the limiting charge on a repeated basis; or (3) fails to comply with the refund requirements, the Secretary would be authorized to impose sanctions in accordance with Section 1842(j) of the Social Security Act.

The committee provision clarifies that the refund requirement does not apply to other third party payers.

The committee understands that Medicare carriers currently ask for a refund where the actual charge exceeds the limiting charge by at least one dollar. Similarly, Medicare carriers include information on the Explanation of Medicare benefits form where the limiting charge exceeds the actual charge by at least one dollar. The committee believes that the use of a one dollar nominal threshold before application of the refund provision (as well as for the reduction of an actual charge where the physician has not collected and for the EOMB) is an appropriate policy that would be consistent with the intention of this provision.

The committee provision makes it clear that the limiting charge policy and enforcement thereof applies to the physician, supplier, or other person performing the service as well as to any person billing or receiving payment on behalf of such physician, supplier, or person.

The committee provision requires that a refund be made to the individual charged, if there is a charge in excess of the limiting charge.

(b) Prepayment screening of claims.—The committee provision requires carriers to screen 100 percent of unassigned claims submitted by nonparticipating physicians prior to making payment to determine whether the amount billed exceeds the limiting charge.

(c) Information Regarding Limiting Charges.—The committee provision requires carriers to provide limiting charge information on the explanation of Medicare benefits form after the submission of an unassigned claim which exceeds the limiting charge. The EOMB must include information on the beneficiary's right to a refund.

The Secretary is required to report to Congress annually on the extent to which annual charges exceeded limiting charges, the number and types of services involved, and the average amount of excess charges.

(d) Applying the Limiting Charge to Nonphysician Services Furnished Under the Physician Fee Schedule.—The committee provision applies the 5 percent differential between payments to participating and nonparticipating physicians and suppliers and limiting charge restrictions to the technical components of nonphysician services paid on the basis of the physician fee schedule. The extra billing limits and participation differential are extended so that they apply to any nonparticipating supplier or other person who furnishes a physician's service that is paid for under the physician fee schedule, or services that would be paid under the fee schedule but have been excluded from the fee schedule by the Secretary.

(e) Clarification of Mandatory Assignment Rules for Certain Practitioners.—The committee provision specifies that physicians' assistants, nurse practitioners, clinical nurse specialists, certified registered nurse anesthetists, certified nurse-midwives, clinical social workers and clinical psychologists may only bill for services on an assignment-related basis and that no person is liable for amounts billed in violation of the assignment-related basis. The Secretary may impose sanctions under Section 1842(j) of the Social Security Act on a practitioner who knowingly and willfully bills in violation of this requirement.

Effective Date

Sections (a), (d), and (e) apply to services furnished on or after the date of enactment, except that it does not take effect for services provided by a nonparticipating supplier or other person until January 1, 1994. Section (b) applies to contracts as of January 1, 1994. Section (c) applies to EOMBs furnished on or after January 1, 1994.

Subpart B—Outpatient Hospital Services and Ambulatory Surgical Services

Extension of 10 Percent Reduction in Payments for Capital-Related Costs of Outpatient Hospital Services

(Section 7221)

Present law

In determining the cost-related portion of Medicare's payment for outpatient services, OBRA 90 reduced reasonable cost payments for

capital-related costs by 10 percent for portions of cost-reporting periods occurring during FY 1992 through FY 1995.

Committee Proposal

The 10 percent reduction in reasonable cost payments for capital-related costs would be extended through portions of cost reporting periods occurring in FY 1998.

Effective Date

Upon enactment.

Extension of Reduction in Payments for Other Costs of Outpatient Hospital Services

(Section 7222)

Present Law

In determining the cost-related portion of Medicare's payment for outpatient services, OBRA 90 reduced reasonable cost payments for non-capital related costs by 5.8 percent for portions of cost reporting periods occurring during FY 1991 through FY 1995.

Committee Proposal

The 5.8 percent reduction in reasonable cost payments for non-capital related costs would be extended through portions of cost reporting periods occurring in FY 1998.

Effective Date

Upon enactment.

Changes to Payment Formulas for Certain Hospital Outpatient Services

(Section 7223)

Present Law

The aggregate amount of Medicare payments made for hospital outpatient services (or rural primary care hospital services) furnished in connection with ambulatory surgery, radiology and diagnostic tests equals the lesser of: (i) the lower of a hospital's reasonable costs or its customary charges, net of deductible and coinsurance amounts, and (ii) a blended amount comprised of a cost portion and a charge portion. The cost portion of the blend is based on the lower of a hospital's costs or charges net of beneficiary cost-sharing. The cost portion of the blend is 42 percent for ambulatory surgery and radiology services and 50 percent for diagnostic tests. The charge portion of the blend is 58 percent of the ambulatory surgery center (ASC) facility payment rates net of beneficiary coinsurance, and 58 percent of the physician fee schedule amount for radiology services net of coinsurance, and 50 percent of the physician fee schedule for diagnostic tests net of coinsurance.

A hospital may bill a beneficiary for coinsurance equal to twenty percent of its charge for an outpatient service. However, the blended amounts are calculated after application of beneficiary cost-sharing (e.g., lower of hospital cost or charges net of cost-sharing and 80 percent of the ASC rate). This inconsistency in application of

cost-sharing results in an anomaly whereby the amount a beneficiary pays in coinsurance does not result in a dollar for dollar decrease in Medicare program payment.

Committee Proposal

Using the current blend percentages, the payment formula would be changed to determine the blended payment limit prior to application of beneficiary cost-sharing provisions. Medicare's payment amount would be determined based on the lesser of (i) the lower of the hospital's reasonable costs or customary charges, or (ii) the blended payment limit. Medicare would then pay the lesser of (i) 80 percent of the lowest amount, or (ii) the lowest amount less the beneficiary cost sharing amounts.

Effective Date

Effective for portions of cost reporting periods occurring after October 1, 1993.

Payments to Ambulatory Surgery Centers; Payment for Intraocular Lenses

(Section 7224)

Present Law

(a) Intraocular Lenses.—The Omnibus Budget Reconciliation Act of 1990 (OBRA 90) established payment for intraocular lenses inserted in an ambulatory surgery center during or subsequent to cataract surgery at $200 until December 31, 1992. Current payment remains at $200.

(b) Payment Amounts.—Current law requires the Secretary to update ambulatory surgery center payment rates by July 1, 1987 and annually thereafter, as determined appropriate by the Secretary. The OBRA 90 conferees had intended to include a provision requiring an annual update to ASC rates, but it was omitted from the law.

(c) Adjustments to Payment Amounts for New Technology Intraocular Lenses.—OBRA 90 included a provision capping payments for IOLs at $200 in 1991 and 1992. As drafted, the statutory language could be interpreted as limiting payments for cataract surgery to $200. The OBRA 90 conferees also agreed to a provision providing for a process by which the fee for new technology intraocular lenses (IOLs) could be adjusted. Statutory language reflecting this agreement was inadvertently omitted from OBRA 90.

Committee Proposal

(a) Intraocular Lenses.—The committee provision establishes payment for intraocular lenses inserted in an ambulatory surgery center during or subsequent to cataract surgery on or after the date of enactment and on or before December 31, 1998 at $150.

(b) Payment Amounts.—The committee provision establishes the update for ambulatory surgery services, beginning with fiscal year 1995, at the CPI–U for the 12 month period ending with March of the preceding year minus 1 percentage point. The Secretary would be required to conduct a survey, based on a representative sample of procedures and facilities, beginning by July 1, 1994 and updated

every 5 years thereafter, of the actual audited costs of ambulatory surgery facilities. The survey results would be used in establishing payment rates. The Secretary would be required to consult with appropriate trade and professional organizations in updating the list of procedures that can be performed in ambulatory surgery centers.

(c) Adjustments to Payment Amounts for New Technology Intraocular Lenses.—The committee provision requires the Secretary to develop and implement a process for reviewing reimbursement for new technology intraocular lenses (IOLs). In order to be considered a new technology IOL, the device would have to be approved by the FDA. The Secretary would also be required to consider specific circumstances in determining whether to adjust the payment amount for new technology IOLs. The provision also specifies administrative procedures for reviewing and approving new technology IOLs.

Effective Date

Section (a) is effective for items and services on or after January 1, 1994. Sections (b) and (c) take effect as if included in the enactment of OBRA 90.

Subpart C—Durable Medical Equipment

(Sections 7231, 7232, 7233, and 7234)

Present Law

(a) Narrowing the Range of Payment Limits for Durable Medical Equipment.—Medicare currently pays for durable medical equipment (DME) on the basis of a fee schedule that has national floors and ceilings (lower and upper limits) on payments. The floor is equal to 85 percent of weighted average of local payment amounts and the ceiling is equal to 100 percent of the weighted average of local payment amounts.

(b) National Payment Limits for Prosthetic Devices, Orthotics and Prosthetics.—Medicare currently pays for prosthetics and orthotics on the basis of a fee schedule that has regional floors and ceilings on payments. The floor is equal to 85 percent of the weighted average of local payment amounts and the ceiling is equal to 120 percent of the weighted average of local payment amounts.

(c) Parenteral and Enteral Nutrients, Supplies and Equipment.—Payment for parenteral and enteral nutrients, supplies and equipment is made on the basis of reasonable charges, updated by the CPI–U.

(d) Treatment of Nebulizers and Aspirators.—There are five categories in the DME fee schedule. Aspirators and nebulizers are in a category entitled items requiring frequent and substantial servicing. These items may only be rented on the grounds that they require frequent servicing in order to avoid imminent danger to a beneficiary's health.

(e) Reduction in Payment for Transcutaneous Electrical Nerve Stimulators.—No provision.

Committee Proposal

(a) Narrowing the Range of Payment Limits for Durable Medical Equipment.—The committee provision would change the basis of calculating the national payment ceilings and floors from the

weighted average of local payment amounts to the median of local payment amounts.

(b) National Payment Limits for Prosthetic Devices, Orthotics and Prosthetics.—The committee provision would change the basis of calculating the payment ceilings and floors from the weighted average of local payment amounts to the median of local payment amounts. It would also subject payment limits for these devices to the same national payment ceilings and floors applied to durable medical equipment items.

(c) Parenteral and Enteral Nutrients, Suppliers and Equipment.—The committee provision eliminates the 1994 payment update for parenteral and enteral nutrients, supplies and equipment.

(d) Treatment of Nebulizers and Aspirators.—The committee provision removes aspirators and nebulizers from the category of DME items requiring frequent and substantial servicing and includes disposable supplies used in conjunction with aspirators and nebulizers in the category of inexpensive and other routinely purchased equipment. The committee provision specifies that separate payment will be made for accessories used in conjunction with nebulizers and aspirators. The committee does not intend to interfere with the Secretary's existing authority for payment for accessories for other durable medical equipment items and supplies by granting explicit statutory authority for payment of accessories used in conjunction with nebulizers and aspirators.

The committee provision would eliminate the mandate for the treatment of ventilators, aspirators, IPPB machines and nebulizers as items that require frequent and substantial servicing. This would give the Secretary of Health and Human Services discretion to determine whether these items should continue to be paid for on this basis. The committee understands, based on correspondence received from the Health Care Financing Administration (HCFA), that if this provision is enacted HCFA intends to remove all nebulizers and aspirators from the frequent servicing category along with the following items which are currently classified as ventilators: Continuous Airway Pressure Device (EO601), Intermittent Assist Device with Continuous Airway Pressure Device (EO452) and Therapeutic Ventilator (EO453). While most of these items would be moved to the so-called rental cap category, a few inexpensive items would be moved to the inexpensive and other routinely purchased category. In either case, Medicare would make separate payment for accessories for these items (tubing, masks, filters, etc.)

The committee expects that respirators and other ventilators not specifically mentioned above would continue to be categorized as items requiring frequent and substantial servicing.

(e) Reduction in Payment for Transcutaneous Electrical Nerve Stimulators.—In addition, the conference agreement reduces the DME fee schedule amount for transcutaneous electrical nerve stimulation (TENS) devices by 30 percent.

Effective Date

Applies to items furnished on or after January 1, 1994.

Subpart D—Part B Premium

(Section 7251)

Present Law

The Omnibus Budget Reconciliation Act of 1990 (OBRA 90) established Part B premiums in statute from 1991 through 1995. When OBRA 90 was enacted, Congress intended that premiums equal 25 percent of Part B outlays from 1991 through 1995. After 1995, increases in premiums are limited to the cost of living adjustment (COLA) in Social Security benefits.

Committee Proposal

The committee provision would require that premiums for 1996 through 1998 be established to cover 25 percent of projected Part B outlays.

Effective Date

Upon enactment.

Subpart E—Other Provisions

One Year Freeze in Part B Payments Except Physicians, Clinical Laboratories and Parenteral and Enteral Nutrients, Equipment and Supplies for 1994

(Section 7261)

Present Law

Under current law, most Part B services, including, but not limited to durable medical equipment; prosthetics, orthotics, and prosthetic devices; ambulatory surgical center services; rural health clinic services; Federally qualified health center services; and comprehensive outpatient facility services receive an annual inflationary adjustment.

Committee Provision

The committee provision would not provide for any inflationary updates for all Part B services excluding physicians' services, clinical laboratory services and parenteral and enteral nutrition nutrients, supplies and equipment in 1994.

Effective Date

Effective for all items and services furnished in 1994.

Reduction in Update for All Part B Services Except Physicians and Clinical Laboratory Services

(Section 7261)

Present Law

Under current law, most Part B services, including, but not limited to durable medical equipment; prosthetics, orthotics, and prosthetic devices; ambulatory surgical center services; rural health clinic services; Federally qualified health center services; and com-

prehensive outpatient facility services receive an annual inflationary adjustment.

Committee Proposal

The committee provision would reduce updates otherwise scheduled for these services for 1995 through 1998 by one percentage point.

Effective Date

Upon enactment.

Lower Ceiling on Clinical Laboratory Fee Schedule and Freeze on Payment Updates for Clinical Laboratory Payments

(Section 7262)

Present Law

Medicare pays for clinical laboratory services on the basis of a fee schedule established in 1984. Beginning July 1, 1986, local laboratory fee schedules became subject to national ceilings. These ceilings was based on the median of all carrier-side fee scheduled established for each particular test in a given laboratory setting. The ceiling was initially set at 115 percent of the median. It is now set at 88 percent of the national median. The clinical laboratory fee schedule was updated by 2 percent in 1993. After that, the update to the fee schedule is the CPI–U.

Committee Proposal

The committee provision would reduce the ceiling on laboratory fee schedules to 76 percent of the national median. The committee provision would eliminate the update to the clinical laboratory fee schedule from 1994 through 1998.

Effective Date

Upon enactment.

PART III—PROVISIONS RELATING TO PARTS A AND B

Payments for Direct Graduate Medical Education Costs

(Section 7301)

Present Law

Medicare makes a separate payment to hospitals for the direct costs of approved graduate medical education programs, including residents' salaries and fringe benefits, teaching physician compensation, and overhead expenses. Effective with cost reporting periods beginning on or after July 1, 1985, the payment is based on a per resident amount derived from each hospital's costs per resident in a base period (the hospital's cost reporting period that began in FY 1984) and updated for subsequent cost reporting periods based on the percentage change in the consumer price index (CPI). The law provides for no other adjustments to the per resident amounts. Medicare's share of the per resident amount is

based on the ratio of Medicare inpatient days to total inpatient days.

Fulltime residents in their initial residency period count as 1.0 FTE; those that are beyond their initial residency period count as .5 FTE. The initial residency period is defined as the minimum number of years necessary to satisfy the requirements for initial board eligibility in the particular specialty for which the resident is training plus 1 year. The total period may not exceed 5 years. Up to 2 years in a geriatric residency program are treated as part of the initial residency period but do not count toward the 5-year limit. In determining the FTE count, the time a resident spends in patient care activities is counted, including time spent in non-hospital settings if the hospital incurs all, or substantially all, of the training costs in that setting.

A graduate of a foreign medical school is not counted unless the resident has passed parts I and II of the Foreign Medical Graduate Examination in the Medical Sciences (FMGEMS).

Committee Proposal

(a) *Different Weighting Factors for Primary Care and Non-Primary Care Residency Programs.* A fulltime resident in the initial residency period of a primary care residency program would be counted as 1.1 FTE; a fulltime resident in the initial residency period of a non-primary care residency program would be counted as 0.7 FTE. If completion of a primary care training program is a prerequisite for board eligibility in a non-primary care specialty or sub-specialty, a resident would count as 1.1 FTE for the time spent in the primary care residency program. A fulltime resident in training beyond the initial residency period would continue to count as 0.5 FTE.

(b) *Definition of Primary Care Residency Program.* Primary care residency programs would be defined as residency programs in family medicine, general internal medicine, general pediatrics, preventive care, geriatric care and osteopathic general practice.

(c) *Definition of Initial Residency Period.* "Initial residency period" would be defined as the minimum number of years required for board eligibility.

(d) *Preventive Care Residency Programs.* In addition to geriatric residency programs, up to two years spent in preventive care residency programs would not be counted toward the initial residency period.

(e) *Foreign Medical Graduates.* A foreign medical graduate would be counted if the resident has passed parts I and II of the FMGEMS or a successor test recognized by the Secretary.

(f) *Report.* The Secretary would be required to submit by March 31, 1994 a report concerning (1) the causes for the variation in the per resident amounts, (2) whether provision should be made for adjustments in the per resident amounts to recognize substantial changes in operating a residency program since the base year, and (3) any changes that should be made in graduate medical education payments that would promote residency training in non-hospital ambulatory sites. The report should consider the extent to which the variation in per resident amounts is attributable to differences in financial arrangements between sponsoring institutions and af-

filiated hospitals, to actual differences in teaching physician involvement in supervision of residents and in billing for physician services under Part B, and to differences in base year accounting practices. With respect to non-hospital residency programs, the report should address payments for both the direct and indirect costs of graduate medical education.

Effective Dates

(a) Effective for residents entering a primary care or non-primary care specialty training program (including a sub-specialty training program) after the date of enactment.
(b) Effective upon date of enactment.
(c) Effective July 1, 1995.
(d) Effective September 1, 1993.
(e) Effective as if included in COBRA 85.
(f) Effective upon date of enactment.

Revision of Home Health Agency Cost Limits (Section 7302)

Present Law

The Omnibus Budget Reconciliation Act of 1987 (OBRA 87) limited payment for home health agency (HHA) costs to 112 percent of the mean labor-related and nonlabor per visit costs for freestanding HHAs. For hospital-based HHAs, the Secretary is required to make appropriate adjustments in the limits for administrative and general costs. OBRA 87 also provided that the limits must be imposed on an aggregate basis, rather than for each specific discipline (such as skilled nursing, home health aide, or physical therapy).

Committee Proposal

The cost limit would be lowered to 110 percent of the median labor-related and nonlabor per visit costs for all HHAs (freestanding and hospital-based). The add-on for hospital-based HHAs would be eliminated.

Effective Date

Cost reporting periods beginning on or after October 1, 1993.

Secondary Payer (Section 7303)

IRS/SSA/HCFA Data Match

Present Law

The Commissioner of Social Security is required, at least annually, to transmit to the Secretary of the Treasury, a list of the names and tax identification numbers (TINs) of Medicare beneficiaries and request that the Secretary disclose the following to the Commissioner: the name and TIN of each Medicare beneficiary identified as having received wages from a qualified employer in a previous year; for each married Medicare beneficiary whose spouse is identified as having received wages from a qualified employer in a previous year, the name, address and TIN of the employer and

the number of individuals for whom the individual furnished W-2 forms for the previous year. The HCFA Administrator is required to disclose this information to Medicare intermediaries and carriers.

The HCFA administrator is permitted to disclose the following information: (1) to the qualified employer, the name and TIN of Medicare beneficiaries and their spouses receiving wages from the employer, in order to determine the period during which such employees or the employees' spouses may be (or have been) covered under a group health plan of the employer and what benefits are (or were) covered under the plan (including the name, address, and identifying number of the plan); (2) to any group health plan that provides coverage to such an employee or spouse, the name of such an employee or spouse, the name of such employee and the employee's spouse (if the spouse is a Medicare beneficiary), the name and address of the employer and the TIN of the employee and/or spouse if Medicare benefits were paid during the a period in which the plan was a primary plan; and (3) to any agent of the HCFA administrator, the name and TIN of Medicare beneficiaries and spouses receiving wages from a qualified employer and the name, address and TIN of their employers.

Within 30 days of receiving an inquiry, an employer is required to respond to the intermediary or carrier making the inquiry. An employer who willfully fails or repeatedly fails to provide timely and accurate information to the intermediary or carrier is subject to a civil monetary penalty not to exceed $1,000 for each individual for whom an inquiry is made. The requirement to respond to the data match inquiry does not apply to inquiries made after September 30, 1995.

Committee Proposal

The committee provision would extend the requirement to respond to data match inquiries through September 30, 1998. The provision also would permit the Secretary of Health and Human Services (HHS) to request information with regard to wages only above a certain amount. In addition, the Secretary of the Treasury would, upon the request of the Secretary of HHS, be required to disclose the status of any activities undertaken to enforce excise tax penalties on large employer group health plans that do not comply with Medicare secondary payor requirements.

Effective Date

Upon enactment.

Secondary Payer for the Disabled

Present Law

Medicare is secondary payer to specified group health plans offered by employers of 100 or more, for disabled beneficiaries. This provision expires September 30, 1995.

Committee Proposal

The committee provision would extend the requirement that Medicare be secondary payer to employer group health offered by

employers of 100 or more persons to September 30, 1998. (The provision regarding the size of employer subject to secondary payer requirements is amended in another provision).

Effective Date

Applies to items and services furnished after the third calendar month after the date of enactment.

Secondary Payer for End Stage Renal Disease Beneficiaries for 24 Months

Present Law

Medicare is secondary payer to specified group health plans for the first 18 months for which a beneficiary is entitled to Medicare solely on the basis of end stage renal disease. This provision expires September 30, 1995.

Committee Proposal

The committee provision would extend the requirement that Medicare be secondary payer to specified group health plans for beneficiaries who are entitled to Medicare solely on the basis of end stage renal disease for 24 months until September 30, 1998.

Effective Date

Applies with respect to items and services furnished after the third calendar month beginning after enactment.

Secondary Payer Reforms

Present Law

(a) Application to members of religious orders.—Medicare secondary payer provisions do not apply to certain members of religious orders for items and services furnished on or after October 1, 1989.

(b) Uniform Rules for Size of Employer.—Under current law, different rules apply to employer size and type of eligibility for Medicare. For the working aged, secondary payer rules apply to employers with 20 or more employees. For the disabled, secondary payer rules apply to employers with 100 or more employees. For beneficiaries with end stage renal disease, secondary payer rules apply to all employers, regardless of the number of employees.

(c) Permanent Application to Disabled Active Individuals.—Under current law, Medicare is secondary payer to a large group health plan providing benefits to a disabled active individual, which is defined as an individual who (1) is eligible for Medicare on the basis of disability; and (2) continues to be treated an employee by an employer considered commonly accepted indicators of employee status, even though the individual is not currently working. This provision expires October 1, 1995.

Committee Proposal

(a) Application to members of religious orders.—The committee provision would clarify that the Medicare secondary payer provisions do not apply to secondary payer situations identified after October 1, 1989 for services provided prior to such date for members

of religious orders who are "deemed employees" because of an election of Social Security coverage.

(b) Uniform Rules for Size of Employer.—The committee provision would establish a uniform standard regarding application of the secondary payer rules and employer size. Employers, multiemployers, or multiple employer group health plans of 20 or more would be required to comply with secondary payer rules for all Medicare beneficiaries. It would also specify that employees working for employers under common control would be treated as though they work for one employer. It would also specify that the term employer includes a self employed person.

(c) The committee provision would permanently extend Medicare's secondary payer status in relation to large group plans offering health insurance to disabled active individuals.

Effective Date

Provisions (a) and (c)—Enactment. Section (b) applies to items and services furnished after the third calendar month after the date of enactment.

Prohibition on Physician Self Referral (Section 7304)

Present Law

(a) Application of Prohibition.—Physicians are prohibited from referring patients to clinical laboratories in which they have ownership and or compensation arrangements. The law includes general exceptions to these prohibitions and specific exceptions from just the ownership or just the compensation provisions.

(b) In-office ancillary exception.—One of the general exceptions to both the ownership and compensation prohibitions is for in-office ancillary services. In-office ancillary services are defined as services furnished by the physician himself, another physician in the same group practice, or employees of the physician or the physician's group practice. To be exempted from the referral ban, the services must be provided in a building in which the physician or other member of the group practice provides services unrelated to laboratory services, or in a central building set up by the group to perform ancillary services for its members. The services must be billed by the physician performing or supervising the service or by that physician's group, or by an entity owned by the physician or group practice. In addition, the ownership or compensation interests in such in-office ancillary services must meet other requirements as the Secretary may impose by regulation as needed to protect against patient fraud and abuse.

(c) Rural providers.—In addition to general exceptions, the law includes specific exceptions from just the ownership prohibitions and specific exemptions from just the compensation provisions. The law includes an exemption under the ownership prohibition for rural providers.

(d) General Exception Related to Publicly Traded Securities.—There is a general exception related to the ownership or investment prohibition for publicly traded securities whose total assets exceed $100 million.

(e) Exceptions Related to Other Compensation Arrangements.—(1) Rental of Office Space and Equipment.—The law includes specific exceptions from just the compensation prohibitions. One exception is for the rental of office space. There must be a written agreement, signed by the parties, for the rental or lease of the space which: (1) specifies the space covered by the agreement; (2) provides for a term of rental or lease of at least one year; (3) provides for payment on a periodic basis of an amount consistent with fair market value; (4) provides for an amount of aggregate payments that does not vary directly or indirectly based on the volume or value of any referrals between the parties; and (5) would be considered to be commercially reasonable even if no referrals were made between the two parties.

(2) Bona Fide Employment Relationships.—The law provides a specific exception to the compensation prohibition for employment arrangements between a physician (or immediate family member) with hospitals under specified conditions. The employment must be for identifiable services and the amount of remuneration must: (1) be consistent with fair market value of the services; and (2) not determined in a manner that takes into account the volume or value of any referrals by the referring physician. Remuneration must be provided pursuant to an agreement that would be commercially reasonable even if no referrals were made to the hospital and must meet other requirements imposed by the Secretary through regulation to protect against program or patient abuse.

(3) Personal Service Arrangements.—The law provides for exceptions to the compensation prohibition for "other service arrangements" between an entity (other than a hospital) and a physician under specified conditions. The conditions relating to remuneration are the same as those for employment relationships between hospitals and physicians.

(4) Payments by Physicians.—No provision.

(5) Remuneration.—Under current law, remuneration is defined as including any remuneration, directly or indirectly, overtly or covertly, in cash or in kind.

(f) Treatment of Group Practices—

(1) Definition of group practice.—The law contains a definition of group practice for purposes of the self-referral provision. Under this definition, a group practice is defined as a group of two or more physicians legally organized as partnership, professional corporation, foundation, not-for-profit corporation, faculty practice plan or similar association in which: (1) each physician group member furnishes substantially the full range of his or her services through the joint use of shared office space, facilities, equipment, and personnel; (2) substantially all of the services of the physician group members are furnished through the group and billed in the name of the group, with billing receipts treated as receipts of the group; (3) the practice cost expenses and income generated by group members are distributed in accordance with predetermined methodologies; and (4) any additional standards established by the Secretary are satisfied.

(2) Definition of Group Practices.—Some group practices operate full-service laboratories and contract with hospitals and other providers to furnish clinical laboratory services to hospital and other

provider patients "under arrangements" with such entities. Medicare requires that the hospital or other provider bill for such services. These "under arrangements" services are therefore not protected under the general exception for in-office ancillary services.

(3) Faculty practice plans.—Faculty practice plans operated by a hospital fall under the definition of group practice only for those services provided within the faculty practice plan.

(4) Billing Numbers.—No provision.

(g) Definition of Referring physician.—Under current law, a request by a pathologist for clinical diagnostic laboratory tests and pathological examination services, is not considered a referral by a referring physician if such services are furnished by (or under the supervision of) the pathologist pursuant to a consultation requested by another physician.

Committee Proposal

(a) Application of Prohibition.—The committee provision would expand the prohibition on referring patients to services in which a physician has an ownership or investment interest to include the following services: (1) physical or occupational therapy; (2) radiology or other diagnostic services; (3) radiation therapy; (4) the furnishing of durable medical equipment; (5) the furnishing of parenteral and enteral nutrition equipment or supplies; (6) the furnishing of prosthetics, orthotics, and prosthetic devices; and (7) home health services.

(b) In-office ancillary exception.—The committee provision modifies the general exception for in-office ancillary services by exempting ancillary services provided by a group practice with multiple office locations. The following services are excluded from the exception: durable medical equipment; parenteral and enteral nutrition equipment and supplies and ambulance services. Further, the committee provision modifies (as a technical amendment) the current in-office ancillary services exception for services personally performed by and personally supervised by the physician or group; the employment requirement is deleted and direct supervision is required.

(c) Rural providers.—Provides a general exception (in lieu of the current ownership only exception) if the designated health services are furnished in a rural area as defined for purposes of the hospital prospective payment system. The provision specifies that to qualify for the exception, the services are furnished in a rural area and substantially all of the Medicare services are furnished to Medicare beneficiaries residing in the rural area.

(d) General Exception Related to Publicly Traded Securities.—The committee provision would replace the existing exception from the prohibition for publicly traded securities with an exception for interests in corporations with stockholder equity exceeding $75 million.

(e) Exceptions Related to Other Compensation Arrangements.—(1) Rental of Office Space and Equipment.— The committee provision revises exceptions relating to the rental of office space and adds an exception for the leasing of equipment. To qualify for the exception, payments made by a lessee to a lessor must comply with the following conditions: (1) the lease must be set out in writing,

signed by the parties, and specify the premises covered by the lease; (2) the space rented or leased must be reasonable and necessary for the legitimate business purposes of the lease or rental and used exclusively by the lessee when being used by the lessee, except that the lessee may make payment for the use of common areas, if such payments do not exceed the pro rata share of payments for such space, based on the ratio of space used exclusively by the lessees to the total amount of space occupied by all persons using such common areas or contributing to such expenses; (3) the lease must provide for a term of lease or rental of at least one year; (4) the rental charges over the term of the lease are set out in advance, are consistent with fair market value, and are not determined in a manner that takes into account the volume or value of any referrals or other business generated between the parties; (5) the lease would be commercially reasonable even if no referrals were made between the parties; (6) the lease covers all of the premises leased between the parties for the period of the lease; and (7) the compensation arrangement meets other requirements imposed by the Secretary through regulation as needed to protect against program or patient abuse. Similar exceptions are established for equipment leases.

(2) Bona Fide Employment Relationships.—The committee provision applies the exception to an employment arrangement with a physician or an immediate family member of the physician for the provision of services.

The committee provision clarifies that the current prohibition on an arrangement determined in a manner that takes into account the volume or value of referrals. It specifies that this is not to be construed as prohibiting the payment of remuneration in the form of a productivity bonus based on services personally performed by the physician or family member.

(3) Personal Service Arrangements.—The committee provision establishes an exception for personal services arrangements under which remuneration is made from an entity under an arrangement provided the following conditions are met. The arrangement must be in writing, signed by the parties, specify the covered services and cover all of the services to be provided. The aggregate services contracted for must not exceed those reasonable and necessary for legitimate business purposes. The arrangement must be for at least 1 year. Compensation, set in advance, must not exceed fair market value and not be set in a manner that takes into account the volume or value of any referrals or other business generated between the parties. Further, the services provided cannot involve counseling or promotion of a business arrangement that violates the law. Further, it must meet other requirements imposed by the Secretary as needed to protect against program or patient abuse. The provision retains the current law exception for "other service arrangements" involving remuneration only.

(4) Payments by Physicians.—The committee provision would add an exception for payments made by physicians to: (a) a lab in exchange for lab services, or (b) an entity as compensation for other items and services if such items and services are furnished at a price that is consistent with fair market value.

(5) Remuneration.—The committee provision amends the definition of remuneration. Remuneration is defined as not including: (1) the forgiveness of amounts owed for inaccurate tests or procedures, mistakenly performed tests or procedures, or the correction of minor billing errors; and (2) the provision of items, devices, or supplies of minor value that are used to collect, transport, process, or store specimens for the entity providing the item, device or supply, or to communicate the results of tests or procedures for such entity.

(f) Treatment of Group Practices—

(1) Definition of group practice.—The committee provision expands the standards used to define a group practice. No physician who is a member of the group can receive compensation based on the volume or value of referrals by the physician except that: (a) a physician may be paid shares of overall profits of the group as long as the share is not determined in any manner which is directly related to the volume or value of referrals by that physician; and (b) a physician can be paid a productivity bonus under the same conditions. The group may have no less than, on average, five physicians for each office location, except groups of less than fifteen physicians may have up to three office locations. Further, members of the group must personally conduct no less than 75 percent of the physician-patient encounters of the group practice.

The committee provision specifies that for purposes of the standard, the term office location is an office where physician services are offered to patients. Excluded from the definition are locations consisting solely of diagnostic facilities, nursing facilities, treatment facilities (such as physical or occupational therapy centers) or administrative services affiliated with the group practice. Any office location which is physically located immediately adjacent to another office location is treated as the same office location. Offices located in rural areas (as defined for purposes of the prospective payment system) are not included as an office location so long as at least 85 percent of the physician services at these locations are provided to individuals who reside in such rural areas.

(2) Group Practice Arrangements with Hospitals.—The committee provision adds an additional exemption to the list of exceptions to the compensation prohibition. The exception is for an arrangement between a hospital and a group practice for the provision of designated health services by the group but billed through the hospital if the group would, except for the billing arrangement, be a group practice. The arrangement must: (a) be pursuant to the provision of inpatient hospital services; (b) have begun before December 19, 1989 and have continued uninterrupted since that date; (c) provide substantially all of the designated health services furnished under arrangements to the hospital's patients; (d) be pursuant to an agreement that is set out in writing and that specifies the services to be provided by the parties and the compensation for the services provided under the arrangement; (e) provides that the compensation paid over the term of the agreement is consistent with fair market value and that the compensation per unit of service be fixed in advance and not be determined in a manner that takes into account the volume or value of referrals or other business generated between the parties; (f) provide that the compensation is provided pursuant to an agreement that would be commer-

cially reasonable even if no referrals were made by the entity; and (g) meet such other requirements imposed by the Secretary in regulation as needed to protect against patient or program abuse.

(3) Faculty practice plans.—The committee provision modifies the definition of group practice to expand the definition of faculty practice plans to include those associated with a university or medical school, in addition to those operated by a hospital.

(4) Billing Number.—The committee provision specifies that when services are billed by a physician member of a group practice, the billing number of the group is to be used.

(g) Definition of Referring physician.—The committee provision specifies that a request by a radiologist for diagnostic radiology services and a request by a radiation oncologist for radiation therapy do not constitute a referral by a referring physician if the services are furnished by (or under the supervision of) such physician pursuant to a consultation requested by another physician.

Effective Date

Applies to referrals made on or after January 1, 1992, except that extension to additional designated health services applies to physician referrals made after December 31, 1994.

Reducing Payment for Erythropoietin

(Section 7305)

Present Law

Medicare is the principal purchaser of a erythropoietin, an anti-anemia drug given end stage renal disease (ESRD) beneficiaries with a specified level of anemia. Payment for the drug is made as an add-on to the composite rate paid to facilities for dialysis treatment. Payments to facilities are made in increments of 1,000 unit doses, rounded to the nearest 100 units, with a maximum payment of $11 per 1,000 units.

Committee Proposal

The committee provision would reduce Medicare payments for EPO by $1.00 per 1,000 units. The provision would not alter payments to physicians for EPO.

Effective Date

Applies to erythropoietin furnished after 1993.

OTHER HEALTH PROGRAMS

Health Coverage Clearinghouse

(Section 7904)

Present Law

No provision.

Committee Proposal

The committee provision would establish a clearinghouse to increase information available to Medicare and Medicaid on third party health insurance coverage available to program beneficiaries.

Employers would be required to include limited health insurance information on employees' W-2s. This information, along with other information regarding Medicare beneficiaries and their spouses which the IRS may disclose, would be available to appropriate Federal program administrators through the clearinghouse.

The committee provision would amend the Internal Revenue Code to require that W-2s indicate whether an employee obtained (or could have obtained) coverage under group health insurance offered by the employer.

The clearinghouse would channel all computer matches of tax return information with lists of health program beneficiaries. The clearinghouse would also be authorized to assist these programs in collecting amounts due from insurers and would maintain a data bank of information obtained through computer matches and contacts with employers. Employers who failed to provide information on health insurance coverage would be subject to civil monetary penalties.

Effective Date

April 1, 1995.

SUBTITLE B—MEDICAID PROGRAM

Part I—Program Savings Provisions

Subpart A—Repeal of Mandate

Rescind Personal Care Mandate (Section 7401)

Present Law

As enacted in OBRA 90, states are required to provide personal care services to Medicaid-eligible individuals entitled to nursing facility benefits, starting in October 1994, under the mandatory home health benefit.

Committee Proposal

Clarifies the original intent of Congress to specify the conditions under which optional personal care services can be provided by rescinding the personal care services mandate, and retaining the State option to provide these services. Personal care can be provided to an individual who is not a resident or inpatient of a nursing facility or other medical institution, and must be authorized by a physician and supervised by a registered nurse. The personal care provider must be qualified to provide such services and cannot be a member of the individual's family. Services can be provided in the home or other location.

Effective Date

Amendments made by this section shall take effect as if included in the enactment of section 4721(a) of OBRA-1990.

Subpart B—Outpatient Prescription Drugs

Drug Formularies
(Section 7411)

Present Law

Requires drug manufacturers to provide rebates to State Medicaid programs as a condition of coverage of their products. The rebates required by current law include (1) a basic rebate designed to ensure that states are paying less than the average manufacturer price (AMP) for a product, and (2) an additional rebate designed to ensure that increases in Medicaid's prescription drug prices do not exceed inflation in the general economy. States must permit the coverage of all products of a manufacturer who has a rebate agreement in effect except for those classes of drugs expressly listed in law which a state can exclude or otherwise restrict. States, however, do have the discretion to impose prior authorization on any covered outpatient drug. The only exception to this discretionary authority is that States may not impose such controls during the first 6 months after a drug has been approved for marketing by the Food and Drug Administration.

Committee Proposal

Permits States to operate Medicaid drug formularies under certain conditions. A State's formulary must be developed by the State's drug use review board or a committee consisting of physicians, pharmacists, and other appropriate individuals appointed by the Governor of the State. The formulary established by the committee generally must include each covered outpatient drug of a manufacturer, except that it can exclude a drug from coverage if it is contained in section 1927(d)(2) of the Social Security Act (*e.g.*, drugs used for cosmetic purposes). The formulary also can exclude a drug with respect to the treatment of a specific disease for an identified population if the committee determines that the product does not have a significant, clinically meaningful therapeutic advantage in terms of safety, effectiveness, or clinical outcome over a drug already on the formulary. Any such exclusion must be based on the drug's labeling, or in the case of off-label uses, on the basis of certain compendia. While the statute establishes federal minimum sources of information for use in determining whether to include a particular drug on a formulary, the formulary committee can use its judgment about the extent to which peer reviewed medical literature or other sources will be used in making a determination about a specific drug. The committee will have met its obligations under federal statute, however, in using the FDA labeling and appropriate compendia as specified above. Drugs excluded from the formulary, except for those drugs listed as excludable in statute, must be made available through a prior authorization process. The committee must make public, in writing, its findings relative to exclusion of a covered outpatient drug from the formulary.

Effective Date

Amendments made by this section shall apply to calendar quarters beginning on or after October 1, 1993, without regard to

whether or not regulations to carry out such amendments have been promulgated by such date.

Treatment of New Drugs Under Medicaid (Section 7412)

Present Law

Medicaid programs are prohibited from imposing prior authorization conditions on drugs for a 6-month period following their approval by the Food and Drug Administration.

Committee Proposal

Eliminates the six months special exemption accorded to newly approved drugs and permits states to restrict access to new drugs approved by the Food and Drug Administration through prior authorization conditions or through exclusion using a State's formulary process.

Effective Date

Amendments made by this section shall apply to calendar quarters beginning on or after October 1, 1993, without regard to whether or not regulations to carry out such amendments have been promulgated by such date.

Modifications to Drug Rebate Program (Section 7413)

Present Law

a. *Rebate Formula.* Manufacturers of covered outpatient drugs pay basic rebates to States to assure that State Medicaid programs receive the lower of the manufacturer's "best price" (with certain statutory exceptions) for that drug or a minimum discount. Manufacturers also pay an additional rebate to the States based on the amount by which their prices for single-source and innovator multiple-source drugs exceed the rate of inflation. The additional rebate is based on the difference between the drug's current Average Manufacturer Price (AMP) and the AMP on October 1, 1990, indexed by the CPI–U (urban consumer price index). Prior to 1994, the rebate is calculated on a drug-by-drug basis. After 1994, the amount of the rebate is to be calculated on an aggregate basis for each manufacturer's product line, weighted for volume.

b. *Maximum Allowable Cost Limitations.* States may impose "maximum allowable cost" (MAC) limitations on the reimbursement for generic drugs.

Committee Proposal

a. *Rebate Formula.*

(1) Changes the base date from which Medicaid price increases are calculated from the AMP on October 1, 1990, to the average AMP during the period from July 1 to September 30, 1990. Provides that, for drugs approved after October 1, 1990, the base date is the AMP during the first full calendar quarter after which the drug was marketed. Changes the base CPI–U to be used to calculate the additional (inflation) rebate from the CPI–U on October

1, 1990, to the average CPI–U during the month of September, 1990. Provides that, for drugs approved after October 1, 1990, the base CPI–U level to be used is the CPI–U during the first full month prior to the first full calendar quarter in which the drug was marketed.

(2) Strikes provision that requires that the additional (inflation adjusted) rebate after 1994, be calculated on the basis of the weighted AMP (WAMP) for all the drugs in a manufacturer's product line.

(3) Clarifies that for purposes of computing the additional (inflation adjusted) rebate for any covered outpatient drug that is sold or transferred to another entity (including a subsidiary), the base date after the sale or transfer shall remain the original base date established for the drug.

b. *Maximum Allowable Cost limitations.* Adds a new subsection (l) to section 1927 of the Social Security Act to clarify that the prescription drug rebate law, particularly the moratorium on changes in pharmacy reimbursement, does not supersede or affect provisions of the law relating to the States' use of MAC limitations in effect prior to January 1, 1991.

Effective Date

The rebate formula provision related to the sale or transfer of a drug is effective upon enactment, all other provisions are effective as if included in OBRA 90.

Subpart C—Restrictions on Divestiture of Assets and Estate Recoveries

Estate Recoveries

(Section 7421)

Present Law

States have the option to recover the costs of all Medicaid expenditures from the estates of deceased Medicaid clients who were at least 65 years old when they were eligible for Medicaid. Recoveries may not be made from an individual's estate until the death of the surviving spouse, and only at such time as there is no surviving child under 21 years old or a surviving child who is blind or permanently and totally disabled. Current law does not specify a definition of estate.

Committee Proposal

Extends current law as a mandate on all states. Provides a minimum definition of estate as including all real and personal property and other assets included within estate as defined by state laws governing treatment of inheritance. Allows states to expand the definition of estate to include other real or personal property or other assets in which the individual had any legally cognizable title or interest at the time of death, including such assets conveyed to a survivor, heir, or assignee of the deceased individual through joint tenancy, survivorship, life estate, living trust, or other arrangement. Requires state to develop procedures for determina-

tions of hardship and requires the Secretary to develop standards for those procedures and criteria for granting hardship exemptions.

Effective Date

Amendments made by this section shall apply to Medicaid payments made for calendar quarters beginning on or after October 1, 1993, or, if the Secretary of Health and Human Services determines that State legislation is needed, the State plan shall not be regarded as failing to comply with the requirements of this section before the first day of the first calendar quarter beginning after the first regular session of the State legislature that begins after the date of the enactment of this Act. In States with a 2-year legislative session, each year of such a session shall be deemed to be a separate regular session of the State legislature for the purposes of establishing the effective date of this section.

Transfer of Assets and Medicaid Qualifying Trusts (Sections 7422 and 7423)

Present Law

When an individual applies for Medicaid long term care service coverage (either institutional or community services under Sec. 1915 (c) or (d)) states are to review the prior 30 months to ascertain whether the individual transferred resources for less than fair market value which would result in a period of ineligibility for long term care services. If such a transfer has occurred, a person is made ineligible for the above listed long term care services for a period of time equal to the dollar amount of the transfer divided by the average cost of nursing home care at private pay rates. The penalty period is limited to no more than 30 months and begins retroactively on the date of the transfer. The penalty period in the case of multiple transfers runs concurrently.

Under Medicaid law, Medicaid Qualifying Trusts (MQTs) are those grantor trusts or similar legal devices established by an individual (or the individual's spouse) where all or part of the payments from the trust benefit the individual. Only trusts where the trustee(s) can exercise discretion over distributions from the trust are MQTs. These trusts are classified as MQTs regardless of whether or not a trustee exercises discretion over payments, whether or not the trust is revocable, and whether or not the individual (grantor) established the trust for the purpose of qualifying for Medicaid. Payments from the MQT are to be counted as income in determining Medicaid eligibility.

Committee Proposal

Transfers—Eliminates the 30 month maximum limit on the penalty period so that larger transfers result in longer periods of ineligibility. Expands the definition of transfer to include both transfers of income and resources. Requires that penalties for multiple transfers run consecutively rather than concurrently. Begins the penalty period on the date that application for eligibility is made. Treats as a transfer any action that reduces or eliminates an individual's ownership or control in a jointly owned asset to the extent that such action is not consistent with partial ownership. Limits trans-

fers from the institutional to the community spouse, which are not subject to transfer penalties, to no more than the Community Spouse Resource Allowance. This provision is intended to clarify that the Community Spouse Resource Allowance does apply to transfers other than those made pursuant to a court order or a fair hearings process.

Requires that when calculating the penalty period based on private pay nursing facility rates, the state shall include in the private pay costs all nursing facility related costs covered under a state's Medicaid per diem. Prohibits states from imposing a penalty when the transferred assets have been returned to the individual. In demonstrating whether an individual transferred assets for purposes of Medicaid eligibility, requires states to consider the individual's health status at the time of the transfer and whether the individual retained sufficient assets after the transfer to take care of his/her foreseeable needs. Requires states to develop methodologies for apportioning the penalty period between spouses in situations where the community spouse enters a nursing home and applies for Medicaid during the time the institutionalized spouse is in a period of penalty and therefore ineligible, so that the second spouse to enter the nursing home does not have to undergo another full period of ineligibility for the same transfer, as can occur under current law. Requires states to establish threshold amounts so that if the sum total of transfers during the look back period is below the threshold amount, the transfer will be deemed not to have occurred for purposes of Medicaid eligibility. Prohibits nursing homes from requiring any financial information other than to identify the source of payment the individual intends to use. Through a process of financial screening, facilities accomplish what the nursing home reform act intended to limit, assuring that an individual will pay privately for a certain period of time before becoming eligible for Medicaid. This provision is intended to clarify that such financial screening is prohibited while retaining the nursing facility's right to inquire about the source of payment of an applicant or resident.

Requires the Secretary to publish regulations concerning diminution or elimination of control or ownership of jointly held assets; criteria for making determinations of transfers not done for purposes of Medicaid eligibility; and criteria for determinations of hardship.

Allows states, at their option, to look back up to 4 years. Provides states the option to apply transfer rules to applications for home and community based long term care other than waiver program services subject to restrictions imposed by the Secretary.

Trusts—Treats most grantor trusts as either resources or illegal transfers. In the case of revocable trusts, the corpus of the trust is treated as a resource, payments from the trust to, or for the benefit of, the individual are treated as income, and any other payments from the trust are to be treated as a transfer. An irrevocable trust is to be treated as an MQT if there is any situation under which payments could be made from the trust for the benefit of the individual, in which case the corpus and payments from the trust will be treated the same as revocable trusts. An irrevocable grantor trust from which no payments may be made to the individual, shall be treated as a transfer of resources. Clarifies the definition of

grantor trust to specify trusts established by the individual, the individual's spouse, or any person (including a court or administrative body) acting at the direction or upon the request of the individual (or spouse).

Creates exemptions from the MQT provisions for two types of grantor trusts. The first of these, 'special needs' or 'supplemental needs' trusts, would be exempted if the trust is established using the assets of an individual who is determined disabled under SSI rules, and the trust is established by a parent, grandparent, legal guardian or a court. Further, all funds remaining in the trust, up to the amount expended for medical assistance, must revert to the state upon the death of the individual. The second type of trust, known as "Miller Trusts" would be exempted if the trust is composed only of the individual's income including Social Security and pension and the individual is seeking nursing home services in a state that does not provide nursing facility services to the medically-needy population (or does not have a medically needy spenddown program). The amounts remaining in the trust, up to the amount expended for medical assistance, must revert to the state upon the death of the individual.

The Secretary is required to specify standards for states to use in developing procedures in applying hardship waivers of this provision for individuals.

Effective Date (for transfer of asset provisions)

Applies to Medicaid payments made on or after October 1, 1993, except with respect to assets disposed of before 60 days after the date of enactment of this Act, and, except if the Secretary of Health and Human Services determines that State legislation is needed for the State plan to be in compliance. In this case, the State plan shall not be regarded as failing to comply with the additional requirements contained in this section before the first day of the first calendar quarter beginning after the first regular session of the State legislature that begins after the date of the enactment of this Act. In States with a 2-year legislative session, each year of such a session shall be deemed to be a separate regular session of the State legislature for the purposes of establishing the effective date of this section.

Effective Date (for treatment of certain trusts)

Applies to Medicaid payments for calendar quarters beginning on or after October 1, 1993, except with respect to trusts established before the date which is 60 days after the date of the enactment of this Act, and, except if the Secretary of Health and Human Services determines that State legislation is needed for a State plan to be in compliance. In this case, the State plan shall not be regarded as failing to comply with the additional requirements contained in this section before the first day of the first calendar quarter beginning after the first regular session of the State legislature that begins after the date of the enactment of this Act. In States with a 2-year legislative session, each year of such a session shall be deemed to be a separate regular session of the State legislature for the purposes of establishing the effective date of this section.

Subpart D—Improvement in Identification and Collection of Third Party Payments

Third Party Liability Improvements (Section 7431)

Present Law

States are required to pursue third party collections under a variety of conditions. As a condition of eligibility, an individual must assign to the State any rights to payment for health insurance coverage. The individual is also required to cooperate with the State in identifying, and providing information to assist the State in pursuing, any third party who may be liable to pay for medical services, unless the State medicaid agency determines that the individual has good cause for refusing to do so.

Committee Proposal

Requires states to enact laws prohibiting insurers (including ERISA plans, health maintenance organizations, and service benefit plans) from taking into account an individual's Medicaid eligibility status when enrolling an individual, or making benefit payments to, or on behalf of, that individual. Also requires states to enact laws to require insurers to recognize state rights to collect from liable third parties for expenditures already paid out by Medicaid on behalf of a Medicaid client who has private health insurance.

Effective Date

Applies to Medicaid payments made for calendar quarters beginning on or after October 1, 1993, except if the Secretary determines that a state must pass laws in order to comply with certain provisions of this section. In this case, the State has until the first day of the first calendar quarter beginning after the close of the first regular session of the State legislature. For states with a two-year legislative session, each year of their legislative session shall be deemed a separate regular session of the legislature for the purposes of this section.

Medical Child Support Enforcement (Section 7432)

Present Law

The Child Support Enforcement Amendments of 1984 (P. L. 98-378) required the Secretary of Health and Human Services to issue regulations requiring State child support enforcement agencies to petition for the inclusion of medical support as part of any child support order whenever health care coverage is available to an absent parent at a reasonable cost.

Title XIX of the Social Security Act requires State Medicaid plans to provide that, as a condition of eligibility for Medicaid, an individual must assign to the State any rights to medical support that has been ordered by a court or administrative order. The individual is also required to cooperate with the State in identifying, and providing information to assist the State in pursuing, any

third party who may be liable to pay for medical services, unless the State Medicaid agency determines that the individual has good cause for refusing to do so.

Committee Proposal

Each State would be required to have laws that:

(1) prohibit an insurer from denying enrollment of a child under the health insurance coverage of the child's parent on the grounds that the child was born out of wedlock, is not claimed as a dependent on the parent's Federal income tax return, or does not reside with the parent or in the insurer's service area;

(2) require an insurer and an employer doing business in the State, in any case in which a parent is required by court or administrative order to provide health coverage for a child and the child is otherwise eligible for family health coverage through the insurer, (a) to permit the parent, upon application and without regard to any enrollment season restrictions, to enroll such child under such family coverage; (b) if the parent fails to provide health insurance coverage for a child, to enroll the child upon application by the child's other parent or the State child support or Medicaid agency; and (c) with respect to employers, not to disenroll (or eliminate coverage of) the child unless there is satisfactory written evidence that the order is no longer in effect, or the child is or will be enrolled in comparable health coverage through another insurer that will take effect not later than the effective date of the disenrollment;

(3) require an employer doing business in the State, in the case of health insurance coverage offered through employment and providing coverage for a child pursuant to a court or administrative order, to withhold from the employee's compensation the employee's share of premiums for health insurance, and to pay that share to the insurer. The Secretary of Health and Human Services may provide by regulation for such exceptions to this requirement as the Secretary determines necessary to ensure compliance with an order, or with the limits on withholding that are specified in section 303(b) of the Consumer Credit Protection Act;

(4) prohibit an insurer from imposing requirements upon a State agency, which is acting as an agent or assignee of an individual eligible for medical assistance and covered by the insurer, that are different from requirements applicable to an agent or assignee of any other individual;

(5) require an insurer, in the case of a child who has coverage through the insurer of a noncustodial parent, (a) to provide the custodial parent with the information necessary for the child to obtain benefits; (b) to permit the custodial parent (or provider, with the custodial parent's approval) to submit claims for covered services without the approval of the noncustodial parent; and (c) to make payment on claims directly to the custodial parent or the provider; and

(6) permit the State Medicaid agency to garnish the wages, salary, or other employment income of, and to withhold State tax refunds to, any person who (a) is required by court or administrative order to provide health insurance coverage to an individual eligible for Medicaid, (b) has received payment from a third party for the costs of medical services to that individual, and (c) has not reim-

bursed either the individual or the provider. The amount subject to garnishment or withholding would be the amount required to reimburse the State agency for expenditures for costs of medical services provided under the Medicaid program. However, claims for current or past-due child support shall take priority over any claims for the costs of medical services.

Effective Date

April 1, 1994, or, if the Secretary determines that State legislation is needed, the State plan shall not be regarded as failing to comply with the requirements of title IV–D because it has not met these additional requirements before the first day of the first calendar quarter beginning after the close of the first regular session of the State legislature that begins after the date of enactment.

Offset of Payment Obligations Relating to Medical Assistance Against Overpayments of State and Federal Income Taxes

(Section 7433)

Present Law

There is no provision to allow states to collect for overpayments using the Internal Revenue Service refund intercept system. States are permitted to use a federal intercept system for past due child support payments and, on a pilot basis, food stamp overpayments. Current HCFA policy requires states to 'cost avoid' most medical claims which means that the state sends a claim for services to a known third party for payment before the Medicaid agency will pay. Current law requires that in the case of pregnancy related or preventive pediatric care, the state receiving a claim must first pay the claim, then seek recovery from a liable third party. The Committee understands that while the intent of this provision is to assure timely access to needed services, the requirement has created some problems, particularly in situations of medical support where the absent parent is living out of state and erroneously receives payment under an insurance policy that should have been remitted to the state agency.

Committee Proposal

Permits states to request an intercept of federal income tax return funds for Medicaid overpayments. The Committee expects this provision to supplement existing state recovery efforts. While an intercept can be used for any legally enforceable debt for medical assistance, the intercept should be particularly useful with specific reference to payments erroneously made by insurers to policyholders (such as absent fathers in medical support situations) when a state has insufficient other means by which to obtain recognition of state's rights of assignment from insurers operating out of state. Upon receiving notice from any state, the Secretary of the Treasury is directed to reduce the amount of any refund by the amount of the overpayment and send that money to the requesting state. State Medicaid programs may access the Federal intercept program only if the state (which has a state income tax) has in place a state tax refund intercept system for the collection of overpayments. The

Secretary of the Treasury, in consultation with the Secretary of Health and Human Services, shall issue regulations which prescribe the timing, manner and format of state Medicaid agency notification to the Secretary of payment obligations, the minimum payment obligation that must be requested, and the fee to the state for the intercept. The Secretary of the Treasury will notify the Secretary of HHS annually of the states requesting an intercept and the amounts collected for each state. Prior to sending notice to the Treasury, the state agency must notify the individual against whom there is a legally enforceable claim to explain that a withholding is pending and to inform the individual how to contest the state's finding that an amount is owed, or to contest the size of the amount.

Effective Date

Amendments from this section relating to the Internal Revenue Code of 1986 shall be effective for taxable years beginning after December 31, 1993. Amendments from this section relating to the Social Security Act shall apply to calendar quarters beginning on or after December 31, 1993, except if the Secretary determines that State legislation is required in order to comply with these provisions. In this case, the state has until the first day of the first calendar quarter beginning after the close of the first regular session of the State legislature to comply with this section. For states with a two-year legislative session, each year of their legislative session shall be deemed a separate regular session of the legislature for the purposes of this section.

Subpart E—Assuring Proper Payments to Disproportionate Share Hospitals

Limit Medicaid Payments to Disproportionate Share Hospitals (Section 7441)

Present Law

States are required to make supplemental payments to hospitals that serve a larger than average (disproportionate) number of low income or Medicaid clients. The law sets out minimum standards by which a hospital may qualify as a disproportionate share hospital, and minimum payments to be made to those hospitals. States are generally free to exceed federal minimums in both designation and payment.

Committee Proposal

Limits the amount states may pay public or other government affiliated hospitals to no more than the cost of care provided to Medicaid recipients and the individuals who have no health insurance or other third party coverage for services provided during the year (net of non-disproportionate share Medicaid payments and payments by the uninsured). Payments made to hospitals for services provided to indigent patients made by a state or unit of local government shall not be considered to be a source of third party payment. Also limits state ability to designate these hospitals by re-

quiring that any disproportionate share hospital serve at least 1% Medicaid clients among its caseload.

Effective Date

Applies to payments to states made after the end of the State fiscal year that ends during 1995.

Subpart F—Anti-Fraud and Abuse Provisions

Limitations on Physician Referrals (Section 7451)

Present Law

Under current law, physicians with certain ownership and/or compensation arrangements with clinical laboratories are prohibited from referring Medicare patients to these clinical laboratories. The Committee bill extends these self referral prohibitions to other designated health services.

Committee Proposal

Extends the Medicare rules to the Medicaid program.

Effective Date

Applies to services and items furnished on or after October 1, 1993.

PART II—OTHER MEDICAID PROVISIONS

Extension of OBRA 90 Demonstration Project (Section 7501)

Present Law

The Omnibus Budget Reconciliation Act of 1990 (OBRA 1990, section 4745) established a 4-year, $40 million demonstration program to study the effects of allowing 3 to 4 States to provide Medicaid coverage to individuals in uninsured families with incomes below 150 percent of the Federal poverty line who are not otherwise eligible for Medicaid. Families with incomes below 100 percent of the poverty level cannot be subject to any premiums, deductibles, or other cost-sharing; families with incomes between 100 and 150 percent of the poverty level may not be subject to cost-sharing in excess of 3 percent of the family's average gross monthly earnings. If the Secretary determines that it is cost-effective for the project to utilize employer coverage, an employer contribution is required. Federal funds available for the project are limited to $12 million in each of fiscal years 1991, 1992 and 1993, and $4 million in FY 1994. These demonstrations did not commence, however, until FY 1992, and are not expected to be completed until FY 1995.

Committee Proposal

Specifies that the Federal expenditures authorized for the OBRA 1990 demonstration project will remain available until expended.

Effective Date

The amendments made by this section shall take effect as if included in the enactment of OBRA–1990.

Subtitle C—Income Security Provisions

Federal Matching for AFDC Administrative Costs (Section 7601)

Present Law

In general, the Social Security Act provides 50 percent Federal matching funds to the States for the costs of administering the Aid to Families with Dependent Children (AFDC) program. However, enhanced matching at the rate of 100 percent is available for the costs of verifying with the Immigration and Naturalization Service the immigration status of aliens; 90 percent for the costs of planning, designing, developing, or installing statewide information and management systems, and 75 percent for the costs of carrying out specified fraud control programs. (Enhanced matching for certain administrative activities is also available to the territories in the operation of their programs for the aged, blind, and disabled under titles I, X, XIV and XVI of the Social Security Act.) In addition, under current law, States must require all adult members of a family or household to sign a written declaration attesting to their own and their children's citizenship status for purposes of the AFDC, Medicaid, and other programs.

Committee Proposal

The Federal matching rate available to the States for all AFDC administrative costs would be limited to 50 percent. (A similar change would apply to the programs for the aged, blind and disabled in the territories.) The requirement that all adult members of a family or household must sign a written declaration attesting to their own and their children's citizenship status would be modified. Instead, one adult would be allowed to sign for the entire family or household. A family or household member would not be required to attest to the status of a newborn until the household's next determination.

Effective Date

The amendment applies to payments made for calendar quarters beginning on or after April 1, 1994; or, in the case of a State whose State legislature is not scheduled to have a regular legislative session in 1994, the new matching requirements would be effective no later than the first day of the first calendar quarter beginning after the close of the first regular session of the State legislature that begins after the date of enactment.

State Paternity Establishment Programs (Section 7602)

Present Law

The Child Support Enforcement program was enacted as Part D of title IV of the Social Security Act in 1975. Its purpose is to locate absent parents, establish paternity, obtain child and spousal support, and assure that assistance in obtaining support is available to all children (whether or not eligible for Aid to Families with Dependent Children—AFDC) for whom such assistance is requested.

As a condition of eligibility for AFDC, each applicant or recipient must assign the State any right to support which she may have in her own behalf or in behalf of children in the family, and must cooperate with the State in establishing paternity and in obtaining support payments. States are also required to provide child support services to families who are not eligible for AFDC upon their application for services.

The Federal government pays 66 percent of State and local administrative costs for services on an open-ended entitlement basis. In addition, 90 percent Federal matching is available on an open-ended entitlement basis to States for the costs of establishing an approved automated data processing and information retrieval system.

The Family Support Act of 1988 required the States to meet paternity establishment requirements specified in law. To meet these requirements, a State's paternity establishment percentage must be at least 50 percent or it must equal or exceed the average for all States, or have increased by 3 percentage points from fiscal year 1988 to 1991, and by 3 percentage points each year thereafter.

A State's paternity establishment percentage is: the number of children in the State who are born out of wedlock, are receiving AFDC benefits or title IV–D child support enforcement services, and for whom paternity has been established, divided by the number of children who are born out of wedlock and are receiving AFDC or IV–D child support services.

The 1988 Act also: required each State to require a child and all other parties in a contested paternity case to submit to genetic tests upon the request of any party; encouraged each State, in the administration of its program, to implement a simple civil process for voluntarily acknowledging paternity, and a civil procedure for establishing paternity in contested cases; and provided 90 percent Federal matching for the costs of laboratory testing to establish paternity.

Committee Proposal

New State paternity performance standards would be established. The proposal would require that a State's paternity establishment percentage be based on the most recent data available that are determined by the Secretary to be reliable, and must (1) be 75 percent, or (2) have increased by 3 percentage points over the previous fiscal year for a State with a percentage of not less that 50 percent but less than 75 percent, or by 6 percentage points over the previous fiscal year for a State with a percentage below 50 percent.

In addition, each State would be required to have in effect laws requiring the use of additional procedures designed to improve the effectiveness of paternity establishment, including procedures:

(1) for a simple civil process for voluntarily acknowledging paternity under which the State must explain the rights and responsibilities of acknowledging paternity and must afford due process safeguards. The procedures must include (a) a hospital-based program for the voluntary acknowledgement of paternity during the period immediately preceding or following the birth of a child, and (b) the inclusion of signature lines on applications for official birth certificates which, once signed by the father and the mother, constitute a voluntary acknowledgment of paternity;

(2) under which the voluntary acknowledgement of paternity of a child creates a rebuttable or, at the option of the State, conclusive presumption that the individual is the father of the child, and under which such a voluntary acknowledgement is admissible as evidence of paternity;

(3) under which the voluntary acknowledgment of paternity must be recognized as a basis for seeking a support order without first requiring any proceedings to establish paternity;

(4) which provide that any objection to genetic testing results must be made in writing within a specified number of days prior to any hearing at which such results may be introduced in evidence, and if no objection is made, the test results are admissible as evidence of paternity without the need for foundation testimony or other proof of authenticity or accuracy;

(5) which create a rebuttable or, at the option of the State, conclusive presumption of paternity of a child, upon genetic testing results indicating a threshold probability of the alleged father being the father of the child; and

(6) which require a default order to be entered in a paternity case upon a showing that process has been served on the defendant and any additional showing required by State law.

In addition, States would be required, rather than encouraged, to have expedited processes for paternity establishment in contested cases, and to give full faith and credit to a determination of paternity made by any other State, whether established through voluntary acknowledgement or through administrative or judicial processes.

Effective Date

October 1, 1993, or, if later, upon enactment by the legislature of the State of all laws required by the amendments, but in no event later than the first day of the first calendar quarter beginning after the close of the first regular session of the State legislature that begins after the date of enactment. In the case of a State that has a 2-year legislative session, each year of such session shall be deemed to be a separate regular session of the State legislature.

Fees for Federal Administration of SSI State Supplements (Section 7603)

Present Law

Since the Supplementary Security Income (SSI) program began in 1974, States have had the option of supplementing the Federal SSI payment (currently $434 a month for an individual, and $652 for a couple) and of having these supplements administered by the Social Security Administration. Currently, the Social Security Administration administers the supplementation program for 27 States and the District of Columbia. There is no provision in the statute allowing the Federal government to charge a fee for administering these programs.

Committee Proposal

The Secretary of Health and Human Services is directed to assess the States a fee for each monthly State supplementary benefit payment made by the Federal government on the State's behalf. The fee is $1.67 per payment in fiscal year 1995, $3.33 in fiscal year 1996, $5.00 in fiscal year 1997; and in fiscal year 1998 and each succeeding year, $5.00 or such different rate as the Secretary establishes in regulations, taking into account the complexity of the State's supplementary program.

In addition, the Secretary is directed to charge an additional services fee if, at the request of the State, the Secretary provides additional services beyond the level customarily provided in the administration of State supplementary payments. This fee shall be in an amount that the Secretary determines is necessary to cover all costs incurred by the Federal government in furnishing the additional services.

Effective Date

The amendment applies to supplementary payments made for any calendar month beginning after September 30, 1994, and to services furnished after such date, regardless of whether regulations have been promulgated or existing agreements have been modified.

Subtitle D—Miscellaneous Provisions

PART I—TRADE PROVISIONS

Extension of Customs User Fees (Section 7701)

Present Law

Section 13031(a) of the Consolidated Omnibus Budget Reconciliation Act of 1985 authorizes the Customs Service to collect user fees for certain services. Flat rate fees ("COBRA" fees) are imposed for the processing of air and sea passengers, commercial vessels, barges, rail cars, trucks, dutiable mail packages and Customs broker permits. Fees collected reimburse appropriations for the costs incurred by Customs in providing inspectional overtime and

preclearance services. Expenditures are also authorized from surplus revenues in excess of $30 million to hire additional inspectors and acquire equipment.

Customs also collects a 0.19 percent ad valorem merchandise processing fee (MPF) on the value of formally entered imported commercial cargo, subject to a $21 minimum and $400 maximum fee. In addition, a $2, $5, or $8 entry fee is charged for processing informal entries valued below $1,250.

All user fee authority (for COBRA and MPF) expires September 30, 1995.

Committee Proposal

The Committee proposal extends the authority to collect customs user fees for three additional fiscal years, to September 30, 1998.

Effective Date

Date of enactment.

Extension of, and Authorization of Appropriations for, the Trade Adjustment Assistance Program (Section 7702)

Present Law

The Trade Adjustment Assistance (TAA) program, authorized under Title II of the Trade Act of 1974, as amended, provides benefits to eligible workers and firms found to be adversely affected by increased imports. Certified workers are eligible for income support in the form of trade readjustment allowances, training, job search and relocation allowances, and other employment services. Certified firms are eligible for technical assistance, administered through 12 regional Trade Adjustment Assistance Centers. These Centers receive funding from the Department of Commerce.

Certification of a group of workers by the Secretary of Labor, or a firm by the Secretary of Commerce, as eligible to apply for adjustment assistance requires three general conditions to be met: (1) a significant number or proportion of a firm's workers have been or are threatened to be totally or partially laid off; (2) the firm's sales and/or production have decreased absolutely; and (3) increased imports of articles like or directly competitive with articles produced by the firm contributed importantly to both the layoffs and the decline in sales or production.

The TAA program was most recently extended by the Omnibus Trade and Competitiveness Act of 1988; it is currently authorized through September 30, 1993.

Committee Proposal

The Committee proposal amends section 285(b) of the Trade Act of 1974 to extend the termination date for the TAA program for five years through September 30, 1998. It further amends sections 245 and 256(b) of the Act to authorize appropriations of such sums as may be necessary for the TAA program for fiscal years 1993, 1994, 1995, 1996, 1997, and 1998.

TAA is designed specifically to respond to the needs of American workers and firms adversely affected by imports. By extending the

program for five additional years, the Committee intends to ensure that its coverage and benefits remain in effect at a time when American workers and firms face intense and increasing competition from abroad. Its extension is especially important at the present time, as the Congress prepares to consider the North American Free Trade Agreement (NAFTA) as well as the Administration's request for an extension of "fast track" negotiating authority needed to complete the Uruguay Round of multilateral trade negotiations.

Effective Date

Date of enactment.

PART II—IMPROVED ACCESS TO CHILDHOOD IMMUNIZATIONS

(Sections 7801, 7802, 7803)

Present Law

Childhood immunization is generally agreed to be one of the most cost-effective preventive health care procedures. Unfortunately, although it is virtually universally recommended, vaccination of young children is very low in many areas and among many groups in the U.S. While comprehensive data are difficult to obtain, sample data indicate that age-appropriate vaccinations for two year olds may be as low as 40 percent nationwide and as low as 10 percent in some inner-city areas. Recent outbreaks of measles have occurred around the nation. The CDC has estimated that the outbreak resulted in over 55,000 cases of measles, more than 130 deaths, and over 11,000 hospitalizations, at an overall direct cost of $150,000,000. Studies have shown that a high percentage of unvaccinated children who got the measles during the outbreak described participated in the Medicaid program, resulting in costs to Federal and State governments. For instance, 45 percent of unvaccinated children in Los Angeles and 75 percent in New York City who got the measles were participating in the Medicaid program.

The cause of such low immunization rates is complex. During the last twelve years, the cost of a full set of immunization has risen because of increased vaccine prices, new excise taxes, and the approval of new vaccines. At the same time as these costs have risen, however, the Federal support for immunization programs has not kept pace. Compounding this problem is the increasing shift of patients from private practices into public clinics. Pediatricians treating patients without insurance for vaccine benefits recognize that the cost of vaccines alone is a significant out-of-pocket expense for many families and increasingly refer these patients to public clinics where vaccines are free. This shift results in the fragmented care of these patients, overloading already under-funded public clinics, and missed opportunities to vaccinate children in a timely manner.

Child immunizations, including the cost of vaccines and administration fees are reimbursed to providers under the Medicaid Early, Periodic, Screening Diagnosis and Treatment (EPSDT) program. Despite this many children are not covered for the full schedule of vaccinations and physician participation in the program is low.

There is a program in the Centers of Disease Control for the federal purchase of vaccines. Prices for vaccines are negotiated by representatives of the CDC and manufacturers in a process that results in one manufacturer getting a contract for a certain vaccine. Under the CDC program, vaccines are distributed free of charge to public providers and who in turn cannot charge for the cost of the vaccines. Providers can charge an administration fee to those with the ability to pay. Some states and localities purchase additional vaccines at the CDC price or negotiate with manufacturers to establish prices for additional vaccines. Eleven states have a universal purchase program for one or more vaccines. Some states that have wanted to purchase vaccines at the current CDC price, taking advantage of the CDC contract optional use clause, have been discouraged from doing so by manufacturers.

Committee Proposal

A central bulk purchasing program is established in the Social Security Act, replacing purchase of vaccines under Medicaid and supplementing the current CDC vaccine purchase program. Under this program, the Secretary of HHS will provide amounts of vaccine to each state which are adequate to fully immunize eligible children within the state. Eligible children are defined to be: children eligible for Medicaid; children with family incomes up to 75% of a state's median income (for a family of 4 without regard to family size) who are either uninsured or lack coverage of immunizations under their health insurance; and children who are native Americans. Creating a new Social Security Act program assures steady funding levels which is of concern to both states and manufacturers. The Secretary is required to establish criteria for the delivery of vaccines by manufacturers or states to providers.

Each state must apply to participate in the federal purchase program and must meet certain conditions including providing assurance that eligible children receive vaccines without charge for its cost and that program-registered providers receive vaccine for eligible children. States with universal programs are exempt from the means test requirements but are still eligible for free vaccines based on their estimates of the eligible population.

While providers are not required to participate in the program, states may not restrict the availability of free vaccines if a provider is willing to participate. Providers can charge an administration fee not to exceed amounts determined appropriate by the Secretary (taking regional variations into account). The Secretary is required to develop a simplified form where eligibility of children is based on parents' self-verified and declared indication of meeting the income test. States may use other forms as approved by the Secretary. Public clinics and providers that receive CDC funded vaccines are excluded from administering the means test for those vaccines.

The Secretary will negotiate with vaccine manufacturers over the price to be paid for federally purchased vaccines. In the negotiations, the Secretary must account for manufacturer costs of research and must provide for a reasonable profit to manufacturers. In consideration of reasonable profit, the Secretary shall consider certain factors, including, the costs of research, development and

production of the vaccine, the costs of research for new or improved vaccine products, the costs of shipping and handling under the contract, and the costs of maintaining an adequate production capacity for disease outbreak control. The Secretary may require other information of manufacturers but only after the publication of regulations with appropriate comment period. The Secretary shall contract with more than one manufacturer of a particular vaccine when there is more than one manufacturer of the vaccine to provide each manufacturer a meaningful and material market share as appropriate.

In addition to the federal purchase and distribution of vaccines for specified populations, states may elect to purchase vaccine at the price negotiated by the Secretary for administration to a larger portion of the child population using state funds. If a state elects this option, it must annually notify the Secretary of its estimated volume of purchase, in advance of the Secretary's purchase price negotiations with manufacturers, so that the effect of state purchases can be accounted for during price negotiations. Annual reports to Congress are required to monitor the price of vaccines to the Federal government and to make sure that prices are not rising substantially due to the state optional use clause.

In order to receive free vaccines, states with laws in effect as of May 1, 1993 which require that some or all insurance plans offer immunization coverage are not allowed to modify or repeal such laws to the extent that current immunization coverage is reduced. In addition, tax penalties can be levied for insurers who reduce their coverage of immunizations.

A National Childhood Immunization Trust Fund is established in the Treasury of the United States consisting of such amounts as may be appropriated or credited to the Fund. Existing Federal and State funds under Medicaid that would otherwise be used to pay for the cost of vaccines (and which will no longer be needed under the new program) are transferred to the trust fund for vaccine purchase.

The effective date of the central bulk purchase program is October 1, 1994 and the program will terminate on such date as may be prescribed in Federal laws that provide for immunization services for all children as part of a broad-based reform of the health care system.

The current requirement that States establish adequate payment rates for pediatric services is expanded to include payment of vaccine administration.

Federal matching payments would not be available with respect to State expenditures for single-antigen vaccines (and their administration) in any case in which the Secretary determines that administration of a combined-antigen vaccine is medically appropriate and cost beneficial.

In conducting outreach efforts to Medicaid-eligible children under the EPSDT program, states are required to inform parents about the need for age-appropriate immunizations. Requires State Medicaid programs to coordinate the provision of information and education on childhood vaccines and the delivery of immunization services with their Maternal and Child Health Services Block Grant programs and the Special Supplemental Food Program for Women,

Infants, and Children (WIC) program. Also, requires MCH Block Grant program coordination with the Medicaid program for payment of services and reports on immunization services.

States contracting with Medicaid managed care plans must stipulate, in the contract, the EPSDT services for which the entity will be responsible and which services will be the responsibility of the state. The contract must detail how services not provided by the entity will be delivered to eligible children. Managed care entities must submit periodic reports on the provision of such services to the State. Establishes a civil money penalty with respect to managed care plans that fail substantially to provide EPSDT services to the extent required by their contract.

Under current law, states may not make payment for covered services provided to Medicaid beneficiaries to anyone other than the beneficiary or the provider of the service, with certain limited exceptions. Provision allows States, at their option, to make payments directly to vaccine manufacturers participating in a voluntary replacement program. Under such a program, the manufacturer supplies doses of the vaccine to providers that administer it, periodically replaces the provider's supply of the vaccines, and charges the State the manufacturer's bid price to the CDC, plus a reasonable premium to cover shipping and handling of returns.

The provision includes limited demonstration authority for up to five states to work through the AFDC program to encourage greater parental responsibility for timely, age appropriate childhood immunizations. In order to receive demonstration authority, states must meet standards in program design as specified in statute.

Effective Date

All provisions except direct payment to manufacturers are effective October 1, 1994; The direct payment provision becomes effective October 1, 1993.

COSTS—The program will be funded through recouping savings accruing to existing state and federal programs that currently purchase vaccines outside the CDC contract for the population that will be covered under this proposal.

OUTLAY-RELATED REVENUE PROVISIONS IN TITLE VII

A. Disclosure Provisions

1. Access to tax information by the Department of Veterans Affairs (sec. 7901 of the bill and sec. 6103 of the Code)

Present Law

The Internal Revenue Code prohibits disclosure of tax returns and return information except to the extent specifically authorized by the Code (sec. 6103). Unauthorized disclosure is a felony punishable by a fine not exceeding $5,000 or imprisonment of not more than five years, or both (sec. 7213). An action for civil damages also may be brought for unauthorized disclosure (sec. 7431). No tax information may be furnished by the Internal Revenue Service (IRS) to another agency unless the other agency establishes procedures satisfactory to the IRS for safeguarding the tax information it receives (sec. 6103(p)).

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

The DVA is required to comply with the safeguards currently contained in the Code and in section 1137(c) of the Social Security Act (governing the use of disclosed tax information). These safeguards include independent verification of tax data, notification to the individual concerned, and the opportunity to contest agency findings based on such information.

The DVA disclosure provision is scheduled to expire after September 30, 1997.

Reasons for Change

The committee believes that it is appropriate to extend the authority to disclose tax information to DVA for an additional year to provide sufficient time to assess the impact of such disclosure on taxpayers' voluntary compliance with the tax laws.

Explanation of Provision

The bill extends the authority to disclose tax information to the DVA for one year, through September 30, 1998.

Effective Date

The provision applies after September 30, 1997.

2. Access to tax information by the Department of Education (sec. 7902 of the bill and sec. 6103 of the Code)

Present Law

The Internal Revenue Code prohibits disclosure of tax returns and return information except to the extent specifically authorized by the Code (sec. 6103). Unauthorized disclosure is a felony punishable by a fine not exceeding $5,000 or imprisonment of not more than five years, or both (sec. 7213). An action for civil damages also may be brought for unauthorized disclosure (sec. 7431). No tax information may be furnished by the Internal Revenue Service (IRS) to another agency unless the other agency establishes procedures satisfactory to the IRS for safeguarding the tax information it receives (sec. 6103(p)).

The IRS may disclose to the Department of Education the mailing address of taxpayers who have defaulted on certain student loans. The Department of Education may in turn make this information available to its agents and to the holders of such loans (and their agents) for the purpose of locating the taxpayers and collecting the loan.

Reasons for Change

The committee believes that the Department of Education should be provided with access to tax return information to assist it carrying out modifications of the Federal student loan program. One component of those modifications will permit students to elect to repay their loans on an income-contingent basis: the amount of each loan payment would be proportional to the former student's income.

The committee, however, is also concerned about the increasing number of requests for disclosure of confidential tax information for nontax purposes and the effect of such disclosure on voluntary taxpayer compliance. Accordingly, only the Department of Education and its employees have been given access to the tax return information necessary to implement income-contingent repayment and the access has been granted only temporarily. The committee also believes that any plan to involve further the IRS in loan collection should be thoroughly studied before implementing legislation is proposed.

Explanation of Provision

The bill gives the Department of Education access to certain tax return information in order to implement this direct student loan program. The only information the Department of Education is permitted to obtain is the name, address, taxpayer identification number, filing status, and adjusted gross income of the former student. Disclosure of this information may be made only to Department of Education employees and may only be used by these employees in establishing the appropriate income-contingent repayment amount for an applicable student loan. Applicable student loans are loans under the new direct student loan program and other student loans that are in default and have been assigned to the Department of Education. The Department of Education and its employees would be subject to the restrictions on unauthorized disclosure in present law. The committee anticipates that information will be provided by means of low-cost computer exchanges of information.

The bill also permits the Department of Education to obtain the mailing address of any taxpayer who owes an overpayment (i.e., has received more than the proper amount) on a Federal Pell Grant or who has defaulted on certain additional student loans administered by the Department of Education.

The authority to disclose tax information to the Department of Education for purposes of establishing the direct student loan program expires on September 30, 1998.

The authority to permit the Department of Education to obtain the mailing address of any taxpayer who owes an overpayment on a Federal Pell Grant or who has defaulted on certain additional student loans administered by the Department of Education is permanent.

Effective Date

The provision is effective on the date of enactment.

3. Access to tax information by the Department of Housing and Urban Development (sec. 7903 of the bill and sec. 6103 of the Code)

Present Law

The Internal Revenue Code prohibits disclosure of tax returns and return information, except to the extent specifically authorized by the Internal Revenue Code (sec. 6103). Unauthorized disclosure is a felony punishable by a fine not exceeding $5,000 or imprisonment of not more than five years, or both (sec. 7213). An action for civil damages also may be brought for unauthorized disclosure (sec. 7431). No tax information may be furnished by the IRS to another agency unless the other agency establishes procedures satisfactory to the IRS for safeguarding the tax information it receives (sec. 6103(p)).

Reasons for Change

The committee believes that the Department of Housing and Urban Development (HUD) should be provided with access to certain items of tax information to assist HUD in determining eligibility for, and establishing correct benefit levels under, certain HUD programs.

The committee, however, is also concerned about the increasing number of requests for disclosure of confidential tax information for nontax purposes and the effect of such disclosure on voluntary taxpayer compliance. Accordingly, HUD's access to tax information has been granted only temporarily to provide the Treasury Department sufficient time to conduct a study on the effectiveness of such disclosure and HUD's compliance with safeguards contained in the Code.

Explanation of Provision

The bill permits disclosure of certain tax information with respect to applicants for, and participants in, certain HUD programs. Such disclosure may be made only to HUD employees and is to be used solely in verifying the taxpayer's eligibility for (or correct amount of benefits under) those HUD programs. The committee anticipates that information will be provided by means of low cost computer exchanges of information. The bill extends the current law restrictions on unauthorized disclosure to HUD and its employees. HUD employees may not redisclose tax information to State or local housing agencies, public housing authorities, or any other third party. However, they may inform such parties of the fact that a discrepancy exists between the information provided by the applicant (or participant) and information provided by other sources.

Effective Date

The provision is effective on the date of enactment. The authority to disclose tax information to HUD under the bill expires after September 30, 1998.

B. Other Revenue-Related Provisions

1. Expansion of 45-day interest-free period for certain refunds (sec. 7950 of the bill and 6611(e) of the Code)

Present Law

No interest is paid by the Government on a refund arising from an original income tax return if the refund is issued by the 45th day after the later of the due date for the return (determined without regard to any extensions) or the date the return is filed (sec. 6611(e)).

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

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

Reasons for Change

The committee believes that it is inappropriate for the payment of interest on tax refunds to be determined by the type of tax involved; all types of taxes should be treated similarly. The committee further believes that it is appropriate to alter the interest rules to provide a 45-day processing period with respect to amended returns, claims for refund and IRS-initiated adjustments.

Explanation of Provision

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

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

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

Effective Date

The extension of the 45-day processing rule is effective for returns required to be filed (without regard to extensions) on or after January 1, 1994. The amended return rule is effective for amended returns and claims for refunds filed on or after January 1, 1995

(regardless of the taxable period to which they relate). The rule relating to IRS-initiated adjustments applies to refunds paid on or after January 1, 1995 (regardless of the taxable period to which they relate).

2. BATF user fees for processing applications for alcohol certificates of label approval (sec. 7951 of the bill)

Present Law

The Treasury Department's Bureau of Alcohol, Tobacco, and Firearms (BATF) is required to approve all alcoholic beverage labels and conduct various laboratory analyses to assure compliance with the Federal Alcohol Administration Act (27 U.S.C., Chapter 8) and Chapter 51 of the Internal Revenue Code. There is currently no charge or fee for these BATF services.

Under the Internal Revenue Code, annual alcohol occupational excise taxes are imposed as follows:

Producers of distilled spirits, wines or beer (secs. 5081, 5091).	$1,000 per year per premise [1]
Wholesale dealers of liquors, wines or beer (sec. 5121).	$500 per year
Retail dealers in liquors, wines or beer (sec. 5121).	$250 per year
Nonbeverage use of distilled spirits (sec. 5131).	$500 per year
Industrial use of distilled spirits (sec. 5276).	$250 per year

[1] Tax is $500 per year per premise for businesses with gross receipts of less than $500,000 in the preceding taxable year.

These annual alcohol occupational tax rates are as enacted in the Omnibus Budget Reconciliation Act of 1987 (P.L. 100–203, "1987 Act"), effective on January 1, 1988. The 1987 Act increased the wholesale and retail alcohol occupational taxes and imposed new occupational taxes on distilled spirits, wine and beer producers as well as for industrial users of distilled spirits.

Reasons for Change

The committee considers it appropriate policy to permit the BATF to charge fees to cover the costs of processing applications for certificates of alcohol label approval and conducting formula reviews or laboratory tests and analyses required under the Federal Alcohol Administration Act and the Internal Revenue Code and regulations. Such BATF services directly benefit the specific users.

Explanation of Provision

Under the bill, BATF user fees are established to cover the costs of processing applications for certificates of alcohol label approval (or exemptions therefrom) required by the Federal Alcohol Administration Act and conducting formula (and statement of process) re-

views or laboratory tests and analyses required under that Act and the Internal Revenue Code and regulations.

The Secretary of the Treasury is authorized to implement the user fee program and to establish fee rates: not less than $50 for each application and not less than $250 for each formula (and statement of process) review or test and analysis. The fees charged under this program are to be determined so that the Secretary estimates that the aggregate of such fees received during any fiscal year will be $5 million. A maximum of $5 million of these fees are to be offsetting receipts deposited in the Treasury and ascribed to BATF's Compliance Alcohol Program.

Effective Date

The provision is effective for applications filed and for formula (and statement of process) reviews or tests and analyses initiated 90 days from the date of enactment.

3. Use of Harbor Maintenance Trust Fund for administrative expenses (sec. 7953 of the bill and sec. 9505(c) of the Code)

Present Law

Under present law (Code sec. 9505(c)), amounts in the Harbor Maintenance Trust Fund ("Harbor Trust Fund") are available, as provided by appropriation Acts, for making expenditures:

(1) under section 210(a) of the Water Resources Development Act of 1986 (Corps of Engineers costs for dredging and maintaining harbors at U.S. ports);

(2) for payments of rebates of certain St. Lawrence Seaway tolls or charges; and

(3) for payment of expenses incurred by the Department of the Treasury in administering the harbor maintenance excise tax ("harbor tax") (but not more than $5 million per fiscal year) for periods during which no Customs processing fee applies under the Consolidated Omnibus Budget Reconciliation Act of 1985 ("1985 Act").

The Customs processing fee currently is in effect through September 30, 1995.[1] Thus, since the Customs processing fee is in effect under the 1985 Act, the Trust Fund is not currently permitted to be used for Treasury Department expenses for administering the harbor tax. The Customs Service generally has the responsibility for collecting and administering the harbor tax. The Corps of Engineers and the Department of Commerce generate certain data related to shipments of commercial cargo.

Reasons for Change

The committee believes that additional enforcement resources are necessary for the Treasury Department to properly administer the harbor tax and to increase collection and audit efforts. This increased enforcement effort should result in the collection of additional tax revenues that are owed but are not being paid. Also, the committee determined that the Corps of Engineers and the Depart-

[1] A separate trade provision (in sec. 7701 of the bill) would extend the current Customs processing fee for three years, through September 30, 1998.

ment of Commerce should be reimbursed for their expenses related to administering the harbor tax.

Explanation of Provision

The bill allows (subject to appropriations) up to $5 million per fiscal year from the Harbor Trust Fund to be used by the Department of the Treasury in administering the harbor tax to improve compliance. This is accomplished by removing the current Harbor Trust Fund restriction against such use while the Customs processing fee is in effect. Also, the bill specifies that such Harbor Trust Fund amounts are available to be used to reimburse the Corps of Engineers and the Department of Commerce for their administrative expenses related to harbor tax collection and enforcement efforts.

Effective Date

The provision applies to fiscal years beginning after the date of enactment.

4. Increase amount of Presidential Election Campaign Fund checkoff (sec. 7954 of the bill and sec. 6096 of the Code)

Present Law

The Presidential Election Campaign Fund ("Fund") provides for public financing of a portion of qualified Presidential election campaign expenditures, and certain qualified convention costs (sec. 9001 et seq.). The Fund is financed through the voluntary designation by individual taxpayers on tax returns of $1 of tax liability, which is commonly known as the Presidential election campaign checkoff. The Treasury Department accumulates revenues in the Fund over a four-year period, and then disburses funds to eligible candidates for President, Vice President, and conventions during the Presidential election year.

Reasons for Change

The Federal Election Commission is projecting a shortfall in the Presidential Election Campaign Fund for the 1996 election cycle. The committee consequently believes it is appropriate to increase the amount of the checkoff, which has not been increased since it was enacted in 1966.

Explanation of Provision

The bill increases amount of the checkoff from $1 to $3.

Effective Date

The provision is effective for tax returns required to be filed after December 31, 1993.

C. Increase in Statutory Limit on the Public Debt (sec. 7955 of the bill)

Present Law

The statutory limit on the public debt currently is $4.37 trillion. It was set at this level temporarily in P.L. 103-12, enacted into law

on April 6, 1993. The current debt limit will expire after September 30, 1993.

Reasons for Change

When the current temporary debt limit expires after September 30, 1993, the debt limit will revert to $4.145 trillion. At this level of borrowing authority, the Treasury will be unable to meet the Federal government's financial obligations and to manage the Federal debt effectively.

The committee believes it is imperative to increase the debt limit on a permanent basis to facilitate the smooth functioning of the Federal government and to prevent any disruption of financial markets.

Explanation of Provision

The bill repeals the temporary limit that expires after September 30, 1993, and instead increases the statutory limit on the public debt to $4.9 trillion. The new debt limit has no expiration date.

Effective Date

The provision is effective on the date of enactment.

TITLE VIII—FINANCE COMMITTEE REVENUE PROVISIONS

I. TRAINING AND INVESTMENT PROVISIONS

A. Education and Training Provisions

1. Extension of employer-provided educational assistance (sec. 8101 of the bill and sec. 127 of the Code)

Present Law

Prior to July 1, 1992, an employee's gross income and wages for income and employment tax purposes 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 (sec. 127). This exclusion, which expired with respect to amounts paid after June 30, 1992, was limited to $5,250 of educational assistance with respect to an individual during a calendar year. Education that did not qualify for the exclusion (e.g., because it exceeded the $5,250 limit) was excludable from income if and only if it qualified as a working condition fringe benefit (sec. 132). To be excluded as a working condition fringe, the cost of the education must have been a job-related deductible expense.

In the absence of the exclusion, for purposes of income and employmenttaxes, an employee generally is required to include in income and wages the value of educational assistance provided by the employer unless the cost of such assistance qualifies as a deductible job-related expense of the employee.

Reasons for Change

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

The committee believes that some of the benefits attributable to the exclusion for employer-provided educational assistance accrue to society at large by creating a better-educated workforce. Also, the committee believes that some individuals would underinvest in education if the Federal government did not subsidize the cost of their continuing education.

The committee believes it is appropriate to provide for a temporary extension of the exclusion to provide the opportunity for Congress to reevaluate the exclusion.

Explanation of Provision

The bill retroactively extends the exclusion for employer-provided educational assistance for 24 months (through June 30, 1994). In the case of a taxable year beginning in 1994, only amounts paid before July 1, 1994, by the employer for educational assistance for the employee can be taken into account in determining the amount excludable under section 127 for the taxable year.

The committee understands that the expiration of the exclusion and the retroactive extension creates a number of administrative problems for employers and employees because some employers and employees treated educational assistance provided between July 1, 1992, and December 31, 1992, as excludable from income, while some treated it as taxable income. If educational assistance provided during such period was treated as taxable, then the employee would be entitled to a refund of excess taxes paid. The committee intends that the Secretary will use his existing authority to the fullest extent possible to alleviate any administrative problems and to facilitate the recoupment of excess taxes paid in the simplest way possible.

The bill also clarifies the rule under which educational assistance that does not satisfy section 127 may be excluded from income if and only if it meets the requirements of a working condition fringe benefit.

Effective Date

The extension of the exclusion is effective for taxable years ending after June 30, 1992. The clarification to the working condition fringe benefit rule is effective for taxable years beginning after December 31, 1988.

2. Extension of targeted jobs tax credit (sec. 8102 of the bill and sec. 51 of the Code).

Present Law

Tax credit

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

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

The credit expired for individuals who began work for an employer after June 30, 1992.

Certification of members of targeted groups

Generally, an individual is not treated as a member of a targeted group unless certain certification conditions are satisfied. On or before the day on which the individual begins work for the employer,

the employer has to have received or have requested in writing from the designated local agency certification that the individual is a member of a targeted group. In the case of a certification of an economically disadvantaged youth participating in a cooperative education program, this requirement is satisfied if necessary certification is requested or received from the participating school on or before the day on which the individual begins work for the employer.

The deadline for requesting certification of targeted group membership is extended until five days after the day the individual begins work for the employer, provided that, on or before the day the individual begins work, the individual has received a written preliminary determination of targeted group eligibility (a "voucher") from the designated local agency (or other agency or organization designated pursuant to a written agreement with the designated local agency). The "designated local agency" is the State employment security agency.

Authorization of appropriations

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

Reasons for Change

The committee believes that the targeted jobs tax credit provides a useful incentive for hiring disadvantaged individuals. Further, the committee believes that a temporary extension of the targeted jobs tax credit will permit Congressional oversight of the credit to continue.

Explanation of Provision

The bill extends for 24 months the targeted jobs tax credit for individuals who begin work for the employer after June 30, 1992 and before July 1, 1994. Under this bill, the targeted jobs tax credit does not apply with respect to individuals who begin work for the employer after June 30, 1994.

Effective Date

The extension of the targeted jobs tax credit is effective for individuals who begin work for the employer after June 30, 1992 and before July 1, 1994.

B. Investment Incentives

1. Extend research tax credit (secs. 8111–8112 of the bill and sec. 41 of the Code)

Present Law

The research and experimentation tax credit ("research tax credit") provides a credit equal to 20 percent of the amount by which a taxpayer's qualified research expenditures for a taxable year exceed its base amount for that year. The credit expired after June 30, 1992.

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

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

Qualified research expenditures eligible for the credit consist of: (1) "in-house" expenses of the taxpayer for research wages and supplies used in research; (2) certain time-sharing costs for computer use in research; and (3) 65 percent of amounts paid by the taxpayer for contract research conducted on the taxpayer's behalf. The credit is not available for expenditures attributable to research that is conducted outside the United States. 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).

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

Deductions for expenditures 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.[1]

Reasons for Change

Technological development is an important component of economic growth. However, businesses may not find it profitable to invest in some research activities, because of the difficulty in captur-

[1] Taxpayers may alternatively elect to claim a reduced research credit amount in lieu of reducing deductions otherwise allowed (sec. 280C(c)(3)).

ing 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 to promote investment in research, so that research activities undertaken approach the optimal level for the overall economy. Therefore, the committee believes that it is appropriate to extend the research tax credit for 12 months.

Explanation of Provision

The research tax credit (including the university basic research credit) is extended for 12 months (i.e., for expenditures paid or incurred during the period July 1, 1993, through June 30, 1994).

The bill also adds a new rule regarding the determination of the fixed-base percentage of start-up companies. Under the provision, a 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 .03 for each of its first five taxable years after 1993 in which it incurs qualified research expenditures. The taxpayer's fixed-base percentage for its sixth through tenth taxable years after 1993 in which it incurred qualified research expenditures will be as follows: (1) for the taxpayer's sixth year, its fixed-base percentage will be one-sixth of its ratio of qualified research expenditures to gross receipts for its fourth and fifth years; (2) for its seventh year, its fixed-base percentage will be one-third of its ratio for its fifth and sixth years; (3) for its eighth year, its fixed-base percentage will be one-half of its ratio for its fifth through seventh years; (4) for its ninth year, its fixed-base percentage will be two-thirds of its ratio for its fifth through eighth years; and (5) for its tenth year, its fixed-base percentage will be five-sixths of its ratio for its fifth through ninth years. For subsequent taxable years, the taxpayer's fixed-base percentage will be its actual ratio of qualified research expenditures to gross receipts for five years selected by the taxpayer from its fifth through tenth taxable years.

In extending the research tax credit, the committee wishes to reaffirm Congressional intent that neither the enactment of the credit in 1981 nor the "targeting" modifications to the credit in 1986 affect the definition of "research or experimental expenditures" for purposes of section 174. Thus, the various new credit limitations enacted in the Tax Reform Act of 1986 apply in determining eligibility for the credit (in taxable years beginning after December 31, 1985), and do not determine eligibility of product development costs under section 174.

Effective Date

The provision applies to expenditures paid or incurred during the period July 1, 1993, through June 30, 1994.

2. Eliminate ACE depreciation adjustment (sec. 8115 of the bill and sec. 56 of the Code)

Present Law

A taxpayer is subject to an alternative minimum tax (AMT) to the extent that the taxpayer's tentative minimum tax exceeds the

taxpayer's regular income tax liability. A taxpayer's tentative minimum tax generally equals 20 percent (24 percent in the case of an individual) of the taxpayer's alternative minimum taxable income in excess of an exemption amount. Alternative minimum taxable income (AMTI) is the taxpayer's taxable income increased by certain tax preferences and adjusted by determining the tax treatment of certain items in a manner which negates the deferral of income resulting from the regular tax treatment of those items.

One of the adjustments which is made to taxable income to arrive at AMTI relates to depreciation. For AMT purposes, depreciation on most personal property to which the modified Accelerated Cost Recovery System (MACRS) adopted in 1986 applies is calculated using the 150-percent declining balance method (switching to straight line in the year necessary to maximize the deduction) over the property's class life. The class lives of MACRS property generally are longer than the recovery periods allowed for regular tax purposes.

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

Reasons for Change

The committee believes that the two depreciation calculations required by the corporate AMT is a source of considerable complexity. In addition, the committee believes that requiring the AMTI of a corporation to be calculated, in part, by using the straight-line depreciation method contained in the ACE adjustment may present a disincentive to the investment in certain property.

Explanation of Provision

The depreciation component of the ACE adjustment is eliminated for property placed in service after December 31, 1993. Thus, corporations would compute AMT depreciation by using the rules generally applicable to individuals (i.e., the 150-percent declining balance method over the class life of the property for tangible personal property.)

Effective Date

The provision is effective for property placed in service after December 31, 1993.

3. Increase expensing for small business (sec. 8119 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 $10,000 of the cost of qualifying property placed in service for the taxable year. In general, qualifying property is defined as depreciable tangible personal property that is purchased for use in the active conduct of a trade or business. The $10,000 amount is reduced (but not below zero) by the amount by which the cost of qualifying property placed in service during the taxable year exceeds $200,000. In addition, the amount eligible to be expensed for a taxable year may not exceed the taxable income of the taxpayer for the year that is derived from the active conduct of a trade or business (determined without regard to this provision). Any amount that is not allowed as a deduction because of the taxable income limitation may be carried forward to succeeding taxable years (subject to similar limitations).

Reasons for Change

The committee believes that increasing the amount allowed to be expensed will provide an incentive for small businesses to increase their investment in capital assets, thus promoting economic growth and increasing demand for productive assets.

Explanation of Provision

The $10,000 amount allowed to be expensed under section 179 is increased to $15,000.

Effective Date

The provision is effective for property placed in service in taxable years beginning after December 31, 1992.

4. Extension of qualified small-issue bonds (sec. 8121 of the bill and sec. 144 of the Code)

Present Law

Interest on certain small issues of private activity bonds is excluded from income if at least 95 percent of the bond proceeds is used to finance manufacturing facilities or agricultural land or property for first-time farmers ("qualified small-issue bonds"). Qualified small-issue bonds are issues having an aggregate authorized face amount of $1 million or less. Alternatively, the aggregate face amount of the issue, together with the aggregate amount of certain related capital expenditures during the six-year period beginning three years before the date of the issue and ending three years after that date, may not exceed $10 million. Special limits apply to these bonds for first-time farmers.

Authority to issue qualified small-issue bonds expired after June 30, 1992.

Reasons for Change

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

Explanation of Provision

The bill extends the authority to issue qualified small-issue bonds for 24 months (through June 30, 1994).

Effective Date

The provision is effective for bonds issued after June 30, 1992 and before July 1, 1994.

C. Expansion and Simplification of Earned Income Tax Credit (sec. 8131 of the bill and secs. 32, 162, and 213 of the Code)

Present Law

Eligible low-income workers can claim a refundable earned income tax credit (EITC) of up to 18.5 percent of the first $7,750 of earned income for 1993 (19.5 percent for taxpayers with more than one qualifying child). The maximum amount of credit for 1993 is $1,434 ($1,511 for taxpayers with more than one qualifying child).

This maximum credit is reduced by 13.21 percent of earned income (or adjusted gross income, if greater) in excess of $12,200 (13.93 percent for taxpayers with more than one qualifying child). In 1993, the EITC is totally phased out for workers with earned income (or adjusted gross income, if greater) over $23,050. The maximum amount of earned income on which the EITC may be claimed, and the income threshold for the phaseout of the EITC, are indexed for inflation. Earned income consists of wages, salaries, other employee compensation, and net self-employment income.

Present law provides that the credit rates for the EITC increase in 1994, as shown in the following table.

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

A worker may elect to receive the EITC on an advance basis by furnishing a certificate of eligibility to his or her employer. For such a worker, the employer makes an advance payment of the credit at the time wages are paid.

A supplemental young child credit is available to taxpayers with qualifying children under the age of one year. This young child credit rate is 5 percent and the phase-out rate is 3.57 percent. It is computed on the same income base as the ordinary EITC. The maximum supplemental young child credit for 1993 is $388.

A supplemental health insurance credit is available to taxpayers who provide health insurance coverage for their qualifying children. This health insurance credit rate is 6 percent and the phase-out rate is 4.285 percent. It is computed on the same income base as the ordinary EITC, but the credit claimed cannot exceed the out-of-pocket cost of the health insurance coverage. In addition, the taxpayer is denied an itemized deduction for medical expenses of qualifying insurance coverage up to the amount of credit claimed. The maximum supplemental health insurance credit for 1993 is $465.

Reasons for Change

Providing a larger basic EITC to larger families recognizes the role that the EITC can play in alleviating poverty. Moreover, this larger credit may provide an increased work incentive to some tax-

payers and may increase the equity of the individual income tax system by reducing the tax burden on those with the least ability to pay taxes. Finally, repeal of the supplemental young child and health insurance components of the EITC should both ease compliance burdens for lower-income taxpayers and provide substantial simplification.

Explanation of Provision

For taxpayers with one qualifying child, the EITC will be increased to 26.0 percent of the first $7,750 of earned income in 1994. The maximum credit will be $2,015 which is reduced by 16.16 percent of earned income (or adjusted gross income, if greater) in excess of $11,000. The credit will be completely phased out for taxpayers with earned income (or adjusted gross income, if greater) over $23,470. In 1995 and thereafter, the credit rate will increase to 34.0 percent. The maximum amount of earned income on which the credit could be claimed will be (an estimated) $6,170 (this is a $6,000 base in 1994, adjusted for projected inflation). Thus, the maximum credit in 1995 will be approximately $2,098. The phase-out rate will remain the same as in 1994.

For taxpayers with two or more qualifying children, the EITC will be increased to 30.0 percent of the first $8,500 of earned income in 1994. The maximum credit will be $2,550 which is reduced by 15.94 percent of earned income (or adjusted gross income, if greater) in excess of $11,000. Thus, in 1994, the credit will be completely phased out for taxpayers with earned income (or adjusted gross income, if greater) over $27,000. The credit rate will increase over time and equal 34.0 percent in 1995 and 39.0 percent in 1996 and thereafter. The phase-out rate will be 18.06 percent in 1995 and 20.72 percent in 1996 and thereafter.

As under present law, all dollar thresholds for years after 1994 will be indexed for inflation.

The supplemental young child credit and the supplemental health insurance credit will be repealed.

Effective Date

The provision is effective for taxable years beginning after December 31, 1993.

D. Real Estate Investment Provisions

1. Extension of qualified mortgage bonds and mortgage credit certificates (sec. 8141 of the bill and sec. 143 of the Code).

Present Law

Qualified mortgage bonds

Qualified mortgage bonds ("QMBs") are bonds the proceeds of which are used to finance the purchase, or qualifying rehabilitation or improvement, of single-family, owner-occupied residences located within the jurisdiction of the issuer of the bonds (sec. 143). Persons receiving QMB loans must satisfy a home purchase price, borrower income, first-time homebuyer, and other requirements. Part or all of the interest subsidy provided by QMBs is recaptured if the borrower experiences substantial increases in income and disposes of the subsidized residence within nine years after purchase.

Mortgage credit certificates

Qualified governmental units may elect to exchange QMB authority for authority to issue mortgage credit certificates ("MCCs") (sec. 25). MCCs entitle homebuyers to nonrefundable income tax credits for a specified percentage of interest paid on mortgage loans on their principal residences. Once issued, an MCC remains in effect as long as the loan remains outstanding and the residence being financed continues to be the certificate-recipient's principal residence. MCCs are subject to the same targeting requirements as QMBs.

Expiration

Authority to issue QMBs and to elect to trade in bond volume authority to issue MCCs expired after June 30, 1992.

Reasons for Change

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

Explanation of Provision

The bill extends the authority to issue QMBs and to elect to trade in QMB authority for authority to issue MCCs for 24 months (through June 30, 1994).

Effective Date

The extension of the QMB and MCC programs is effective after June 30, 1992.

2. Permanent extension of the tax credit for low-income residential rental housing (sec. 8142 of the bill and sec. 42 of the Code)

Present Law

In general

A tax credit is allowed in annual installments over 10 years for qualifying newly constructed or substantially rehabilitated low-income residential rental housing. For most qualifying housing, the credit has a present value of 70 percent of the qualified basis of the low-income housing units. For housing also receiving other Federal subsidies (e.g., tax-exempt bond financing) and for the acquisition cost (e.g., costs other than rehabilitation expenditures) of existing housing that is substantially rehabilitated, the credit has a present value of 30 percent of qualified costs.

Full-time students

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

Deep-rent skewing

Generally, the credit amount is based on the qualified basis of the housing units serving low-income tenants. A residential rental project will qualify for the credit only if (1) 20 percent or more of the aggregate residential rental units in the project are occupied by individuals whose incomes do not exceed 50 percent of area median income, or (2) 40 percent or more of the aggregate residential rental units in the project are occupied by individuals whose incomes do not exceed 60 percent of area median income. These income figures are adjusted for family size. The low income set-aside is elected when the project is placed in service.

To qualify under the deep rent skewing exception from the general targeting requirements, at least 15 percent of the low-income units must be occupied by tenants whose incomes do not exceed 40 percent of area median income, the rents on such units must be restricted to 30 percent of the qualifying income limitation, and rents on the market rate units must be at least 200 percent of rents charged on comparable rent restricted units. For projects receiving allocations prior to 1990, rents on market rate units must be at least 300 percent of rents charged on comparable rent restricted units.

Maximum rent

The maximum rent that may be charged a family in a low-income housing tax credit unit depends on the number of bedrooms in that unit. Prior to 1990, maximum allowable rent was determined on the basis of the actual family size of the occupants.

Tenant occupancy

Under the general low-income tenant occupancy requirement, a residential rental project qualifies for the low-income housing tax credit only if at least: (1) 20 percent or more of the aggregate residential rental units in the project are occupied by individuals whose incomes do not exceed 50 percent of area median income or, (2) 40 percent or more of the aggregate residential rental units in the project are occupied by individuals whose incomes do not exceed 60 percent of area median income.

Income recertification

Generally, the owner of a low-income housing project must annually recertify tenant incomes to meet the low-income tenant occupancy requirements, regardless of whether the building is entirely occupied by low-income tenants.

Tenant protection

The low-income housing tax credit provisions in the Code do not include any specific provisions concerning the grounds for denial of admission to low-income housing projects, for termination of a tenancy, or for refusal to renew the lease of a tenant.

Developmental and operational costs

In general, housing credit agencies cannot allocate more low-income housing tax credits to a project than are necessary for the financial feasibility of the project and its viability as a qualified low-income housing project throughout the 10-year credit period. In making this determination, a housing credit agency must consider (1) the sources and uses of funds and the total financing of the project, (2) any proceeds expected to be generated by reason of tax benefits and (3) the percentage of the housing credit dollar amount to be used for project costs other than the costs of intermediaries.

Allocation between buyer and seller in month of disposition

The Code requires that the low-income housing tax credit be divided between a buyer and seller of a low-income housing tax credit project based upon the number of days during the year of disposition that the project was held by each. The Internal Revenue Service has issued guidance that requires a mid-month averaging convention.

The low-income housing tax credit expired after June 30, 1992.

Reasons for Change

The committee believes that the low-income housing tax credit is a useful incentive for increasing the stock of affordable housing available to low-income individuals. Further, the committee believes that a permanent extension of the low-income housing credit will provide greater planning certainty needed for the efficient delivery of this Federal subsidy without sacrificing necessary Congressional oversight of the program. Finally, the committee believes that the modifications to the credit will improve its operation.

Explanation of Provision

The bill permanently and retroactively extends the low-income housing tax credit. The bill also makes the following modifications:

Full-time students

The bill provides 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. The bill also codifies the present-law exception regarding married students filing joint returns (which continues to apply to all buildings placed in service since original enactment of the low-income housing tax credit by the Tax Reform Act of 1986).

Deep-rent skewing

The bill allows an irrevocable election by the owner of a low-income building receiving a credit allocation before 1990 to satisfy the 200 percent rent restriction rather than the 300 percent rent restriction. The election is available only to taxpayers who enter into a compliance monitoring agreement with a housing credit agency. Further, the election applies only with respect to tenants first occupying any unit in the building after the date of the election, and must be made within 180 days after the date of enactment.

Maximum rent

The bill allows an irrevocable election by the owner of a low-income building placed in-service before 1990 to use either apartment size or family size in determining maximum allowable rent. The election is available only to taxpayers who enter into a compliance monitoring agreement with a housing credit agency. Further, the election applies only with respect to tenants first occupying any unit in the building after the date of the election, and must be made within 180 days after the date of enactment.

Tenant occupancy

The bill authorizes the Treasury Department to provide a waiver of penalties for de minimis errors in the application of the low-income tenant occupancy requirement.

Income recertification

The bill authorizes the Treasury Department to grant a waiver from the annual recertification of tenant income for tenants in buildings that are occupied entirely by low-income tenants.

Tenant protection

The bill provides that an applicant may not be denied admission to a low-income housing tax credit project because the applicant holds a voucher or certificate of eligibility under Section 8 of the Housing Act of 1937.

Developmental and operational costs

The bill requires a housing credit agency to consider the reasonableness of the developmental and operational costs of a project as an additional factor in making its determination as to the proper amount of low-income housing tax credits to allocate to a project.

Reasons for a determination of unreasonableness might include, for example, costs not comparable to costs to develop or operate similar projects in the locality, inefficient development practices, building design of a nature above what is necessary to provide basic, safe housing for the intended population in the locality. The committee also intends that an allocating agency make a determination as to the appropriateness of amenities included in a project. Amenities, and the space attributable thereto, should be appropriate to the size and type of the resident population to be served.

Allocation between buyer and seller in month of disposition

The bill provides that the buyer and seller may agree to use either the exact number of days or the mid-month convention to determine the division of the credit in the month of disposition.

Effective Date

The extension of the low-income housing tax credit and the provisions relating to: (1) full-time students, and (2) developmental and operational costs are effective after June 30, 1992. The provisions relating to: (1) tenant occupancy, (2) income certification, (3) tenant protection, and (4) allocations between the buyer and seller are effective on the date of enactment. The elections relating to deep-rent skewing and maximum rent must be made within 180 days after the date of enactment.

3. Modification of passive loss rules for certain real estate persons (sec. 8143 of the bill and sec. 469 of the Code)

Present Law

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

The passive loss rules apply to individuals, estates and trusts, closely held C corporations, and personal service corporations. A special rule permits closely held C corporations to apply passive activity losses and credits against active business income (or tax liability allocable thereto) but not against portfolio income.

Passive activities are defined to include trade or business activities in which the taxpayer does not materially participate. To materially participate in an activity, a taxpayer must be involved in the operations of the activity on a regular, continuous, and substantial basis. Except as provided in regulations, a taxpayer is treated as not materially participating in an activity held through a limited partnership interest.[2]

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

Reasons for Change

The committee considers it unfair that a person who performs more than half his personal services in a real property trade or business is not permitted in some cases to offset losses from rental real estate activities in which he materially participates against nonpassive income from the conduct of a real property trade or business. The committee bill modifies the passive loss rule to alleviate this unfairness.

Explanation of Provision

Under the provision, an eligible taxpayer's net loss from rental real estate activities in which the taxpayer materially participates generally is allowed to offset income from real property trade or business activities. The loss allowed under the provision may not exceed the least of (1) the taxpayer's net loss for the taxable year from rental real estate activities in which the taxpayer materially participates, (2) the taxpayer's net loss for the taxable year from all rental real estate activities[3], (3) the taxpayer's net income for

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

[3] For example, assume a taxpayer has a $100 loss from a rental real estate activity in which he materially participates, $40 of income from a rental real estate activity in which he does not materially participate, and $110 of other passive losses from nonrental real estate activities. Under the bill, the loss allowed may not exceed $60 ($100 less $40). Thus, because the tax-

the taxable year from real property trade or business activities which are not passive activities, or (4) the taxpayer's taxable income for the taxable year (determined without regard to this provision). A similar rule applies with respect passive activity credits.

Real property trade or business means any real property development, redevelopment, construction, reconstruction, acquisition, conversion, rental, operation, management, leasing, or brokerage trade or business.

A taxpayer meets the eligibility requirements if more than half of the personal services the taxpayer performs in a trade or business during the taxable year are in real property trades or businesses in which he materially participates.

In the case of a joint return, it is intended that for purposes of the eligibility requirements, each spouse's personal services are taken into account separately. In determining material participation, however, the provision does not change the present-law rule (sec. 469(h)(5)) that the participation of the spouse of the taxpayer is taken into account. Thus, for example, a husband and wife filing a joint return meet the eligibility requirements (assuming neither is an employee) if during the taxable year one spouse performs at least half of his or her business services in a real estate trade or business in which either spouse materially participates. The couple does not fail the eligibility requirements if less than half of their business services, taken together, are performed in real estate trades or businesses in which either of them materially participates, provided that more than half of one spouse's business services qualify.

For purposes of the eligibility requirements, personal services performed as an employee are not treated as performed in a real estate trade or business unless the person performing services has more than a 5 percent ownership interest in the employer (within the meaning of sec. 416(i)(1)(B)).

Material participation has the same meaning as under present law. Thus, as under present law, except as provided in regulations, no interest as a limited partner in a limited partnership is treated as an interest with respect to which the taxpayer materially participates.

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

Losses allowed by reason of the present-law $25,000 allowance are determined before the application of this provision.

Effective Date

The provision is effective with respect to taxable years beginning after December 31, 1993.

payer's rental real estate activities are netted under this limitation, no portion of the $110 of other passive losses from nonrental real estate activities is allowed under the provision.

4. Changes relating to real estate investments by pension funds and others (secs. 8144-8149)

a. Modification of the rules related to debt-financed income (sec. 8144 of the bill and sec. 514 of the Code)

Present Law

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

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

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

Reasons for Change

The committee believes that modifications to the debt-financed income rules are desirable to permit qualified organizations to make debt-financed investments in real property on commercially reasonable terms in circumstances where the committee believes there is no potential for abuse.

Explanation of Provision

Relaxation of the leaseback and disqualified person restrictions

The provision relaxes the leaseback and disqualified person restrictions to permit a limited leaseback of debt-financed real property to the seller (or a person related to the seller) or to a disqualified person.[4] The exception applies only where (1) no more than 25 percent of the leasable floor space in a building (or complex of buildings) is leased back to the seller (or related party) or to the disqualified person, and (2) the lease is on commercially reasonable terms, independent of the sale and other transactions.

Relaxation of the seller-financing restriction

The provision relaxes the seller-financing restriction to permit seller financing on terms that are commercially reasonable independent of the sale and other transactions. The provision grants authority to the Treasury Department to issue regulations for the purpose of determining commercially reasonable financing terms.

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

Relaxation of the fixed price and participating loan restriction for property acquired from financial institutions

The provision relaxes the fixed price and participating loan restrictions for certain sales of real property foreclosed upon by financial institutions.[5] The relaxation of these rules is limited to cases where: (1) a qualified organization acquires the property from a financial institution that acquired the real property by foreclosure (or after an actual or imminent default), or was held by the selling financial institution at the time that it entered into conservatorship or receivership; (2) any gain recognized by the financial institution with respect to the property is ordinary income; (3) the stated principal amount of the seller financing does not exceed the financial institution's outstanding indebtedness (including accrued but unpaid interest) with respect to the property at the time of foreclosure or default; and (4) the present value of the maximum amount payable pursuant to any participation feature cannot exceed 30 percent of the total purchase price of the property (including contingent payments).

Effective Date

The provision is effective for acquisitions (and also for leases entered into) on or after January 1, 1994.

[4] As under present law, a leaseback to a disqualified person is subject to the prohibited transaction rules set forth in section 4975.

[5] For this purpose, financial institutions include financial institutions in conservatorship or receivership, certain affiliates of financial institutions, and government corporations that succeed to the rights and interests of a receiver or conservator.

b. Repeal of the automatic UBTI rule for publicly-traded partnerships (sec. 8145 of the bill and sec. 512 of the Code)

Present Law

In general, the character of a partner's distributive share of partnership income is the same as if the income had been directly realized by the partner. Thus, whether a tax-exempt organization's share of income from a partnership (other than from a publicly-traded partnership) is treated as unrelated business income depends on the underlying character of the income (sec. 512(c)(1)).

By contrast, a tax-exempt organization's distributive share of gross income from a publicly-traded partnership (that is not otherwise treated as a corporation) automatically is treated as gross income derived from an unrelated trade or business (sec. 512(c)(2)(A)). The organization's share of the partnership deductions is allowed in computing the organization's UBTI (sec. 512(c)(2)(B)).

Reasons for Change

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

Explanation of Provision

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

Effective Date

The provision is effective for partnership years beginning on or after January 1, 1994.

c. Permit title-holding companies to receive small amounts of UBTI (sec. 8146 of the bill and secs. 501(c)(2) and (c)(25) of the Code)

Present Law

Section 501(c)(2) provides tax-exempt status to certain corporations organized for the exclusive purpose of holding title to property and remitting any income from the property to one or more related tax-exempt organizations. Section 501(c)(25) provides tax-exempt status to certain corporations and trusts that are organized for the exclusive purposes of acquiring and holding title to real property, collecting income from such property, and remitting the income to no more than 35 shareholders or beneficiaries that are: (1) qualified pension, profit-sharing, or stock bonus plans (sec. 401(a)); (2) governmental pension plans (sec. 414(d)); (3) the United

States, a State or political subdivision, or governmental agencies or instrumentalities; or (4) tax-exempt charitable, educational, religious, or other organizations described in section 501(c)(3). However, the IRS has taken the position that a title-holding company described in section 501(c)(2) or 501(c)(25) will lose its tax-exempt status if it generates any amount of certain types of UBTI.[6]

Reasons for Change

Typical investments of section 501(c)(2) and (c)(25) corporations include shopping centers, office buildings, and apartment buildings. These real estate investments typically generate rental income, which generally is not considered UBTI, but may also generate small amounts of income which could be treated as UBTI (e.g., money collected from laundry machines used by tenants, or from vending machines offered as a convenience to the patrons of a shopping center).

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

Explanation of Provision

The provision permits a title-holding company that is exempt from tax under sections 501(c)(2) or 501(c)(25) to receive UBTI (that would otherwise disqualify the company) up to 10 percent of its gross income for the taxable year, provided that the UBTI is incidentally derived from the holding of real property. For example, income generated from parking or operating vending machines located on real property owned by a title-holding company generally would qualify for the 10-percent de minimis rule, while income derived from an activity that is not incidental to the holding of real property (e.g., manufacturing) would not qualify. In cases where unrelated income is incidentally derived from the holding of real property, receipt by a title-holding company of such income (up to the 10-percent limit) will not jeopardize the title-holding company's tax-exempt status, but nonetheless, will be subject to tax as UBTI.

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

Effective Date

The provision is effective for taxable years beginning on or after January 1, 1994.

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

d. Exclusion from UBTI of gains from the disposition of real property acquired from financial institutions in conservatorship or receivership (sec. 8147 of the bill and sec. 512(b) of the Code)

Present Law

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

Reasons for Change

Real property that is owned by troubled financial institutions often is sold in bundled packages. This enables the financial institution to dispose of the less desirable properties together with the more desirable properties. It also allows institutions with large portfolios of properties to pass on to purchasers some of the burden of an orderly liquidation of the properties.

The committee understands that the dealer UBTI rule effectively discourages pension funds and other tax-exempt organizations from investing in the properties bundled together by troubled financial institutions. The committee believes that these investors could provide a valuable source of capital for the purchase of these bundled properties.

Explanation of Provision

The provision provides an exception to the dealer UBTI rule by excluding gains and losses from the sale, exchange or other disposition of certain real property and mortgages acquired from financial institutions that are in conservatorship or receivership. Only real property and mortgages owned by a financial institution (or that was security for a loan held by the financial institution) at the time that the institution entered conservatorship or receivership are eligible for the exception.

The exclusion is limited to properties designated as disposal property within nine months of acquisition, and disposed of within two-and-a-half years of acquisition. The two-and-a-half year disposition period may be extended by the Secretary if an extension is necessary for the orderly liquidation of the property. No more than one-half by value of properties acquired in a single transaction may be designated as disposal property.

The exclusion is not available for properties that are improved or developed to the extent that the aggregate expenditures on development do not exceed 20 percent of the net selling price of the property.

Effective Date

The provision is effective for property acquired on or after January 1, 1994.

e. Exclusion of certain option premiums and loan commitment fees from UBTI (sec. 8148 of the bill and sec. 512(b) of the Code)

Present Law

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

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

Reasons for Change

The committee believes that gains and losses from options should be treated consistently for purposes of the UBTI. In addition, the committee believes that taxing loan commitment fees and premiums from unexercised options on real estate is inconsistent with the generally tax-free treatment of income from investment activities accorded to exempt organizations.

Explanation of Provision

The provision expands the current exception for gains on the lapse or termination of options on securities to gains or losses from such options (without regard to whether they are written by the organization), from options on real property, and from the forfeiture of good-faith deposits (that are consistent with established business practice) for the purchase, sale or lease of real property.

In addition, the provision excludes loan commitment fees from UBTI. For purposes of this provision, loan commitment fees are non-refundable charges made by a lender to reserve a sum of money with fixed terms for a specified period of time. These charges are to compensate the lender for the risk inherent in committing to make the loan (e.g., for the lender's exposure to interest rate changes and for potential lost opportunities).

Effective Date

The provision is effective for premiums or loan commitment fees that are received on or after January 1, 1994.

f. Relaxation of limitations on investments in real estate investment trusts by pension funds (sec. 8149 of the bill and sec. 856(h) of the Code)

Present Law

A real estate investment trust ("REIT") is not taxed on income distributed to shareholders. A corporation does not qualify as a REIT if at any time during the last half of its taxable year more than 50 percent in value of its outstanding stock is owned, directly or indirectly, by five or fewer individuals ("the five or fewer rule").

A domestic pension trust is treated as a single individual for purposes of this rule.

Dividends paid by a REIT are not UBTI,[7] unless the stock in the REIT is debt-financed. Depending on its character, income earned by a partnership may be UBTI (sec. 512(c)). Special rules treat debt-financed income earned by a partnership as UBTI (sec. 514(c)(9)(B)(vi)).

Reasons for Change

The committee believes that relaxation of the five or fewer rule is appropriate to encourage pension fund investment in REITs. Such investment, however, may permit circumvention of the UBIT. Accordingly, in certain circumstances, UBIT is imposed on a pension trust holding shares in a REIT if direct ownership of the REIT assets by the pension trust would have resulted in UBIT.

Explanation of Provision

Qualification as a REIT

The bill provides that a pension trust generally is not treated as a single individual for purposes of the five-or-fewer rule. Rather, the bill treats beneficiaries of the pension trust as holding stock in the REIT in proportion to their actuarial interests in the trust. This rule does not apply if disqualified persons, within the meaning of section 4975(e)(2) (other than by reason of subparagraphs (B) and (I)), together own five percent or more of the value of the REIT stock and the REIT has earnings and profits attributable to a period during which it did not qualify as a REIT.[8]

In addition, the bill provides that a REIT cannot be a personal holding company and, therefore, is not subject to the personal holding company tax on its undistributed income.

Unrelated business taxable income

Under the bill, certain pension trusts owning more than 10 percent of a REIT must treat a percentage of dividends from the REIT as UBTI. This percentage is the gross income derived from an unrelated trade or business (determined as if the REIT were a pension trust) divided by the gross income of the REIT for the year in which the dividends are paid. Dividends are not treated as UBTI, however, unless this percentage is at least five percent.

The UBTI rule applies only if the REIT qualifies as a REIT by reason of the above modification of the five or fewer rule. Moreover, the UBTI rule applies only if (1) one pension trust owns more than 25 percent of the value of the REIT, or (2) a group of pension trusts individually holding more than 10 percent of the value of the REIT collectively own more than 50 percent of the value of the REIT.

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[7] See Rev. Rul. 66-151, 1966-1 C.B. 151.

[8] Moreover, as under present law, any investment by a pension trust must be in accordance with the fiduciary rules of the Employee Retirement Security Act ("ERISA") and the prohibited transaction rules of the Code and ERISA.

Effective Date

The provision applies to taxable years beginning on or after January 1, 1994.

5. Increase recovery period for depreciation of nonresidential real property (sec. 8151 of the bill and sec. 168 of the Code)

Present Law

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

Reasons for Change

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

Explanation of Provision

The bill requires the depreciation deduction allowed with respect to nonresidential real property for regular tax purposes to be determined by using a recovery period of 38 years. The bill does not change the depreciation deduction allowed with respect to nonresidential real property for alternative minimum tax purposes.

Effective Date

The provision generally applies to property placed in service on or after February 25, 1993. The provision does not apply to property that a taxpayer places in service before January 1, 1994, if (1) the taxpayer or a qualified person entered into a binding written contract to purchase or construct the property before February 25, 1993, or (2) construction of the property was commenced by or for the taxpayer or a qualified person before February 25, 1993. A qualified person for this purpose is any person who transfers rights in such a contract or such property to the taxpayer, but only if the property is not placed in service by such person before such rights are transferred to the taxpayer.

E. Luxury Excise Tax; Diesel Fuel Tax for Motorboats

1. Repeal of luxury excise tax on boats, aircraft, jewelry, and furs; Indexing of luxury excise tax on automobiles (secs. 8161 and 8162 of the bill and secs. 4001-4012 of the Code)

Present Law

Present law imposes a 10-percent excise tax on the portion of the retail price of the following items that exceeds the thresholds specified: automobiles above $30,000; boats above $100,000; aircraft above $250,000; jewelry above $10,000; and furs above $10,000. The tax also applies to subsequent purchases of component parts and accessories occurring within six months of the date the automobile, boat, or aircraft is placed in service.

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

The tax applies to sales before January 1, 2000.

Reasons for Change

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

The committee recognizes that in the absence of indexation of the threshold above which the tax on automobiles applies, even modest inflation will subject more automobiles to the luxury tax than were subject to the tax when it was first enacted. The committee believes it is appropriate to index the threshold for inflation so that only the higher-priced segment of the automobile market is subject to tax. The committee does not believe that such a change is discriminatory against automobiles manufactured abroad. Indexation of the threshold helps ensure that only the higher-priced segment of the automobile market, both those produced domestically and those produced abroad, will be subject to tax, while less expensive cars, both domestic and imported, will not be subject to the tax.

The committee further believes that it is unfair and inappropriate to treat as luxury purchases those accessories or modifications which must be purchased by an individual with a disability to enable him or her to operate or to enter or exit a vehicle.

The committee further believes it is more appropriate to tax demonstrator cars when they are sold instead of when a dealer begins to use them as a demonstrator.

Explanation of Provisions

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

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

Indexing of tax on automobiles

The bill modifies the luxury excise tax on automobiles to provide that the $30,000 threshold is indexed annually for inflation occurring after 1990. Consequently, the applicable threshold for 1993 will be $30,000 increased by the 1991 and 1992 inflation rates, or by 8.49 percent which when rounded to the nearest $100[9] is a threshold of $32,500.

Exemption for certain equipment installed on passenger vehicles for use by disabled individuals

The bill provides that the luxury excise tax does not apply to a part or accessory installed on a passenger vehicle to enable or assist an individual with a disability to operate the vehicle, or to enter or exit the vehicle, in order to compensate for the effect of the disability. This exception does not apply to accessories commonly available from the manufacturer or dealer, such as power steering, power door locks, power seats, or power windows.

Exemption for demonstrator vehicles

The bill exempts passenger vehicle dealers from paying the luxury tax on vehicles used as demonstrators for potential customers. Under the provision, the tax, if any, is to be assessed and paid on the sales price of the vehicle when the vehicle is sold.

Effective Date

The repeal of the luxury excise taxes on boats, aircraft, jewelry, and furs is effective for sales on or after January 1, 1993. The indexation of the threshold applicable to passenger vehicles is effective for sales on or after January 1, 1993. The provision relating to the purchase of accessories or modifications by disabled persons is effective for purchases after December 31, 1990. The provision relating to the use before sale of demonstrator vehicles is effective for vehicles used after December 31, 1992.

Persons entitled to a refund may request it from the seller from whom the taxed item was purchased. The seller then obtains the refund as provided under present-law Code section 6416.

2. Impose excise tax on diesel fuel used in noncommercial motorboats (sec. 8163 of the bill and secs. 4092, 4041, 6421, 9503, and 9508 of the Code)

Present Law

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

The revenues from these taxes, minus the 2.5 cents per gallon General Fund rate are deposited in the Highway Trust Fund (through September 30, 1999), the National Recreational Trails

[9] The committee intends that the standard arithmetic rounding convention be applied, to wit, values of $50 or more are rounded up, while values strictly less than $50 are rounded down.

Trust Fund (through September 30, 1997), or the Aquatic Resources Trust Fund (through September 30, 1997). Revenues from the remaining 2.5 cents per gallon are retained in the General Fund through September 30, 1995, after which time the 2.5-cents-per-gallon portion of the taxes (including the tax on diesel fuel used in trains) is scheduled to expire.[10]

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

Diesel fuel used in motorboats is not currently taxed.

Reasons for Change

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

Explanation of Provision

The bill extends the current 20.1-cents-per-gallon diesel fuel excise taxes to diesel fuel used by noncommercial motorboats.[11] Fuel used by boats for commercial fishing, transportation for compensation or hire, or for business use other than predominantly for entertainment, amusement, or recreation, remains exempt.

The tax is collected at the same point in the distribution chain as the highway diesel fuel tax.[12]

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

The 20.1-cents-per-gallon diesel fuel excise tax applies to use of diesel fuel in noncommercial motorboats between January 1, 1994, and December 31, 1999.

Effective Date

The provision is effective after December 31, 1993, and before January 1, 2000.

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[10] A separate committee provision extends the 2.5-cents-per-gallon rate through September 30, 1999, and transfers applicable highway-related revenues to the Highway Trust Fund for the extended period. (See section 8244 of the bill, Item II.D.2., below.)

[11] A separate committee provision imposes a 4.3-cents-per-gallon transportation fuels tax effective October 1, 1993. Diesel fuel used by noncommercial motorboats also is subject to the transportation fuels tax beginning at that time. (See section 8241 of the bill, Item II.D.1, below.)

[12] A separate provision of the bill modifies the point of collection for highway diesel fuel. (See section 8242 of the bill, Item II.D.1., below).

F. Other Provisions

1. Alternative minimum tax treatment for contributions of appreciated property (sec. 8171 of the bill and secs. 56 and 57 of the Code).

Present Law

Donations of appreciated property

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.[13] However, in the case of a charitable contribution of inventory or other ordinary-income property, short-term capital gain property, or certain gifts to private foundations, the amount of the deduction is limited to the taxpayer's basis in the property.[14] In the case of a charitable contribution of tangible personal property, a taxpayer's deduction is limited to the adjusted basis in such property if the use by the recipient charitable organization is unrelated to the organization's tax-exempt purpose (sec. 170(e)(1)(B)(i)).

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

For taxable years beginning after 1989, the AMTI of a corporation is increased by 75 percent of the amount by which adjusted current earnings (ACE) exceeds AMTI (calculated before this adjustment). ACE generally is computed pursuant to the rules that a corporation uses to determine its earnings and profits (sec. 56(g)).

Reasons for Change

Gifts of appreciated property are a critical component of donations to educational institutions, museums, and many medical research facilities and hospitals. Until 1986, these gifts generally were fully deductible at fair market value.

When the Tax Reform Act of 1986 restricted the otherwise available deduction under the alternative minimum tax, the result was a precipitous decline in gifts of appreciated property, although other types of charitable giving remained vigorous. The level of gifts of appreciated property increased, however, when limited relief was provided in 1991 and the first half of 1992. Accordingly, the committee believes that extending and expanding this relief permanently will provide an important incentive for taxpayers to make charitable contributions of appreciated property.

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

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

Explanation of Provision

The bill eliminates the treatment of contributions of appreciated property (real, personal, and intangible) as a tax preference for AMT purposes. In addition, the bill provides that no adjustment related to the earnings and profits effects of any charitable contribution shall be made in computing the ACE component of the corporate AMT.

Thus, the difference between the fair market value of donated appreciated property and the adjusted basis of such property is not treated as a tax preference item for alternative AMT purposes. If a taxpayer makes a gift to charity of property (other than inventory or other ordinary income property, short-term capital gain property, or certain gifts to private foundations) that is real property, intangible property, or tangible personal property the use of which is related to the donee's tax-exempt purpose, the taxpayer is allowed to claim a deduction for both regular tax and AMT purposes in the amount of the property's fair market value (subject to present-law percentage limitations).[15]

Effective Date

The provision is effective for contributions of tangible personal property made after June 30, 1992, and contributions of other property made after December 31, 1992.

2. Substantiation and disclosure of charitable contributions (secs. 8172-8173 of the bill and sec. 170 and new secs. 6115 and 6714 of the Code)

Present Law

An individual taxpayer who itemizes deductions must separately state (on Schedule A to the Form 1040) the aggregate amount of charitable contributions made by cash or check and the aggregate amount made by donated property other than cash or check.

A taxpayer is not required to provide specific information on his or her return regarding a claimed charitable contribution made by cash or check; nor in such a case is a donee organization required to file an information return with the IRS, regardless of the amount of cash or check involved. However, taxpayers must provide certain information (on Form 8283) if the amount of the claimed deduction for all noncash contributions exceeds $500.[16]

A payment to a charity (regardless of whether it is termed a "contribution") in exchange for which the payor receives an economic benefit is not deductible under section 170, except to the extent that the taxpayer can demonstrate that the payment exceeds the fair market value of the benefit received from the charity.[17]

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

[16] If the claimed deduction for a noncash gift exceeds $5,000 per item or group of similar items (other than certain publicly traded securities), a qualified appraiser must sign the Form 8283, and an authorized representative of the donee charity also must sign the Form 8283, acknowledging receipt of the gift and providing certain other information. In certain situations, information reporting by the donee charity is required if it subsequently disposes of donated property (sec. 6050L).

[17] See, e.g., Rev. Rul. 67-246, 1967-2 C.B. 104.

The Code does not require a tax-exempt organization that is eligible to receive tax-deductible contributions to state explicitly, in its solicitations for support from members or the general public, whether an amount paid to the organization is deductible as a charitable contribution or whether all or part of the payment constitutes consideration for goods or services furnished to the payor.[18] In contrast, tax-exempt organizations that are *not* eligible to receive tax-deductible contributions are required to state expressly in certain fund-raising solicitations that contributions or gifts to the organization are not deductible as charitable contributions for Federal income tax purposes (sec. 6113).[19] A penalty is imposed on such organizations for failure to comply with the section 6113 disclosure requirement, unless reasonable cause is shown (sec. 6710).

Tax-exempt organizations generally are required to file an annual information return (Form 990) with the IRS. However, churches (and their affiliated organizations), as well as tax-exempt organizations (other than private foundations) that normally have gross receipts in each taxable year of not more than $25,000, are not required to file the Form 990.[20] If a charity is required to file a Form 990, then it must report, among other items, the names and addresses of all persons who contributed, bequeathed, or devised $5,000 or more (in cash or other property) during the taxable year.[21]

Reasons for Change

Difficult problems of tax administration arise with respect to fundraising techniques in which an organization that is eligible to receive tax deductible contributions provides goods or services in consideration for payments from donors. Organizations that engage in such fundraising practices often do not inform their donors that all or a portion of the amount paid by the donor may not be deductible as a charitable contribution. Consequently, the committee believes that there will be increased compliance with present-law rules governing charitable contribution deductions if a taxpayer

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Under current IRS practice, certain small items and token benefits (e.g., key chains and bumper stickers) that have insubstantial value are disregarded, such that the full amount of the contribution is deductible. Rev. Proc. 90-12, 1990-1 C.B. 471, provides that tokens or benefits given to the donor in connection with a contribution will be considered to have insubstantial value if (1) the payment occurs in the context of a fundraising campaign in which the charity informs patrons how much of their payment is a deductible contribution, *and* (2) *either* (a) the fair market value of all the benefits received in connection with the payment is not more than two percent of the payment, or $50, *whichever is less*, *or* (b) the payment made by the patron is $25 or more (adjusted for inflation) and the only benefits received in connection with the payment are token items (e.g., key chains or mugs) that bear the organization's name or logo and that (in the aggregate) are within the limits for "low-cost items" under section 513(h)(2). See also Rev. Proc. 92-49, 1992-26 IRB 18 (amplifying Rev. Proc. 90-12, by allowing charities to distribute certain low-cost items to contributors without affecting the deductibility of the contribution).

[18] However, Schedule A to the Form 1040 (and the accompanying instructions) inform taxpayers that if they made a contribution to a charity and received a benefit in return, the value of that benefit must be subtracted in calculating the charitable contribution deduction.

[19] However, the disclosure requirement of section 6113 does not apply to an organization the gross receipts of which in each taxable year are normally not more than $100,000, nor does the disclosure requirement apply to any solicitation made by letter or telephone call if such letter or call is not part of a coordinated fundraising campaign soliciting more than 10 persons during the calendar year (sec. 6113(b)(2)(A) and (c)(2)).

[20] See section 6033(a)(2) and Rev. Proc. 83-23, 1983-1 C.B. 687.

[21] See section 6033(b)(5) and Treas. Reg. sec. 1.6033-2(a)(2)(ii)(f). The names and addresses of substantial contributors to a public charity must be reported to the IRS but are not subject to public inspection (sec. 6104(e)(1)(C)).

who claims a separate charitable contribution of $250 or more is required to obtain substantiation from the donee indicating the amount of the contribution and whether any goods, service, or privilege was received by the donor in exchange for making the contribution. In addition, the committee believes it is appropriate that when a charity receives a *quid pro quo* contribution in excess of $75 (i.e., a payment exceeding $75 made partly as a gift and partly in consideration for a benefit furnished to the payor), the charity should inform the donor that the deduction under section 170 is limited to the amount by which the payment exceeds the value of the goods or service furnished by the charity, and should provide a good faith estimate of the value of such goods or service.

Explanation of Provisions

The bill contains the following two provisions that require substantiation and disclosure relating to certain charitable contributions:

Substantiation requirement

Section 170 is amended to provide that no deduction is allowed under that section for any contribution of $250 or more[22] unless the taxpayer has written substantiation from the donee organization of the contribution (including a good faith estimate of the value of any good or service that has been provided to the donor in exchange for making the gift to the donee).[23]

This provision does not impose an information reporting requirement upon charities; rather, it places the responsibility upon taxpayers who claim an itemized deduction for a contribution of $250 or more to request (and maintain in their records) substantiation from the charity of their contribution (and any good or service received in exchange).[24] Taxpayers may not rely solely on a canceled check as substantiation for a donation of $250 or more.

Under the provision, the substantiation must be obtained by the taxpayer prior to filing his or her return for the taxable year in which the contribution was made (or if earlier, the due date, including extensions, for filing such return).[25] Substantiation is not

[22] Separate payments generally will be treated as separate contributions and will not be aggregated for the purposes of applying the $250 threshold. In cases of contributions paid by withholding from wages, the deduction from each paycheck will be treated as a separate payment. However, it is expected that the Treasury Department will issue anti-abuse rules to prevent avoidance of the substantiation requirement by a contributor simply writing multiple checks on the same date.

[23] If the donee organization provided no goods or services to the taxpayer in consideration of the taxpayer's contribution, the written substantiation is required to include a statement to that effect. The substantiation need *not* contain the taxpayer's social security number or taxpayer identification number (TIN).

[24] In the case where a taxpayer makes a noncash contribution claimed by the taxpayer to be worth $250 or more, the taxpayer is required to obtain from the charity a receipt that describes the donated property (and indicates whether any good or service was given to the taxpayer in exchange), but the provision specifically provides that the charity is not required to value the property it receives from the taxpayer.

[25] The provision requires that the written acknowledgment provide information sufficient to substantiate the amount of the deductible contribution, but the acknowledgment need not take any particular form. Thus, for example, acknowledgments may be made by letter, postcard, or computer-generated forms. Further, a donee organization may prepare a separate acknowledgment for each contribution, or may provide donors with periodic (e.g., annual) acknowledgments that set forth the required information for each contribution of $250 or more made by the donor during the period. It is intended that a charitable organization that knowingly provides a false written substantiation to a donor may be subject to the penalties provided for by section 6701 for aiding and abetting an understatement of tax liability.

required if the donee organization files a return with the IRS (in accordance with Treasury regulations) reporting information sufficient to substantiate the amount of the deductible contribution.

The provision explicitly provides that, if in return for making a contribution of $250 or more to a religious organization, a donor receives in return solely an intangible religious benefit that generally is not sold in commercial transactions outside the donative context (e.g., admission to a religious ceremony[26]), then such a religious benefit may be disregarded for purposes of the substantiation requirement.

Information disclosure for quid pro quo contributions

A charitable organization that receives a *quid pro quo* contribution in excess of $75 (meaning a payment exceeding $75 "made partly as a contribution and partly in consideration for goods or services provided to the payor by the donee organization") is required, in connection with the solicitation or receipt of such a contribution, to provide a written statement to the donor that (1) informs the donor that the amount of the contribution that is deductible for Federal income tax purposes is limited to the excess of the amount of any money (and the value of any property other than money) contributed by the donor over the value of the goods or services provided by the organization, and (2) provides the donor with a good faith estimate of the value of goods or services furnished to the donor by the organization.[27]

The disclosure requirement applies to all *quid pro quo* contributions where the donor makes payment of more than $75.[28] Thus, for example, if a charity receives a $100 contribution from a donor, in exchange for which the donor receives a dinner valued at $40, then the charity must inform the donor in writing that only $60 is deductible as a charitable contribution. However, the provision does not apply if only *de minimis*, token goods or services are given to a donor (see Rev. Procs. 90-12 and 92-49, discussed above). In addition, as with the substantiation provision (described above), the provision does not apply to a contribution, in return for which the contributor receives solely an intangible religious benefit that generally is not sold in a commercial context outside the donative context.[29] Furthermore, the provision does not apply to transactions that have no donative element (e.g., sales of goods by a museum gift shop that are not, in part, donations).

The provision also provides that penalties ($10 per contribution, but capped at $5,000 per particular fundraising event or mailing)

[26] This exception does not apply, for example, to tuition for education leading to a recognized degree, travel services, or consumer goods. However, it is intended that *de minimis* tangible benefits furnished to contributors that are incidental to a religious ceremony (such as wine) generally may be disregarded.

[27] The committee intends that the disclosure be made in a manner that is reasonably likely to come to the attention of the donor. For example, a disclosure of the required information in small print set forth within a larger document might not meet the requirement.

[28] For purposes of the $75 threshold, separate payments made at different times of the year with respect to separate fundraising events generally will not be aggregated. However, to prevent avoidance of the *quid pro quo* disclosure requirement by a contributor simply writing multiple checks on the same date, contributions that are part of a single transaction will be aggregated for purposes of the $75 threshold.

[29] No inference is intended, however, whether or not any payment outside the scope of the *quid pro quo* disclosure proposal or substantiation proposal is deductible (in full or in part) under the present-law requirements of section 170.

may be imposed upon charities that fail to make the required disclosure, unless the failure was due to reasonable cause. The penalties will apply if an organization either fails to make any disclosure in connection with a *quid pro quo* contribution or makes a disclosure that is incomplete or inaccurate (e.g., an estimate not determined in good faith of the value of goods or services furnished to the donor).

Effective Date

The provisions are effective for contributions made after December 31, 1993.[30]

3. Permanent extension of General Fund transfer to Railroad Retirement Tier 2 Fund (sec. 8174 of the bill)

Present Law

A portion of the Railroad Retirement Tier 2 benefits are included in gross income of recipients (similar to the treatment accorded recipients of private pensions) for Federal income tax purposes. The proceeds from the income taxation of Railroad Retirement Tier 2 benefits received prior to October 1, 1992, have been transferred from the General Fund of the Treasury to the railroad retirement account. Proceeds from the income taxation of benefits received after September 30, 1992 remain in the General Fund.

Reasons for Change

It is appropriate to make permanent the transfer of funds from the General Fund of the Treasury to the railroad retirement account to promote the on-going solvency of the railroad retirement system.

Explanation of Provision

The transfer of proceeds from the income taxation of Railroad Retirement Tier 2 benefits from the General Fund of the Treasury to the railroad retirement account is made permanent.

Effective Date

The provision is effective for income taxes on benefits received after September 30, 1992.

4. Temporary extension of health insurance deduction for self-employed individuals (sec. 8175 of the bill and sec. 162(l) of the Code)

Present Law

Under present law, an incorporated business can generally deduct, as an employee compensation expense, the full cost of any health insurance coverage provided for its employees (including

[30] The committee intends that, following enactment of the bill, the Secretary of the Treasury will expeditiously issue a notice or other announcement providing guidance with respect to the substantiation and disclosure provisions. In this regard, it is expected that such Treasury guidance will urge charities to assist taxpayers in meeting the substantiation requirement.

owners serving as employees) and its employees' spouses and dependents. Self-employed individuals can fully deduct the cost of health insurance for employees as employee compensation, but can only deduct the cost of health insurance coverage for the individual and his or her dependents to the extent that the cost of the coverage, together with other allowable medical expenses, exceeds 7.5 percent of adjusted gross income. Other individuals (e.g., employees who are not covered by an employer-sponsored plan) who purchase health insurance can deduct the cost of the insurance only to the extent that it, together with their other medical expenses, exceeds 7.5 percent of adjusted gross income.

For coverage prior to July 1, 1992, a self-employed individual was allowed to deduct as a business expense up to 25 percent of the amount paid for health insurance coverage for the taxpayer, the taxpayer's spouse, and the taxpayer's dependents. Only amounts paid prior to July 1, 1992, for coverage before that date were eligible for the deduction. The deduction was not allowed if the self-employed individual or his or her spouse was eligible for employer-paid health benefits.

Reasons for Change

The 25-percent deduction for health insurance costs of self-employed individuals was added by the Tax Reform Act of 1986 to reduce the disparity between the tax treatment of owners of incorporated and unincorporated businesses. The provision was originally enacted on a temporary basis and has been extended several times since enactment.

The committee believes it is appropriate to extend the 25-percent deduction retroactively and to extend it prospectively again on a temporary basis. The provision is not extended for a longer period at this time because it is expected that the deduction will be addressed as part of forthcoming comprehensive health care legislation.

Explanation of Provision

The 25-percent deduction is extended retroactively from July 1, 1992, through December 31, 1993. In addition, the bill provides that the determination of whether a self-employed individual or his or her spouse are eligible for employer-paid health benefits is made on a monthly basis.

Effective Date

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

II. REVENUE-RAISING PROVISIONS

A. Individual Income and Estate and Gift Tax Provisions

1. Increased tax rates for higher income individuals (secs. 8201-8205 of the bill and secs. 1, 55, 68, and 151 of the Code)

Present Law

Regular tax rates

For 1993, the individual income tax rates are as follows—

If taxable income is:	*Then income tax equals:*
Single individuals	
$0–$22,100	15 percent of taxable income.
$22,100–$53,500	$3,315.00 plus 28% of the amount over $22,100
Over $53,500	$12,107.00 plus 31% of the amount over $53,500
Heads of household	
$0–$29,600	15 percent of taxable income
$29,600–$76,400	$4,440.00 plus 28% of the amount over $29,600
Over $76,400	$17,544.00 plus 31% of the amount over $76,400
Married individuals filing joint returns	
$0–$36,900	15 percent of taxable income
$36,900–$89,150	$5,535 plus 28% of the amount over $36,900
Over $89,150	$20,165 plus 31% of the amount over $89,150
Married individuals filing separate returns	
$0–$18,450	15 percent of taxable income
$18,450–$44,575	$2,767.50 plus 28% of the amount over $18,450
Over $44,575	$10,082.50 plus 31% of the amount over $44,575
Estates and trusts	
$0–$3,750	15 percent of taxable income
$3,750–$11,250	$562.50 plus 28% of the amount over $3,750
Over $11,250	$2,662.50 plus 31% of the amount over $11,250

Net capital gains income is subject to a maximum tax rate of 28 percent.

The individual income tax brackets are indexed each year for inflation.

Alternative minimum tax

An individual taxpayer is subject to an alternative minimum tax (AMT) to the extent that the taxpayer's tentative minimum tax exceeds the taxpayer's regular tax liability. A taxpayer's tentative minimum tax generally equals 24 percent of alternative minimum taxable income (AMTI) in excess of an exemption amount. The exemption amount is $40,000 for married taxpayers filing joint returns, $30,000 for unmarried taxpayers filing as single or head of household, and $20,000 for married taxpayers filing separate returns, estates, and trusts. The exemption amount is phased out for taxpayers with AMTI above specified thresholds. These thresholds are: $150,000 for married taxpayers filing joint returns, $112,500 for unmarried taxpayers filing as single or head of household, and $75,000 for married taxpayers filing separate returns, estates, and trusts. The exemption is completely phased out for individuals with AMTI above $310,000 (married taxpayers filing joint returns) or $232,500 (unmarried taxpayers filing as single or head of household).

Surtax on higher-income taxpayers

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

Itemized deduction limitation

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

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

The total amount of otherwise allowable itemized deductions (other than medical expenses, casualty and theft losses, and investment interest) is reduced by 3 percent of the amount of the taxpayer's AGI in excess of $108,450 in 1993 (indexed for inflation). Under this provision, otherwise allowable itemized deductions may not be reduced by more than 80 percent. In computing the reduction of total itemized deductions, all present-law limitations applicable to such deductions are first applied and then the otherwise

allowable total amount of deductions is reduced in accordance with this provision.

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

Personal exemption phaseout

Present law permits a personal exemption deduction from gross income for an individual, the individual's spouse, and each dependent. For 1993, the amount of this deduction is $2,350 for each exemption claimed. This exemption amount is adjusted for inflation. The deduction for personal exemptions is phased out for taxpayers with AGI above a threshold amount (indexed for inflation) which is based on filing status. For 1993, the threshold amounts are $162,700 for married taxpayers filing joint returns, $81,350 for married taxpayers filing separate returns, $135,600 for unmarried taxpayers filing as head of household, and $108,450 for unmarried taxpayers filing as single.

The total amount of exemptions that may be claimed by a taxpayer is reduced by 2 percent for each $2,500 (or portion thereof) by which the taxpayer's AGI exceeds the applicable threshold. (The phaseout rate is 2 percent for each $1,250 for married taxpayers filing separate returns.) Thus, the personal exemptions claimed are phased out over a $122,500 range, beginning at the applicable threshold.

This provision does not apply to taxable years beginning after December 31, 1996.

Reasons for Change

To raise revenue to reduce the Federal deficit and to make the Federal income tax system more progressive, the committee believes that higher marginal tax rates should be imposed on those taxpayers with the greatest ability to pay income taxes. In a similar manner, the progressivity of the individual income tax system would be enhanced by introducing a two-tier rate schedule for the alternative minimum tax and, for higher-income taxpayers, by permanently extending both the existing limitation on itemized deductions and the existing phaseout of personal deductions.

Explanation of Provisions

New marginal tax rates

The bill imposes a new 36-percent marginal tax rate on taxable income in excess of the following thresholds:

Filing status	Applicable threshold
Married individuals filing joint returns	$140,000
Heads of households	127,500
Unmarried individuals	115,000

Filing status	Applicable threshold
Married individuals filing separate returns	70,000
Estates and trusts	5,500

For estates and trusts, the 15-percent rate will apply to income up to $1,500, the 28-percent rate will apply to income between $1,500 and $3,500, and the 31-percent rate will apply to income between $3,500 and $5,500. Under this modified tax rate schedule for estates and trusts, the benefits of the rates below the 39.6-percent surtax-included rate (described below) approximate the benefits of the 15- and 28-percent rates under present law.

For taxable years beginning in 1993, a blended rate (described below) would be used.

As under present law, the tax rate bracket thresholds will be indexed for inflation. However, indexing of thresholds for the 36-percent rate will apply to taxable years beginning after December 31, 1994.

Alternative minimum tax

The bill provides a two-tiered graduated rate schedule for the AMT for taxpayers other than corporations. A 26-percent rate will apply to the first $175,000 of a taxpayer's AMTI in excess of the exemption amount, and a 28-percent rate will apply to AMTI more than $175,000 above the exemption amount. For married individuals filing separate returns, the 28-percent rate will apply to AMTI more than $87,500 above the exemption amount. The bill increases the exemption amount to $45,000 for married individuals filing joint returns, to $33,750 for unmarried individuals, and to $22,500 for married individuals filing separate returns, estates, and trusts.

Surtax on higher-income taxpayers; surtax on net capital gain

The bill imposes a 10-percent surtax on individuals with taxable income in excess of $250,000 and on estates and trusts with taxable income in excess of $7,500. For married taxpayers filing separate returns, the threshold amount for the surtax would be $125,000. The surtax will be computed by applying a 39.6-percent rate to taxable income in excess of the applicable threshold. In a similar manner, an individual's net capital gain will be subject to the surtax by applying a maximum rate of 30.8 percent (instead of the present-law maximum rate of 28 percent) to capital gains income to the extent an individual's taxable income exceeds $250,000.

The thresholds for the surtax will be indexed for inflation in the same manner as other individual income tax rate thresholds for taxable years beginning after December 31, 1994.

Itemized deduction limitation and phaseout of personal exemptions

The bill makes permanent the provisions that limit itemized deductions and phase out personal exemptions.

Effective Date

The provision is effective for taxable years beginning after December 31, 1992. For taxable years beginning in 1993, blended tax rates will be used: the 36-percent tax rate will be reduced to 33.5 percent and the 39.6-percent rate will be reduced to 35.3 percent. In addition, the 30.8-percent maximum rate on capital gains income will be reduced to 29.4 percent for taxable years beginning in 1993. Similarly, for taxable years beginning in 1993, the 26- percent and 28-percent alternative minimum tax rates will be reduced to 25 percent and 26 percent, respectively. The permanent rate levels will be used for 1994 and later years.

Withholding tables for 1993 will not be revised to reflect the changes in tax rates. Penalties for the underpayment of estimated taxes will be waived for underpayments of 1993 taxes attributable to these changes in tax rates.

2. Provisions to prevent conversion of ordinary income to capital gain (sec. 8206 of the bill)

a. Recharacterization of capital gain as ordinary income for certain financial transactions (sec. 8206(a) of the bill and sec. 1258 of the Code)

Present Law

Under present law, the maximum rate of individual income tax on ordinary income is 31 percent. Interest from a loan generally is treated as ordinary income.

Gain or loss from the sale or exchange of a capital asset generally is treated as capital gain or loss. Net capital gain (i.e., net long-term capital gain less net short-term capital loss) of an individual is subject to a maximum tax rate of 28 percent. Capital losses are deductible only to the extent of capital gains for the year plus, in the case of noncorporate taxpayers, ordinary income of up to $3,000.

Reasons for Change

The committee is aware that taxpayers are able to enter into transactions the economic substance of which is indistinguishable from loans in terms of the return anticipated and the risks borne by the taxpayer. However, because of their form, these transactions may permit taxpayers to take the position for tax purposes that their return is capital gain rather than ordinary income. The committee is concerned that, because of the increased differential between the rates of tax on ordinary income and capital gain that results from this bill, taxpayers may enter into such transactions for purposes of avoiding the intended higher rates on ordinary income. In addition, the committee is concerned that these transactions can be used to circumvent the capital loss limitation rules. Accordingly, the committee believes that providing rules that would treat gain from such transactions as ordinary income is appropriate.

Explanation of Provision

Under the provision, capital gain from the disposition or other termination of any position that was part of a "conversion transaction" will be recharacterized as ordinary income,[31] with certain limitations discussed below. No inference is intended as to when income from a conversion transaction is properly treated as capital gain under present law.

A conversion transaction is a transaction, generally consisting of two or more positions taken with regard to the same or similar property, where substantially all of the taxpayer's return is attributable to the time value of the taxpayer's net investment in the transaction. In a conversion transaction, the taxpayer is in the economic position of a lender—he has an expectation of a return from the transaction which in substance is in the nature of interest and he undertakes no significant risks other than those typical of a lender.

A transaction, however, is not a conversion transaction subject to the provision unless it also satisfies one of the following four criteria: (1) the transaction consists of the acquisition of property by the taxpayer and a substantially contemporaneous agreement to sell the same or substantially identical property in the future; (2) the transaction is a straddle, within the meaning of section 1092;[32] (3) the transaction is one that was marketed or sold to the taxpayer on the basis that it would have the economic characteristics of a loan but the interest-like return would be taxed as capital gain; or (4) the transaction is described as a conversion transaction in regulations to be promulgated on a prospective basis by the Secretary of the Treasury.

In addition, transactions (which may include positions other than options or section 1256 contracts) of options dealers and commodities traders in the normal course of their trade or business of dealing in options or trading section 1256 contracts, respectively, generally will not be considered conversion transactions. The term "options dealer" generally means any person registered with an appropriate national securities exchange as a market maker or specialist in listed options. The term "commodities trader" generally means any person who is a member of a domestic board of trade which is designated as a contract market by the Commodity Futures Trading Commission. Commodities traders also, to the extent permitted by Treasury regulations, include persons entitled to trade as a member (e.g., persons who are registered with a board of trade as users of memberships or who are eligible for member rates for the clearing of trades on the board of trade). Special rules limit the availability of the options dealer and commodities trader exception for limited partners or limited entrepreneurs in an entity that is an options dealer or a commodities trader.

Under the provision, gain realized by a taxpayer from disposition or other termination of a position that was part of a conversion transaction that would otherwise be treated as capital gain will be

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[31] The provision is not intended to change the treatment of gain from the sale of property for purposes such as the unrelated business income tax for tax-exempt organizations and the gross income requirement for regulated investment companies.

[32] Except that stock also is treated as personal property in defining a straddle for purposes of the conversion transaction provision.

treated as ordinary income (but not as interest) for all purposes of the Internal Revenue Code. The amount of gain so recharacterized will not exceed the amount of interest that would have accrued on the taxpayer's net investment for the relevant period at a yield equal to 120% of the "applicable rate". This limit is subject to appropriate reduction to reflect prior inclusion of ordinary income items from the conversion transaction or the capitalization of interest on acquisition indebtedness under section 263(g). The "applicable rate" is the applicable Federal rate under section 1274(d) at the time the taxpayer enters into the conversion transaction (if the conversion transaction has a definite term) or the Federal short term rate determined under section 6621(b) (if the conversion transaction has an indefinite term).

For example, assume that X purchases stock for $100 on January 1, 1994, and on that same day agrees to sell it to Y on January 1, 1996 for $115. Assume that the applicable rate is 5%.[33] On January 1, 1996, X delivers the stock to Y in exchange for $115 in satisfaction of their agreement. Assume that, under current law, X would have recognized a capital gain of $15. Under the provision, $12.36 of that amount would be recharacterized as ordinary income (i.e, 120% of 5% compounded for two years, applied to an investment of $100).

In determining a taxpayer's net investment in a conversion transaction, the source of the taxpayer's funds generally will not be taken into account. Assume in the above example that X borrowed $90 of the purchase price of the stock from a bank and was required under section 263(g) to capitalize $10 of interest on that debt into the cost of the stock. Then X's net investment in the transaction will still be $100, even though X's basis is $110 to reflect the capitalized $10 of interest. However, of the gain of $5, only $2.36 will be recharacterized as ordinary income under the provision. This is because the limitation amount of $12.36 will be reduced by the $10 of capitalized interest.

A special rule is included for situations in which the taxpayer has a built-in loss with respect to a position that becomes part of a conversion transaction. Assume that, prior to January 1, 1994, X had purchased the stock in the previous example for $150, and had used that stock as part of a conversion transaction entered into on January 1, 1994, when the stock's value had declined to $100. Under these facts, the stock would be valued at $100 for purposes of this provision, and the results would be the same as in the example, except that X also would recognize the $50 built-in loss when the asset was delivered to Y. The character of that $50 loss would not be affected by this provision.

Amounts that a taxpayer may be committed to provide in the future generally will not be treated as an investment until such time as such amounts are committed to the transaction and unavailable to the taxpayer to invest in other ways. For example, assume that on January 1, 1994, X enters into a long futures contract committing X to purchase a certain quantity of gold on March 1 for $1,000. Also on January 1, 1994, X enters into a short futures contract to sell the same quantity of gold on April 1 for $1,006. Under these

[33] For simplicity, the applicable rate is assumed to be compounded on an annual basis.

contracts, X is not required to make any investment at the time they are entered into, but is required to make a "margin" deposit (which may or may not bear interest), as security for his obligations thereunder. Suppose X terminates both contracts on February 1 for a net profit of $2. No part of that $2 is subject to recharacterization under this provision, since X has no investment in the transaction on which the $2 could be considered to be an interest equivalent return.

A taxpayer's net investment in a conversion transaction generally will be the aggregate amount invested by the taxpayer in the conversion transaction less any amount received by the taxpayer as consideration for entering into any position held as part of the conversion transaction, such as when the taxpayer is the grantor of an option. For example, suppose that on January 1, 1994, X acquires non-publicly-traded common stock for $100 and, on the same day grants Y a call option on the same stock for $106, exercisable any time prior to February 1, 1995. Y pays X a premium of $10 for the call option. At the time X grants Y the call option, there is no substantial certainty that Y will exercise the option. Under these facts, X's net investment in the transaction comprised of the stock purchase and the granting of the option would be $90 (i.e., the $100 paid for the stock minus the $10 received for granting the option). X's return on that investment will be $16 if Y exercises the call option (the excess of $106 of sales proceeds over the net investment of $90). However, if Y does not exercise the option, X's return will be the difference between $90 and the value of the stock on February 1, 1995. The transaction consisting of the stock purchase and the grant of the option is one in which X takes on a risk not typical of a lender and is not a conversion transaction.

Effective Date

The provision is effective for conversion transactions entered into after April 30, 1993.

b. Repeal of certain exceptions to the market discount rules (sec. 8206(b) of the bill and secs. 1276, 1277, 1278 of the Code)

Present Law

Generally, a market discount bond is a bond that is acquired for a price that is less than the principal amount of the bond.[34] Market discount generally arises when the value of a debt obligation declines after issuance (typically, because of an increase in prevailing interest rates or a decline in the credit-worthiness of the borrower).

Gain on the disposition of a market discount bond generally must be recognized as ordinary income to the extent of the market discount that has accrued. This ordinary income rule, however, does not apply to tax-exempt obligations or to market discount bonds issued on or before July 18, 1984. Under current law, income attributable to accrued market discount on tax-exempt bonds is not tax-

[34] Or, in the case of a bond issued with original issue discount (OID), a price that is less than the amount of the issue price plus accrued OID.

exempt but is taxable as capital gain if the bond is held as a capital asset.

Reasons for Change

The committee is concerned about taxpayers being able to purchase market discount bonds as a means of converting returns on investments that are in the nature of interest on debt to capital gains. The committee therefore believes that the market discount rule should apply to tax-exempt bonds and to all taxable bonds, regardless of whether they were issued after July 18, 1984.

Explanation of Provision

The bill extends the ordinary income rule to tax-exempt obligations and to market discount bonds issued on or before July 18, 1984. Thus, gain on the disposition of a tax-exempt obligation or any other market discount bond that is acquired for a price that is less than the principal amount of the bond generally will be treated as ordinary income (instead of capital gain) to the extent of accrued market discount.

Effective Date

The provision is effective for bonds purchased after April 30, 1993. Thus, current owners of tax-exempt bonds and other market discount bonds issued on or before July 18, 1984, will not be required to treat accrued market discount as ordinary income, if they acquired their bonds before May 1, 1993.

c. Accrual of income by holders of stripped preferred stock (sec. 8206(c) of the bill and sec. 305 of the Code)

Present Law

In general, if a bond is issued at a price approximately equal to its redemption price at maturity, the expected return to the holder of the bond is in the form of periodic interest payments. In the case of original issue discount ("OID") bonds, however, the issue price is below the redemption price, and the holder receives part or all of his expected return in the form of price appreciation. The difference between the issue price and the redemption price is the OID, and a portion of the OID is required to be accrued and included in the income of the holder annually. Similarly, for certain preferred stock that is issued at a discount from its redemption price, a portion of the redemption premium must be included in income annually.

A stripped bond (i.e., a bond issued with interest coupons some of which are subsequently "stripped" so that the ownership of the bond is separated from the ownership of the interest coupons) generally is treated as a bond issued with OID equal to (1) the stated redemption price of the bond at maturity minus (2) the amount paid for the stripped bond.

If preferred stock is stripped of some of its dividend rights, however, the stripped stock is not subject to the rules that apply to stripped bonds or to the rules that apply to bonds and certain preferred stock issued at a discount.

Reasons for Change

The committee believes that the purchaser of stripped preferred stock may, in effect, be purchasing at a discount the right to a fixed amount payable at a future date. The committee is concerned that taxpayers may purchase stripped preferred stock as a means of converting ordinary income to capital gains. Therefore, under these circumstances, the committee believes that the rules that apply to stripped bonds provide the appropriate tax treatment.

Explanation of Provision

The bill treats the purchaser of stripped preferred stock (and a person who strips preferred stock and disposes of the stripped dividend rights) in generally the same way that the purchaser of a stripped bond would be treated under the OID rules. Thus, stripped stock is treated like a bond issued with OID equal to (1) the stated redemption price of the stock minus (2) the amount paid for the stock. The discount accrued under the provision is treated as ordinary income and not as interest or dividends.

Stripped preferred stock is defined as any preferred stock where the ownership of the stock has been separated from the right to receive any dividend that has not yet become payable. The provision applies to stock that is limited and preferred as to dividends, does not participate in corporate growth to any significant extent, and has a fixed redemption price.

No inference is intended as to as to the treatment of stripped preferred stock for tax purposes with respect to any issues not directly addressed by this legislation, including the availability of the dividends received deduction to a holder of dividends stripped from preferred stock, the allocation of basis by the creator of stripped preferred stock, or the proper characterization of a purported sale of stripped dividend rights.

Effective Date

The bill is effective for stripped stock that is purchased after April 30, 1993.

d. Treatment of net capital gains as investment income (sec. 8206(d) of the bill and sec. 163(d) of the Code)

Present Law

In the case of a taxpayer other than a corporation, deductions for interest on indebtedness that is allocable to property held for investment ("investment interest") are limited to the taxpayer's net investment income for the taxable year. Disallowed investment interest is carried forward to the next taxable year. Investment income includes gross income (other than gain on disposition) from property held for investment and any net gain attributable to the disposition of property held for investment.

Investment interest that is allowable is deductible against income taxable at ordinary income rates. The net capital gain (i.e., net long-term capital gain less net short-term capital loss) of a noncorporate taxpayer is taxed at a maximum rate of 28 percent.

Prior to 1986, when a significant rate differential existed between long-term capital gains and ordinary income, long-term capital gains were not included in investment income for purposes of computing the investment interest limitation.

Reasons for Change

The committee believes it is inappropriate for a taxpayer who recognizes long term capital gain taxable at favorable rate to be able to use that gain to deduct otherwise non-deductible investment interest against ordinary income. Because the bill increases the rate differential between ordinary income and the net capital gains rate, the possibility of such inappropriate rate arbitrage is increased. The committee believes that the opportunities for this type of rate conversion should be reduced.

Explanation of Provision

The bill generally excludes net capital gain attributable to the disposition of property held for investment from investment income for purposes of computing the investment interest limitation. A taxpayer, however, can elect to include so much of his net capital gain in investment income as the taxpayer chooses if he also reduces the amount of net capital gain eligible for the 28-percent maximum capital gains rate by the same amount.

Effective Date

The provision is effective for taxable years beginning after December 31, 1992.

e. Definition of "substantially appreciated" inventory (sec. 8206(e) of the bill and sec. 751(d) of the Code)

Present Law

Under present law, amounts received by a partner in exchange for his interest in a partnership are treated as ordinary income to the extent they are attributable to substantially appreciated inventory of the partnership. In addition, distributions by a partnership in which a partner receives substantially appreciated inventory in exchange for his interest in certain other partnership property (or receives certain other property in exchange for substantially appreciated inventory) are treated as a taxable sale or exchange of property, rather than as a nontaxable distribution.

For these purposes, inventory is treated as substantially appreciated if the value of the partnership's inventory exceeds both 120 percent of its adjusted basis and 10 percent of the value of all partnership property (other than money).

Reasons for Change

The committee believes that the 10-percent exception creates opportunities for avoidance of the appreciated inventory rule through the manipulation of the partnership's gross assets. The committee also believes that disregarding inventory that is acquired prin-

cipally to avoid the appreciated inventory rule is necessary to prevent circumvention of the rule.

Explanation of Provision

The bill eliminates the requirement that the partnership's inventory exceed 10 percent of the value of all partnership property in order to be substantially appreciated. Thus, if the partnership's inventory is worth more than 120 percent of its adjusted basis, the inventory is treated as substantially appreciated. In addition, any inventory property acquired with a principal purpose to reduce the appreciation to less than 120 percent in order to avoid ordinary income treatment will be disregarded in applying the 120-percent test.

Effective Date

The provision applies to sales, exchanges, and distributions after April 30, 1993.

3. Repeal health insurance wage base cap (sec. 8207 of the bill and sec. 3121(x) of the Code)

Present Law

As part of the Federal Insurance Contributions Act (FICA), a tax is imposed on employees and employers up to a maximum amount of employee wages. The tax is comprised of two parts: old-age, survivor, and disability insurance (OASDI) and Medicare hospital insurance (HI). For wages paid in 1993 to covered employees, the HI tax rate is 1.45 percent on both the employer and the employee on the first $135,000 of wages and the OASDI tax rate is 6.2 percent on both the employer and the employee on the first $57,600 of wages.

Under the Self-Employment Contributions Act of 1954 (SECA), a tax is imposed on an individual's self-employment income. The self-employment tax rate is the same as the total rate for employers and employees (i.e., 2.9 percent for HI and 12.40 percent for OASDI). For 1993, the HI tax is applied to the first $135,000 of self-employment income and the OASDI tax is applied to the first $57,600 self-employment income. In general, the tax is reduced to the extent that the individual had wages for which employment taxes were withheld during the year.

The cap on wages and self-employment income subject to FICA and SECA taxes is indexed to changes in the average wages in the economy.

Reasons for Change

The President's proposal to eliminate the cap on wages and self-employment income subject to the HI tax is a significant revenue source in the administration's overall economic plan. The increased revenues would provide needed funding for the Medicare Hospital Insurance trust fund.

While the committee accepts the President's proposal in the immediate context, the committee is concerned that HI taxes paid by high-income workers would bear little relation to Medicare benefits

such workers can expect to receive, and that this change may make the HI program look more like welfare than social insurance. The committee may want to revisit this issue in the context of health care reform or Medicare financing improvements.

Explanation of Provision

The bill repeals the dollar limit on wages and self-employment income subject to HI taxes.

Effective Date

The provision is effective for wages and income received after December 31, 1993.

4. Reinstate top estate and gift tax rates at 53 percent and 55 percent (sec. 8208 of the bill and sec. 2001 of the Code)

Present Law

A Federal gift tax is imposed on transfers by gift during life and a Federal estate tax is imposed on transfers at death. The Federal estate and gift taxes are unified, so that a single graduated rate schedule is applied to an individual's cumulative gifts and bequests. For decedents dying (or gifts made) after 1992, the estate and gift tax rates begin at 18 percent on the first $10,000 of taxable transfers and reach a maximum of 50 percent on taxable transfers over $2.5 million. Previously, for the nine-year period beginning after 1983 and ending before 1993, two additional brackets applied at the top of the rate schedule: a rate of 53 percent on taxable transfers exceeding $2.5 million and below $3 million, and a maximum marginal tax rate of 55 percent on taxable transfers exceeding $3 million. The generation-skipping transfer tax is computed by reference to the maximum Federal estate tax rate (sec. 2641).

In order to phase out the benefit of the graduated brackets and unified credit, the estate and gift tax is increased by five percent on cumulative taxable transfers between $10 million and $18,340,000, for decedents dying and gifts made after 1992.[35] (Prior to 1993, this phase out of the graduated rates and unified credit applied to cumulative taxable transfers between $10 million and $21,040,000.)

Reasons for Change

To raise revenue to address the Federal deficit, to improve tax equity, and to make the tax system more progressive, the committee believes that the top two estate and gift tax rates which expired at the end of 1992 should be reinstated.

[35] The additional five percent rate applies to the taxable transfers of a nonresident noncitizen in excess of $10 million only to the extent necessary to phase out the graduated rates and unified credit actually allowed, either by statute or by treaty (where applicable).

Explanation of Provision

The bill provides that, for taxable transfers over $2.5 million but not over $3 million, the estate and gift tax rate is 53 percent. For taxable transfers over $3 million, the estate and gift tax rate is 55 percent. The phase out of the graduated rates and unified credit applies with respect to cumulative taxable transfers between $10 million and $21,040,000. Also, since the generation-skipping transfer tax is computed by reference to the maximum Federal estate tax rate, the rate of tax on generation-skipping transfers under the bill is 55 percent.

Effective Date

The provision is effective for decedents dying, gifts made, and generation skipping transfers occurring after December 31, 1992.

5. Reduce deductible portion of business meals and entertainment expenses to 50 percent (sec. 8209 of the bill and sec. 274(n) of the Code)

Present Law

In general, a taxpayer is permitted a deduction for all ordinary and necessary expenses paid or incurred during the taxable year in carrying on any trade or business and, in the case of an individual, for the production of income. No deduction generally is allowed for personal, living, or family expenses.

Meal and entertainment expenses incurred for business or investment reasons are deductible if certain legal and substantiation requirements are met. The amount of the deduction generally is limited to 80 percent of the expense that meets these requirements. No deduction is allowed, however, for meal or beverage expenses that are lavish or extravagant under the circumstances.

No deduction is allowed with respect to business meal and entertainment expenses (as well as other specified items) unless the taxpayer substantiates by adequate records or by sufficient evidence corroborating the taxpayer's own statement (1) the amount of the expense, (2) the time and place of the expense, (3) the business purpose of the expense, and (4) the business relationship to the taxpayer of the persons entertained. Under Treasury regulations, such documentary evidence is required for expenditures of $25 or more (Treas. Reg. sec. 1.274–5T(c)(2)(iii)(B)).

Reasons for Change

Generally, some portion of business meal and entertainment expenses represent personal consumption (even if the expenses serve a legitimate business purpose). The committee believes that denial of some part of the deduction is appropriate as a proxy for income inclusion of the consumption element of the meal or entertainment. The committee believes that increasing the portion of such expenses for which a deduction is denied is appropriate in the context of deficit-reduction legislation.

The committee believes that decreasing the substantiation threshold for meals will increase compliance with the deduction rules.

Explanation of Provision

The bill reduces the deductible portion of otherwise allowable business meals and entertainment expenses from 80 percent to 50 percent. In addition, the substantiation threshold for business meals is reduced from $25 to $20.

Effective Date

The provision is effective for taxable years beginning after December 31, 1993.

6. Deny deduction for club dues (sec. 8210 of the bill and sec. 274(a) of the Code)

Present Law

No deduction is permitted for club dues unless the taxpayer establishes that his or her use of the club was primarily for the furtherance of the taxpayer's trade or business and the specific expense was directly related to the active conduct of that trade or business (Code sec. 274(a)). No deduction is permitted for an initiation or similar fee that is payable only upon joining a club if the useful life of the fee extends over more than one year. Such initial fees are nondeductible capital expenditures.[36]

Reasons for Change

Under present law, taxpayers can obtain a tax deduction for dues for a club (such as a country club) with respect to which some element of personal pleasure and enjoyment is present. The committee believes that it is inappropriate to permit a deduction for such expenditures. Denying a deduction for club dues also simplifies present law, in that a strict nondeductibility rule is easier to comply with than the present-law rule requiring an assessment of the primary purpose of the use of the club.

Explanation of Provision

Under the bill, no deduction is permitted for club dues. This rule applies to all types of clubs, including business, social, athletic, luncheon, and sporting clubs. Specific business expenses (e.g., meals) incurred at a club are deductible only to the extent they otherwise satisfy the standards for deductibility.

Effective Date

The provision is effective for taxable years beginning after December 31, 1993.

7. Deny deduction for executive pay over $1 million (sec. 8211 of the bill and sec. 162 of the Code)

Present Law

The gross income of an employee includes any compensation received for services rendered. An employer is allowed a correspond-

[36] *Kenneth D. Smith*, 24 TCM 899 (1965).

ing deduction for reasonable salaries and other compensation. Whether compensation is reasonable is determined on a case-by-case basis. However, the reasonableness standard has been used primarily to limit payments by closely-held companies where non-deductible dividends may be disguised as deductible compensation.

Reasons for Change

Recently, the amount of compensation received by corporate executives has been the subject of scrutiny and criticism. The committee believes that it is appropriate to place an upper limit on the deductibility of such compensation to the extent it is not explicitly based on objective performance standards.

Explanation of Provision

In general

Under the bill, for purposes of the regular income tax and the alternative minimum tax, the otherwise allowable deduction for compensation paid or accrued with respect to a covered employee of a publicly held corporation is be limited to no more than $1 million per year.[37]

Definition of publicly held corporation

For this purpose, a corporation is treated as publicly held if the corporation has a class of common equity securities that is required to be registered under section 12 of the Securities Exchange Act of 1934. In general, the Securities Exchange Act requires a corporation to register its common equity securities under section 12 if (1) the securities are listed on a national securities exchange or (2) the corporation has $5 million or more of assets and 500 or more holders of such securities. A corporation is not considered publicly held under the bill if registration of its equity securities is voluntary. Such a voluntary registration might occur, for example, if a corporation that otherwise is not required to register its equity securities does so in order to take advantage of other procedures with regard to public offerings of debt securities.

Covered employees

Covered employees are defined by reference to the Securities and Exchange Commission (SEC) rules governing disclosure of executive compensation. Thus, with respect to a taxable year, a person is a covered employee if (1) the employee is the chief executive officer of the corporation (or an individual acting in such capacity) as of the close of the taxable year or (2) the employee's total compensation is required to be reported for the taxable year under the Securities Exchange Act of 1934 because the employee is one of the four highest compensated officers for the taxable year (other than the chief executive officer). If disclosure is required with respect to fewer than four executives (other than the chief executive officer) under the SEC rules, then only those for whom disclosure is required are covered employees.

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[37] The provision does not modify the present-law requirement that, in order to be deductible, compensation must be reasonable. Thus, as under present law, in certain circumstances compensation less than $1 million may not be deductible.

Compensation subject to the deduction limitation

In general

Unless specifically excluded, the deduction limitation applies to all remuneration for services, including cash and the cash value of all remuneration (including benefits) paid in a medium other than cash. If an individual is a covered employee for a taxable year, the deduction limitation applies to all compensation not explicitly excluded from the deduction limitation, regardless of whether the compensation is for services as a covered employee and regardless of when the compensation was earned. The $1 million cap is reduced by excess parachute payments (as defined in sec. 280G) that are not deductible by the corporation.

The deduction limitation applies when the deduction would otherwise be taken. Thus, for example, in the case of a nonqualified stock option, the deduction is normally taken in the year the option is exercised, even though the option was granted with respect to services performed in a prior year.[38]

Certain types of compensation are not subject to the deduction limit and are not taken into account in determining whether other compensation exceeds $1 million. The following types of compensation are not taken into account: (1) remuneration payable on a commission basis; (2) remuneration payable solely on account of the attainment of one or more performance goals if certain outside director and shareholder approval requirements are met; (3) payments to a tax-qualified retirement plan (including salary reduction contributions), (4) amounts that are excludable from the executive's gross income (such as employer-provided health benefits and miscellaneous fringe benefits (sec. 132)), and (5) any remuneration payable under a written binding contract which was in effect on February 17, 1993, and all times thereafter before such remuneration was paid and which was not modified thereafter in any material respect before such remuneration was paid.

Commissions

In order to qualify for the exception for compensation paid in the form of commissions, the commission must be payable solely on account of income generated directly by the individual performance of the executive receiving such compensation. Thus, for example, compensation that equals a percentage of sales made by the executive qualifies for the exception. Remuneration does not fail to be attributable directly to the executive merely because the executive utilizes support services, such as secretarial or research services, in generating the income. However, if compensation is paid on account of broader performance standards, such as income produced by a business unit of the corporation, the compensation would not qualify for the exception because it is not paid with regard to income that is directly attributable to the individual executive.

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[38] Of course, if the executive is no longer a covered employee at the time the options are exercised, then the deduction limitation would not apply.

Other performance-based compensation

Compensation qualifies for the exception for performance-based compensation only if (1) it is paid solely on account of the attainment of one or more performance goals, (2) the performance goals are established by a compensation committee consisting solely of two or more outside directors, (3) the material terms under which the compensation is to be paid, including the performance goals, are disclosed to and approved by the shareholders in a separate vote prior to payment, and (4) prior to payment, the compensation committee certifies that the performance goals and any other material terms were in fact satisfied.

Compensation is not treated as paid solely on account of the attainment of one or more performance goals unless it is paid pursuant to a preestablished objective formula or standard that precludes discretion. In general, this means that a third party with knowledge of the relevant performance results could calculate the amount to be paid. It is intended that what constitutes a performance goal be broadly defined, and include, for example, any performance standard that is applied to the individual executive, a business unit (e.g., a division or a line of business), or the corporation as a whole. Performance standards could include, for example, increases in stock price, market share, sales, or earnings per share.

Compensation does not qualify for the performance-based exception if the executive has a right to receive the compensation notwithstanding the failure of (1) the compensation committee to certify attainment of the performance goal or (2) the shareholders to approve the compensation.

Stock options or other stock appreciation rights generally are treated as meeting the exception for performance-based compensation, provided that the requirements for outside director and shareholder approval are met (without the need for certification that the performance standards have been met), because the amount of compensation attributable to the options or other rights received by the executive would be based on an increase in the corporation's stock price. This does not apply, however, to stock-based compensation that is dependent on factors other than corporate performance. For example, if a stock option is granted to an executive with an exercise price that is less than the current fair market value of the stock at the time of grant, then the executive would have the right to receive compensation on the exercise of the option even if the stock price decreases or stays the same. Thus, stock options that are granted with an exercise price that is less than the fair market value of the stock at the time of grant do not meet the requirements for performance-based compensation. Similarly, if the executive is otherwise protected from decreases in the value of the stock (such as through automatic repricing), the compensation is not performance-based.

In contrast to options or other stock appreciation rights, grants of restricted stock are not inherently performance-based because the executive may receive compensation even if the stock price decreases or stays the same. Thus, a grant of restricted stock is treated like cash compensation and does not satisfy the definition of performance-based compensation unless the grant or vesting of the restricted stock is based upon the attainment of a performance goal

and otherwise satisfies the standards for performance-based compensation under the bill.

For purposes of the exception for performance-based compensation, a director is considered an outside director if he or she is not a current employee of the corporation (or related entities), is not a former employee of the corporation (or related entities) who is receiving compensation for prior services (other than benefits under a tax-qualified pension plan), was not an officer of the corporation (or related entities) at any time, and is not currently receiving compensation for personal services in any capacity (e.g., for services as a consultant) other than as a director.

In order to meet the shareholder approval requirement, the material terms under which the compensation is to be paid must be disclosed. In developing standards as to whether disclosure is adequate, it is intended that the Secretary take into consideration the SEC rules regarding disclosure.

The shareholder approval requirement is met if, after disclosure of material terms, the compensation is approved in a separate vote by a majority of shares voting in the separate vote.

In the case of compensation paid pursuant to a plan (including a stock option plan), the shareholder approval requirement generally is satisfied if the shareholders approve the specific terms of the plan and the class of executives to which it applies and the amount of compensation payable under the plan is not subject to discretion. Further shareholder approval of payments under the plan is not required after the plan has been approved. Of course, if there are material changes to the plan, shareholder approval would have to be obtained again in order for the exception to apply to payments under the modified plan.

Under present law, in the case of a privately held company that becomes publicly held, the prospectus is subject to the rules similar to those applicable to publicly held companies. Thus, if there has been disclosure that would satisfy the rules described above, persons who buy stock in the publicly held company will be aware of existing compensation arrangements. No further shareholder approval is required of compensation arrangements existing prior to the time the company became public unless there is a material modification of such arrangements.

Compensation payable under a written binding contract

Remuneration payable under a written binding contact which was in effect on February 17, 1993, and at all times thereafter before such remuneration was paid is not subject to the deduction limitation. Compensation paid pursuant to a plan qualifies for this exception provided that the right to participate in the plan is part of a written binding contract with the covered employee in effect on February 17, 1993. For example, suppose a covered employee was hired by XYZ Corporation on January 17, 1993, and one of the terms of the written employment contract is that the executive is eligible to participate in the "XYZ Corporation Executive Deferred Compensation Plan" in accordance with the terms of the plan. Assume further that the terms of the plan provide for participation after 6 months of employment, amounts payable under the plan are not subject to discretion, and the corporation does not have the

right to amend materially the plan or terminate the plan. Provided that the other conditions of the binding contract exception are met (e.g., the plan itself is in writing), payments under the plan are grandfathered, even though the employee was not actually a participant in the plan on February 17, 1993.

The fact that a plan was in existence on February 17, 1993, is not by itself sufficient to qualify the plan for the exception for binding written contracts.

The exception for remuneration paid pursuant to a binding written contract ceases to apply to amounts paid after there has been a material modification to the terms of the contract. The exception does not apply to new contracts entered into or renewed after February 17, 1993. For purposes of this rule, any contract that is entered into on or before February 17, 1993, and that is renewed after such date is treated as a new contract entered into on the day the renewal takes effect. A contract that is terminable or cancelable unconditionally at will by either party to the contract without the consent of the other, or by both parties to the contract, is treated as a new contract entered into on the date any such termination or cancellation, if made, would be effective. However, a contract is not treated as so terminable or cancelable if it can be terminated or cancelled only by terminating the employment relationship of the covered employee.

Effective Date

The provision applies to compensation that is otherwise deductible by the corporation in a taxable year beginning on or after January 1, 1994.

8. Reduce compensation taken into account for qualified retirement plan purposes (sec. 8212 of the bill and secs. 401(a)(17), 404(l), 408(k), and 505(b)(7) of the Code)

Present Law

Under present law, the amount of a participant's compensation that can be taken into account under a tax-qualified pension plan is limited (sec. 401(a)(17)). The limit applies for determining the amount of the employer's deduction for contributions to the plan as well as for determining the amount of the participant's benefits. The limit on includible compensation is $235,840 for 1993, and is adjusted annually for inflation. The limit in effect at the beginning of a plan year applies for the entire plan year. The indexed limit in effect for a plan year does not apply to any prior plan years.

Reasons for Change

The limit on compensation taken into account under a qualified pension plan serves as a useful backstop to the nondiscrimination requirements applicable to qualified plans. By limiting the compensation taken into account under a plan, an employer is deemed to be providing greater benefits as a percentage of pay to an employee with compensation in excess of the cap than would be the case if all of the employee's compensation were taken into account. As a result, under the nondiscrimination rules rank-and-file em-

ployees will be entitled to benefits that are a larger percentage of their pay.

The committee believes that the goal of reducing the extent to which employers discriminate in the provision of pension benefits in favor of highly compensated employees can be better served by reducing further the compensation taken into account under qualified plans.

The committee is aware that in some cases State constitutions preclude benefit formulas from being reduced. Accordingly, the committee believes it is appropriate to provide a limited transition rule for existing employees of governmental organizations. However, the committee also believes that State and local governments should be encouraged to conform their tax-qualified pension plans to Federal requirements and so, as a condition of the transition relief, requires the Federal compensation limit to be incorporated into the plan by reference.

The committee believes it is appropriate to provide a delayed effective date in the case of collectively bargained plans.

Explanation of Provision

Under the bill, the limit on compensation taken into account under a qualified plan (sec. 401(a)(17)) is reduced to $150,000. This limit is indexed for cost-of-living adjustments in increments of $10,000. Corresponding changes are also made to other provisions (secs. 404(l), 408(k)(3)(C), (6)(D)(ii), and (8), and 505(b)(7)) that take into account the section 401(a)(17) limit.

Effective Date

The provision is generally effective for benefits accruing in plan years beginning after December 31, 1993. Special transition rules apply in the case of governmental plans and plans maintained pursuant to a collective bargaining agreement.

In the case of an eligible participant in a plan maintained by a State or local government, the limit on compensation taken into account is the greater of the limit under the proposal and the compensation allowed to be taken into account under the plan as in effect on July 1, 1993. For purposes of this rule, an eligible participant is an individual who first became a participant in the plan during a plan year beginning before the first plan year beginning after the earlier of: (1) the plan year in which the plan is amended to reflect the proposal, or (2) December 31, 1995. This special rule does not apply unless the plan is amended to incorporate the dollar limit in effect under section 401(a)(17) by reference, effective with respect to persons other than eligible participants for benefits accruing in plan years beginning after December 31, 1995 (or earlier if the plan amendment so provides).

In the case of a plan maintained pursuant to one or more collective bargaining agreements ratified before the date of enactment, the provision does not apply to contributions or benefits accruing under such agreements in plan years beginning before the earlier of (1) the latest of (a) January 1, 1994, (b) the date on which the last of such collective bargaining agreements terminates (without regard to any extension or modification on or after the date of en-

actment), or (c) in the case of a plan maintained pursuant to collective bargaining under the Railway Labor Act, the date of execution of an extension or replacement of the last of such collect bargaining agreements in effect on the date of enactment, or (2) January 1, 1997.

9. Deduction for moving expenses for meals and real estate expenses (sec. 8213 of the bill and sec. 217 of the Code)

Present law

An employee or self-employed individual may claim a deduction from gross income for certain expenses incurred as a result of moving to a new residence in connection with beginning work at a new location (sec. 217). The deduction is not subject to the floor that generally limits a taxpayer's allowable miscellaneous itemized deductions to those amounts that exceed two percent of the taxpayer's adjusted gross income. Any amount received directly or indirectly by such individual as a reimbursement of moving expenses must be included in the taxpayer's gross income as compensation (sec. 82). The taxpayer may offset this income by deducting the moving expenses that would otherwise qualify as deductible items under section 217.

Deductible moving expenses are the expenses of transporting the taxpayer and members of the taxpayer's household, as well as household goods and personal effects, from the old residence to the new residence; the cost of meals and lodging enroute; the expenses for pre-move househunting trips; temporary living expenses for up to 30 days in the general location of the new job; and certain expenses related to either the sale or settlement of a lease on the old residence or the purchase of or the acquisition of a lease on a new residence in the general location of the new job.

The moving expense deduction is subject to a number of limitations. A maximum of $1,500 can be deducted for pre-move househunting and temporary living expenses in the general location of the new job. A maximum of $3,000 (reduced by any deduction claimed for househunting or temporary living expenses) can be deducted for certain qualified expenses for the sale or purchase of a residence or settlement or acquisition of a lease. If both a husband and wife begin new jobs in the same general location, the move is treated as a single commencement of work. If a husband and wife file separate returns, the maximum deductible amounts available to each are one-half the amounts otherwise allowed.

Also, in order for a taxpayer to claim a moving expense deduction, the taxpayer's new principal place of work must be at least 35 miles farther from the taxpayer's former residence than was the taxpayer's former principal place of work (or at least 35 miles from the taxpayer's former residence, if the taxpayer has no former place of work).

Reasons for Change

The committee believes that no deduction is justified for certain expenses that do not directly relate to the cost of moving. Such expenses include those related to: (1) sale of the old residence, (2) settlement of a lease on the old residence, (3) acquisition of a lease

on or purchase of a new residence in the general location of the new job.[39] Also, the committee believes that it is unfair to provide a deduction for such expenses under sec. 217 to some taxpayers while denying it to others.

Further, the committee believes that the expense of meals in this context are primarily a personal living expense rather than an expense incurred for business purposes and should be afforded similar tax treatment to other personal expenses, namely nondeductibility.

Finally, the committee believes that the $10,000 overall cap is necessary to eliminate excessive moving expense deductions.

Explanation of Provision

The provision excludes from the definition of moving expenses: (1) the costs of selling (or settling an unexpired lease on) the old residence and buying (or acquiring a lease on) the new residence, and (2) the costs of meals consumed while traveling and while living in temporary quarters near the new workplace. In addition, an overall $10,000 cap is imposed on allowable moving expenses (including expenses subject to the limit on househunting and temporary living expenses) for each qualified move (including foreign moves). The $10,000 amount is indexed for inflation occurring after December 31, 1993.

Effective Date

Generally, the provision is effective for expenses incurred after December 31, 1993.

10. Modify estimated tax requirements for individuals (sec. 8214 of the bill and sec. 6654 of the Code)

Present Law

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

In addition, for taxable years beginning after 1991 and before 1997, a special rule provides the 100 percent of last year's liability safe harbor generally is not available to a taxpayer that (1) has a modified adjusted gross income (AGI) in the current year that exceeds the taxpayer's AGI in the preceding year by more than $40,000 ($20,000 in the case of a separate return by a married individual) and (2) has a modified AGI in excess of $75,000 in the current year ($37,500 in the case of a separate return by a married individual).

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[39] These amounts may generally be capitalized into the basis of the underlying asset.

Reasons for Change

The committee believes that the application of the special rule that denies the use of the 100 percent of last year's liability safe harbor is unduly cumbersome. In order to simplify the calculation of estimated taxes for individuals, the special rule is replaced with a new, permanent safe harbor that applies to individuals with a preceding year AGI above a certain threshold.

Explanation of Provision

The special rule that denies the use of the 100 percent of last year's liability safe harbor is repealed for taxable years beginning after 1993. However, the 100 percent of last year's liability safe harbor is modified to be a 110 percent of last year's liability safe harbor for any individual with an AGI of more than $150,000 ($75,000 in the case of a married individual filing a separate return in the current year) as shown on the return for the preceding taxable year. For this purpose, the AGI of a trust or an estate is determined pursuant to rules similar to those in Code section 67(e).

For taxable years beginning after 1993, the bill does not change the availability of (1) the 100 percent of last year's liability safe harbor for an individual with a preceding year AGI of $150,000 or less, or (2) the present-law rule that allows any individual to base estimated tax payments on 90 percent of the tax shown on the return for the current year.

Effective Date

The provision is effective for estimated tax payments applicable to taxable years beginning after December 31, 1993.

11. Increase taxable portion of Social Security and Railroad Retirement Tier 1 benefits (sec. 8215 of the bill and sec. 86 of the Code)

Present Law

Under present law, a portion of Social Security and Railroad Retirement Tier 1 benefits is includible in gross income for taxpayers whose provisional incomes exceed a threshold amount. For purposes of this computation, a taxpayer's provisional income includes modified adjusted gross income (adjusted gross income plus tax-exempt interest plus certain foreign source income) plus one-half of the taxpayer's Social Security or Railroad Retirement Tier 1 benefit. The threshold amount is $25,000 for unmarried taxpayers, $32,000 for married taxpayers filing joint returns, and $0 for married taxpayers filing separate returns. A taxpayer is required to include in gross income the lesser of: (1) 50 percent of the taxpayer's Social Security or Railroad Retirement Tier 1 benefit, or (2) 50 percent of the excess of the taxpayer's provisional income over the applicable threshold amount.

Proceeds from the income taxation of these benefits are credited quarterly to the Old-Age and Survivors Insurance Trust Fund, the Disability Insurance Trust Fund, or the Social Security Equivalent Benefit Account (of the Railroad Retirement system), as appropriate.

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Reasons for Change

The committee desires to more closely conform the income tax treatment of Social Security benefits and private pension benefits by increasing the amount of Social Security benefits included in gross income for certain higher-income beneficiaries. Moreover, the committee recognizes that reducing the exclusion of these benefits would enhance both the horizontal and vertical equity of the individual income tax system by treating all income in a more similar manner. To limit the effect of this provision to taxpayers with a greater ability to pay taxes, a second threshold would be created at a level greater than the present-law threshold for Social Security benefit inclusion. Further, the committee believes that revenues attributable to the increased portion of Social Security benefits included in gross income should be dedicated to the Medicare Hospital Insurance (HI) Trust Fund because this fund is currently in a weak financial position.

Explanation of Provision

The bill creates a second tier of Social Security benefit inclusion in gross income. Present-law inclusion rules will apply to taxpayers with provisional income below $32,000 for unmarried taxpayers or $40,000 for married taxpayers filing joint returns.

For taxpayers with provisional incomes above these higher thresholds, gross income will include the lesser of:

(1) 85 percent of the taxpayer's Social Security benefit or

(2) the sum of:

(a) the smaller of (i) the amount included under present law; or (ii) $3,500 (for unmarried taxpayers) or $4,000 (for married taxpayers filing joint returns),*

plus,

(b) 85 percent of the excess of the taxpayer's provisional income over the applicable new threshold amounts.

* These figures equal 50 percent of the difference between the present law thresholds for 50 percent Social Security benefit inclusion and the proposed new thresholds for 85 percent Social Security benefit inclusion.

For married taxpayers filing separate returns, gross income will include the lesser of 85 percent of the taxpayer's Social Security benefit or 85 percent of the taxpayer's provisional income.

For purposes of this computation, a taxpayer's provisional income (modified adjusted gross income plus one-half of the taxpayer's Social Security or Railroad Retirement Tier 1 benefit) is calculated the same as under present law.

Revenues from the income taxation of Social Security and Railroad Retirement Tier 1 benefits attributable to the increased portion of benefits included in gross income will be transferred to the Medicare Hospital Insurance (HI) Trust Fund.

Effective Date

The provision is effective for taxable years beginning after December 31, 1993.

B. Business Provisions

1. Increase corporate tax rate for taxable income over $10 million (sec. 8221 of the bill and sec. 11 of the Code)

Present Law

The highest marginal tax rate imposed on the taxable income of corporations is 34 percent. The maximum rate of tax on corporate net capital gain is also 34 percent. This rate applies to income in excess of $75,000. A 15-percent rate applies to taxable income not exceeding $50,000 and a 25-percent rate applies to taxable income over $50,000 and not exceeding $75,000. A corporation with taxable income in excess of $100,000 is required to increase its tax liability by the lesser of 5 percent of the excess or $11,750. This increase in tax phases out the benefits of the 15- and 25-percent rates for corporations with taxable income between $100,000 and $335,000; a corporation with taxable income in excess of $335,000, in effect, pays tax at a flat 34-percent rate.

Reasons for Change

The committee believes that raising the top marginal tax rate for profitable corporations by one percentage point is an appropriate means to help reduce the budget deficits projected for the Federal Government.

Explanation of Provision

The bill provides a new 35-percent marginal tax rate on corporate taxable income in excess of $10 million. The maximum rate of tax on corporate net capital gains is also 35 percent.

A corporation with taxable income in excess of $15 million is required to increase its tax liability by the lesser of 3 percent of the excess or $100,000. This increase in tax recaptures the benefits of the 34-percent rate in a manner analogous to the recapture of the benefits of the 15- and 25-percent rates.

Effective Date

The 35-percent marginal rate is effective for taxable years beginning on or after January 1, 1993. Under existing law provisions regarding changes in tax rates during a taxpayer's taxable year (section 15 of the Code), a fiscal year corporation is required to use a "blended rate" for its fiscal year that includes January 1, 1993. Accordingly, the corporation's tax liability will be a weighted average of the tax resulting from applying the existing corporate rate schedule and the tax resulting from applying the changes described above, weighted by the number of days before and after January 1, 1993. Penalties for the underpayment of estimated taxes, however, are waived for underpayments of 1993 taxes attributable to the changes in tax rates.

2. Disallowance of deduction for lobbying expenditures (sec. 8222 of the bill and sec. 162(e) and new secs. 280I and 6050O of the Code)

Present Law

Trade or business expenses

Taxpayers engaged in a trade or business generally are allowed a deduction for all ordinary and necessary expenses paid or incurred during the taxable year in carrying on such trade or business (sec. 162). Present-law section 162(e)(1) specifically provides a deduction for certain so-called "direct lobbying" expenses (including travel expenses, costs of preparing testimony, and a portion of dues) paid in carrying on a trade or business if such expenses are (1) in direct connection with appearances before, submissions of statements to, or sending communications to, the committees, or individual members, of Congress or of any legislative body of a State, a possession of the United States, or a political subdivision of any of the foregoing with respect to legislation or proposed legislation of direct interest to the taxpayer, or (2) in direct connection with communication of information between the taxpayer and an organization of which he is a member with respect to legislation or proposed legislation of direct interest to the taxpayer and to such organization.[40]

Section 162(e)(2) provides, however, that no deduction is allowed for any amount paid (whether by contribution, gift, or otherwise) for participation or intervention in any political campaign (i.e., "political campaign" expenses) or if paid in connection with any attempt to influence the general public, or segments thereof, with respect to legislative matters, elections, or referendums (i.e., "grass roots lobbying").

Treasury Department regulations further provide that if expenditures for lobbying purposes do not meet the requirements of section 162(e)(1), then such expenditures are not deductible as ordinary and necessary business expenses (Treas. Reg. sec. 1.162-20(c)(1)).[41] The regulations provide, however, that expenditures for institutional or "good will" advertising which keeps the taxpayer's name before the public are generally deductible, provided such expenditures are related to the patronage the taxpayer might reasonably expect in the future (Treas. Reg. sec. 1.162-20(a)(2)).[42]

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[40] Prior to 1963, Treasury Department regulations (originally dating back to 1915) provided that *all* expenditures for lobbying purposes, for the promotion or defeat of legislation, for political campaign purposes, or for propaganda (including advertising) related to any such purposes, were not deductible as "ordinary and necessary" business expenses. See *Cammarano v. United States*, 358 U.S. 498 (1959)(upholding validity of regulation denying deduction for lobbying expenses, even if expenses related to proposed legislation that affected the very survival of the taxpayer's business). In response to the *Cammarano* decision, Congress enacted, as part of the Revenue Act of 1962, the statutory rule contained in section 162(e)(1) specifically allowing a deduction for certain "direct lobbying" expenses.

[41] Thus, lobbying of foreign government officials is not a deductible business expense under section 162.

[42] See also Proposed Treasury Regulation section 1.162–20(c)(4) (proposed November 25, 1980), providing a three-part test to distinguish nondeductible "grass roots" lobbying from deductible institutional advertising.

Rules governing lobbying by tax-exempt organizations

Non-charitable tax-exempt organizations.—Although most tax-exempt organizations other than charitable organizations (e.g., social welfare organizations and trade associations) generally may engage in unlimited lobbying efforts, some restrictions do exist. If political campaign or grass roots lobbying activities constitute a substantial part of the activities of an organization, such as a labor union or a trade association, the portion of dues or other payments to the organization that is attributable to such activities cannot be deducted by the payor under section 162.

Charitable organizations.—A charitable organization otherwise described in section 501(c)(3) is not entitled to tax-exempt status under that section if a substantial part of its activities is "carrying on propaganda, or otherwise attempting, to influence legislation."[43] There is no statutory definition under section 501(c)(3) of "propaganda, or otherwise attempting, to influence legislation," but Treasury regulations provide that an organization will be regarded as "attempting to influence legislation" if it (1) contacts, or urges the public to contact, members of a legislative body for the purpose of proposing, supporting, or opposing legislation, or (2) advocates the adoption or rejection of legislation (meaning action by Congress or another legislative body). Treas. Reg. sec. 1.501(c)(3)-1(c)(3). However, an organization will not fail to meet the requirements of section 501(c)(3) merely because it advocates, as an insubstantial part of its activities, the adoption or rejection of legislation. *Id.* Moreover, conducting nonpartisan research (while not advocating legislative action) is not considered lobbying for purposes of the section 501(c)(3) restriction, nor is seeking to protect the organization's own existence or responding to a governmental request for testimony.[44]

For public charities making the section 501(h) election, permitted lobbying expenditures are measured against a specific arithmetical test.[45] Under section 501(h), "lobbying expenditures" are defined as "expenditures for the purpose of influencing legislation (as defined in section 4911(d))." Section 4911(d), in turn, defines the term "influencing legislation" as—

> "(A) any attempt to influence any legislation through an attempt to affect the opinions of the general public or any segment thereof, and

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[43] See *Regan v. Taxation With Representation*, 461 U.S. 540 (1983)(upholding constitutionality of section 501(c)(3) lobbying restriction on grounds that legislature is not required to subsidize lobbying through a tax exemption or deduction).

[44] See Rev. Rul. 70-79, 1970-1 C.B. 127; Rev. Rul. 70-449, 1970-2 C.B. 111; *Slee v. Commr*, 42 F.2d 184 (2d Cir. 1930).

[45] For organizations making the section 501(h) election, the allowable amount of all lobbying expenditures for any tax year is the lesser of: (1) $1 million or (2) the sum of (a) 20 percent of the first $500,000 of the organization's exempt purpose expenditures for the year, plus (b) 15 percent of the next $500,000 of such expenditures, plus (c) 10 percent of the third $500,000 of such expenditures, plus (d) five percent of any additional such expenditures. "Grass roots" lobbying expenditures are limited to 25 percent of the overall permissible lobbying amount (sec. 4911(c)). Certain affiliated organizations are treated as one organization for purposes of applying the section 501(h) arithmetical test.

Under section 501(h), if lobbying expenditures (for either all lobbying or grass roots lobbying in particular) made during a taxable year exceed the allowable amounts, an excise tax is imposed on the organization equal to 25 percent of the excess lobbying expenditures (sec. 4911(a)). If the sum of the electing organization's lobbying expenditures during a four-year period exceeds 150 percent of the sum of the allowable amounts during that period, then the organization loses its tax-exempt status under section 501(c)(3) (Treas. Reg. sec. 1.501(h)-3(b)).

(B) any attempt to influence any legislation through communication with any member or employee of a legislative body, or with any government official or employee who may participate in the formulation of the legislation."[47]

However, section 4911(d)(2) specifically excludes from the definition of "influencing legislation" the following activities:

"(A) making available the results of nonpartisan analysis, study, or research;[48]

(B) providing of technical advice or assistance (where such advice would otherwise constitute the influencing of legislation) to a governmental body or to a committee or other subdivision thereof in response to a written request by such body or subdivision, as the case may be;[49]

(C) appearances before, or communications to, any legislative body with respect to a possible decision of such body which might affect the existence of the organization, its powers and duties, tax-exempt status, or the deduction of contributions to the organization;

(D) communications between the organization and its bona fide members with respect to legislation or proposed legislation of direct interest to the organization and such members, other than communications which directly encourage members to contact a legislative body in an attempt to influence legislation, or which directly encourage members to urge persons other than members to attempt to affect the opinions of the general public or to contact a legislative body in an attempt to influence legislation; and

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[47] For purposes of section 4911, the term "legislation" includes action taken by a legislative body, meaning the "introduction, amendment, enactment, defeat, or repeal of Acts, bills, resolutions, or similar items" but does not include action taken by executive, judicial, or administrative bodies. See Treas. Reg. sec. 56.4911-2(d).

[48] Under the section 4911 regulations, "nonpartisan analysis, study, or research" means an independent and objective exposition of a particular subject matter, including any activity that is "educational" within the meaning of Treasury Regulation section 1.501(c)(3)-1(d)(3). Thus, "nonpartisan analysis, study, or research" may advocate a particular position or viewpoint so long as there is a sufficiently full and fair exposition of the pertinent facts to enable the public or an individual to form an independent opinion or conclusion. The mere presentation of unsupported opinion, however, does not qualify as "nonpartisan analysis, study, or research." The determination of whether a publication or broadcast qualifies as "nonpartisan analysis, study, or research" generally is made on a presentation-by-presentation basis, but if a publication is prepared as part of a series, the series as a whole will be judged against the standards determining whether it is "nonpartisan analysis, study or research." Nonpartisan analysis may be made available to the general public, a segment thereof, or governmental bodies. Communications may not be limited to, or be directed toward, persons who are interested solely in one side of a particular issue. Treas. Reg. sec. 56.4911-2(c)(1).

Furthermore, a Treasury regulation under section 4911 provides that "[e]xaminations and discussions of broad social, economic, and similar problems are neither direct lobbying communications ... nor grass roots lobbying communications ... even if the problems are of the type with which government would be expected to deal ultimately. Thus, ... lobbying communications do not include public discussion, or communications with members of legislative bodies or governmental employees, the general subject of which is also the subject of legislation before a legislative body, so long as such discussion does not address itself to the merits of a specific legislative proposal and so long as such discussion does not directly encourage recipients to take action with respect to legislation." Treas. Reg. sec. 56.4911-2(c)(2).

[49] Under this exception, the request for assistance or advice must be made in the name of the requesting governmental body, committee, or subdivision rather than an individual member thereof; and the response to such request must be made available to every member of the requesting body, committee, or subdivision. Treasury regulations further provide that because such assistance or advice may be given only at the express request of a governmental body, the oral or written presentation of such assistance or advice need not qualify as nonpartisan analysis, study or research. The offering of opinions or recommendations will ordinarily qualify under this exception only if such opinions or recommendations are specifically requested by the governmental body or are directly related to the materials so requested (Treas. Reg. secs. 56.4911-2(c)(3) and 53.4945-2(d)(2)).

(E) any communication with a government official or employee, other than—

(i) a communication with a member or employee of a legislative body (where such communication would otherwise constitute the influencing of legislation), or

(ii) a communication the principal purpose (of which is to influence legislation.

Private foundations.—Private foundations (as distinguished from public charities) generally are subject to penalty excise taxes under section 4945 if they engage in any direct or grass roots lobbying, even if not substantial. For purposes of section 4945, lobbying is defined in a manner similar to the definition under section 4911(d). Specifically, the section 4945 penalty excise taxes do not apply to nonpartisan analysis, the provision of technical advice to a governmental body in response to a written request, or lobbying before a legislative body with respect to a possible decision of such body which might affect the existence of the private foundation, its powers and duties, its tax-exempt status, or the deduction of contributions to such foundation (sec. 4945(e)).

Reasons for Change

The committee has determined that it is appropriate to deny a business deduction for certain lobbying expenses.

Explanation of Provision

Under the bill, no deduction is allowed for amounts paid for certain lobbying activities before Congress and Federal agencies, as well as State and local legislative bodies.[46] The present-law rule disallowing business deductions for expenses of grass roots lobbying and participation in political campaigns will remain in effect.

General rule

The bill disallows a deduction for amounts paid or incurred for any "lobbying contact," meaning (1) in the case of a "lobbyist" (as defined below), any oral or written communication with a legislative branch official or employee or certain high-ranking Federal executive branch officials,[47] and (2) in the case of any other person

[46] The provision applies to attempts to influence State and local *legislation* but not to attempts to influence actions of State or local executive branch or administrative bodies. For purposes of the provision, the term "legislation" has the same meaning as under present-law section 4911(e)(2), which defines "legislation" as including "action with respect to Acts, bills, resolutions, or similar items by the Congress, any State legislature, any local council, or similar governing body, or by the public in a referendum, initiative, constitutional amendment, or similar procedure."

Treasury regulations provide that "legislation" for purposes of section 4911(e)(2) includes action by legislative bodies but does not include action by "executive, judicial, or administrative bodies" (Treas. Reg. sec. 56.4911-2(d)(3)). Treasury regulations further provide that "administrative bodies" includes school boards, housing authorities, sewer and water districts, zoning boards, and other similar special purpose bodies, whether elective or appointive (Treas. Reg. sec. 56.4911-2(d)(4)). Thus, communications with, and attempts to influence, members of a local zoning board (acting in their capacity as members of that board, regardless of whether or not such members are elected to their position) will not be affected by the provision.

[47] The provision applies to the costs of communications with the following Federal executive branch officials: (1) the President; (2) the Vice President; (3) any officer or employee of the Executive Office of the President other than a clerical or secretarial employee; (4) any officer or employee serving in an Executive level I, II, III, IV, or V position, as designated in statute or Executive order (such as Secretaries, Deputy Secretaries and Assistant Secretaries, Directors, and

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(i.e., a non-lobbyist), any oral or written communication (a) with a legislative branch official or employee in an attempt to influence the formulation of legislation or (b) with certain high-ranking Federal executive branch officials in an attempt to influence legislation or the formulation of a Federal rule, regulation, Executive order, or any other program, policy, or position of United States, or in attempt to influence the administration or execution of a Federal program or policy (with certain exceptions described below).

Exceptions to general rule [48]

Exception for legislative lobbying.—The provision does not apply to amounts incurred for contacting a legislative branch official or employee if such contact is required by subpoena, civil investigative demand, or otherwise compelled by statute or other action of Congress or a State or local legislative body.

Exceptions for Federal executive branch lobbying.—Exceptions to the provision's general disallowance rule for lobbying of certain high-ranking Federal executive branch officials are provided for contacts that are (1) compelled by statute, regulation, or other action of a Federal agency, (2) communications with respect to the administration or execution of Federal programs or policies (including the award of a Federal contract, grant, or license) if such communications are made to executive branch officials in the agency responsible for taking such action who serve in the Senior Executive Service, or who are members of the uniformed services whose pay grade is lower than O-9 under 37 U.S.C. section 201,[49] (3) written comments filed in a public docket or other communications that are made on the record in a public proceeding, (4) made in response to a notice in the Federal Register, Commerce Business Daily, or similar publication soliciting communications from the public and directed to the agency official specifically designated in the notice to receive such communications, (5) made to agency officials with regard to judicial proceedings, criminal or civil law enforcement inquiries, investigations or proceedings, or filings required by statute or regulation, (6) made in compliance with written agency procedures regarding an adjudication conducted by the agency under 5 U.S.C. section 554 (or substantially similar provisions), or (7) made on behalf of an individual with regard to such individual's benefits, employment, other personal matters involving only that individual, or disclosures by that individual pursuant to applicable whistleblower statutes.

Commissioners); (5) any officer or employee serving in a Senior Executive Service position as defined under 5 U.S.C. section 3232(a)(2); (6) any member of the uniformed services whose pay grade is at or in excess of O-7 under 37 U.S.C. section 201; and (7) any officer or employee serving in a position of confidential or policy-determining character under Schedule C of the excepted service pursuant to 5 U.S.C. section 7511. Under the Lobbying Disclosure Act of 1993 (S. 349), as passed by the Senate on May 6, 1993, such Federal executive branch officials are referred to as "covered executive branch officials," communications to whom are subject to the Act's reporting requirements.

[48] These exceptions (along with others not included in the proposal) are included in the Lobbying Disclosure Act of 1993 (S. 349), as passed by the Senate on May 6, 1993.

[49] This exception applies to communications with a high-ranking Federal executive branch official with respect to the administration or execution of a Federal program or policy, but (as provided under the Lobbying Disclosure Act of 1993, as passed by the Senate on May 6, 1993) the exception does not apply to communications with respect to the formulation (or modification, adoption, or repeal) of a Federal rule, regulation, Executive order, or any other program, policy, or position of the United States.

Definition of "lobbyist"

As described above, the bill provides for a presumption that communications made by "lobbyists" to certain government officials are nondeductible lobbying. In contrast, communications made by other persons (i.e., non-lobbyists) to certain government officials are nondeductible lobbying only if such communications are made *in an attempt to influence* legislation or certain Federal executive branch actions.[50] For purposes of the bill, the term "lobbyist" has a meaning similar to the definition under the Lobbying Disclosure Act of 1993 (S. 349), as passed by the Senate on May 6, 1993, and includes any person who is employed or retained by another for financial or other compensation to perform services that include any attempt to influence the formulation of legislation or the formulation or administration of Federal rules, regulations, programs, or policies (with the exceptions described above).

The definition of "lobbyist" includes both "in-house" lobbyists who are hired as employees and "outside" lobbyists who are hired as independent contractors. The term "lobbyist" does not include a person whose lobbying activities are only incidental to, and are not a significant part of, the services provided by such person to the client. Consistent with the legislative history of the Lobbying Disclosure Act of 1993, it is intended that a person who spends less than 10 percent of his or her time for a particular client on lobbying activities for that client would not be a "lobbyist" (with regard to that client).

Under the bill, the determination of whether an individual is a "lobbyist" is made on a client-by-client basis. That is, a person may be a "lobbyist" for a particular client on the basis of the services provided for that client, but the same person may not be a "lobbyist" with respect to a different client.

Activities in support of lobbying

The bill disallows the costs of activities in support of a "lobbying contact" (as defined above), including (1) any preparation or planning activity relating to a lobbying contact (including, in the case of a lobbyist, the formulation, review, and management of the lobbying contacts on behalf of a client), (2) any research or other background work relating to a lobbying contact, and (3) any activity coordinating the lobbying activity of two or more persons.[51]

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[50] The committee intends that, with respect to persons who are not "lobbyists," the Secretary of the Treasury will provide guidance for distinguishing (1) attempts to influence legislation or certain Federal executive branch actions, from (2) mere monitoring of legislative or executive branch activities where there is no attempt to influence the formulation of legislation or executive branch regulations or policies. In cases where an individual or organization monitors legislative activities or Federal executive branch actions and subsequently attempts to influence the outcome of the same (or similar) legislative or executive branch actions, it is intended that the costs of the monitoring activities generally will be treated as nondeductible lobbying expenses.

[51] The bill contains a special provision to prevent a "cascading" of the lobbying disallowance rule. The bill provides that in the case of any taxpayer engaged in the trade or business of lobbying activities (e.g., a lobbying consultant hired by a client) or any taxpayer who is an employee and is reimbursed by his employer for lobbying expenses, the disallowance rule will not apply to expenditures of the taxpayer in conducting lobbying activities on behalf of another person or his employer (but shall apply to payments made by the client or employer to the taxpayer).

The committee intends that the Secretary of the Treasury will permit taxpayers to adopt reasonable methods for allocating expenses to their lobbying and other coordinating activities in order to reduce taxpayer recordkeeping responsibilities.

In addition, the bill provides for a *per se* rule that disallows a deduction for any amount paid or incurred in connection with the providing of meals, entertainment, or travel to legislative officials or employees or certain high-ranking Federal executive branch officials referred to above (or to an individual accompanying such official or employee).

Dues paid to trade associations

The bill provides for a flow-through rule to disallow a deduction for a portion of the membership dues (or other similar amounts) paid by a person to a tax-exempt organization (other than a charity eligible to receive tax-deductible contributions) if such dues are allocable to lobbying activities conducted by the organization. For this purpose, lobbying expenditures incurred by an organization are treated as paid first from dues (or other similar amounts) collected by the organization.

Tax-exempt organizations are required by the bill to annually report to their members (and the IRS) the portion of membership dues allocable to lobbying activities. However, a *de minimis* exception is provided, so that flow-through reporting to members or the IRS is not required if the lobbying expenditures of the organization for the calendar year are less than $2,000.[52] Penalties may be imposed under present-law section 6721 on organizations for failing to make the required flow-through information reporting.

The Secretary of the Treasury is granted authority to provide by regulation that the reporting requirement applicable to tax-exempt organizations will not apply where unnecessary to effectuate the purposes of the proposal (e.g., where the disallowed portion of such expenditures will not materially affect the tax liability of dues-paying members, as, for example, where a tax-exempt organization derives no more than an insubstantial portion of its dues income from persons entitled to deduct the dues in determining their taxable income).

Limited flow-through for charities

The bill provides for a targeted flow-through of the lobbying disallowance rule when, under certain circumstances, a business makes a contribution or other payment to a charity eligible to receive tax-deductible contributions under section 170.[53] Such a payment to a charity will receive the same treatment as payments to a trade association that are allocable to lobbying[54] if (1) the lobbying activities of the charity are of direct financial interest to the payor's (or a related person's) trade or business, and (2) the payor makes total payments to the charity during the year exceeding

[52] For purposes of determining whether the $2,000 *de minimis* exception applies, an organization is required to take into account direct expenses incurred for lobbying activities (i.e., labor and materials costs and fees paid to outsiders for lobbying) but need not take into account indirect expenses (i.e., a portion of general overhead) otherwise allocable to lobbying.

[53] The flow-through rule for charities does not apply to churches described in present-law section 170(b)(1)(A)(i). Thus, contributions to churches are not affected by the bill's lobbying provision.

[54] Lobbying expenses incurred by a charity (to the extent described in the text) are treated as paid first from contributions, dues, or other amounts paid by contributors or members that have a direct business interest in the outcome of the charity's lobbying activities.

$2,000. In such cases, a portion of a payment that otherwise may be deductible under section 170 is disallowed.[55]

Effective Date

The provision is effective for amounts paid or incurred after December 31, 1993.22

3. Mark-to-market accounting method for dealers in securities (sec. 8223 of the bill and new sec. 475 of the Code)

Present Law

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

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

Under the so-called "wash sale rule," losses on the sale of securities are not allowed if the taxpayer acquires substantially identical securities within 30 days of the loss transaction. The wash sale rule does not apply to security dealers. Thus, a securities dealer that determines its inventory based on the cost of its securities may recognize losses on those securities that have built-in losses by selling the securities at year end, even if identical securities are acquired immediately to replenish the dealer's inventory.

Reasons for Change

Inventories of securities generally are easily valued at year end, and, in fact, are currently valued at market by some securities dealers in adjusting their inventory using the LCM method for Federal income tax purposes. The committee believes that the cost method and the LCM method generally understate the income of securities dealers and that the mark-to-market method most clearly reflects their income. Denial of the LCM method to securities dealers would have little effect because of the dealers' exemption from the wash sale rule. Consequently, the bill generally requires securities dealers to mark their securities inventories to market for Federal income tax purposes.

[55] The bill provides that no tax shall be imposed under present-law section 4911 with respect to any amount as to which a deduction is disallowed under the bill's lobbying provision. Any such amount, however, is to be taken into account for purposes of determining under section 501(h) whether a charity normally makes lobbying expenditures in excess of its lobbying ceiling amount and, therefore, is not entitled to tax-exempt status.

The committee also believes that hedges of securities that are subject to the bill should be treated in a manner similar to the hedged securities. Thus, the bill provides that such hedges are to be marked to market and any gain or loss with respect to such hedges will be treated as ordinary gain or loss.

Explanation of Provision

In general

The bill provides two general rules (the "mark-to-market rules") that apply to certain securities that are held by a dealer in securities. First, any such security that is inventory in the hands of the dealer is required to be included in inventory at its fair market value. Second, any such security that is not inventory in the hands of the dealer and that is held as of the close of any taxable year is treated as sold by the dealer for its fair market value on the last business day of the taxable year and any gain or loss is required to be taken into account by the dealer in determining gross income for that taxable year.[56]

If gain or loss is taken into account with respect to a security by reason of the second mark-to-market rule, then the amount of gain or loss subsequently realized as a result of a sale, exchange, or other disposition of the security, or as a result of the application of the mark-to-market rules, is to be appropriately adjusted to reflect such gain or loss. In addition, the bill authorizes the Treasury Department to promulgate regulations that provide for the application of the second mark-to-market rule at times other than the close of a taxable year or the last business day of a taxable year.

The mark-to-market rules do not apply for purposes of determining the holding period of any security. In addition, the mark-to-market rules do not apply in determining whether gain or loss is recognized by any other taxpayer that may be a party to a contract with a dealer in securities.

Character of gain or loss

Any gain or loss taken into account under the provision (or any gain or loss recognized with respect to a security that would be subject to the provision if held at the end of the year) generally is treated as ordinary gain or loss. This special character rule does not apply to any gain or loss allocable to any period during which the security (1) is a hedge of a position, right to income, or a liability that is not subject to a mark-to-market rule under the provision, or (2) is held by the taxpayer other than in its capacity as a dealer in securities. In addition, the special character rule does not apply to any security that is improperly identified (as described in detail below) by the taxpayer.

No inference is intended as to the character of any gain or loss recognized in taxable years prior to the enactment of this provision or any gain or loss recognized with respect to any property to which this special character rule does not apply.

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

Definitions

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

A security is defined as: (1) any share of stock in a corporation; (2) any partnership or beneficial ownership interest in a widely-held or publicly-traded partnership or trust; (3) any note, bond, debenture, or other evidence of indebtedness; (4) any interest rate, currency, or equity notional principal contract (but not any other notional principal contract such as a notional principal contract that is based on the price of oil, wheat, or other commodity); and (5) any evidence of an interest in, or any derivative financial instrument in, any currency or in a security described in (1) through (4) above, including any option, forward contract, short position, or any similar financial instrument in such a security or currency. Such term includes an obligation to acquire a security.

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

A security, however, is not to include a contract to which section 1256(a) of the Code applies, unless such contract is a hedge of a security to which the provision applies. The special character rule of the bill (rather than the special character rule of section 1256(a)) will apply to any such contract that is a hedge of a security to which the bill applies.

A hedge is defined as any position that reduces the dealer's risk of interest rate or price changes or currency fluctuations, including any position that is reasonably expected to become a hedge within 60 days after the acquisition of the position.

Exceptions to the mark-to-market rules

Notwithstanding the definition of security, the mark-to-market rules generally do not apply to: (1) any security that is held for investment;[57] (2) any security which is a hedge with respect to a security that is not subject to the mark-to-market rules (i.e., any security that is a hedge with respect to a security held for investment); or (3) any security which is a hedge with respect to a position, right to income, or a liability that is not a security in the hands of the taxpayer.[58] Securities held for investment include debt instruments acquired (included originated) by the taxpayer in

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[57] To the extent provided in regulations to be promulgated by the Treasury Department, the exception to the mark-to-market rules for a security that is held for investment is not to apply to any notional principal contract or any derivative financial instrument that is held by a dealer in such securities.

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

the ordinary course of a trade or business of the taxpayer and not held for sale. Whether or not a security is required to be marked-to-market under the applicable financial accounting rules is not dispositive for purposes of determining whether such security or evidence of indebtedness is treated as held for investment under the provision.

To the extent provided in regulations to be promulgated by the Treasury Department, the exceptions to the mark-to-market rules for certain hedges do not apply to any security that is held by a taxpayer in its capacity as a dealer in securities. Thus, regulations may provide that the exceptions to the mark-to-market rules for certain hedges do not apply to securities that are entered into with customers in the ordinary course of a trade or business. In addition, a dealer may not treat a security that is identified as a hedge or as an investment as also held in its capacity as dealer. Thus, securities identified as qualifying for one of the exceptions to the mark-to-market rules may not be accounted for using the LCM or other inventory method of accounting.

In addition, the exceptions to the mark-to-market rules do not apply unless, before the close of the day on which the security (including any evidence of indebtedness) is acquired, originated, or entered into (or such other time as the Treasury Department may specify in regulations),[59] the security is clearly identified in the dealer's records as being described in one of the exceptions listed above.[60]

It is anticipated that the identification rules with respect to hedges will be applied in such a manner as to minimize the imposition of additional accounting burdens on dealers in securities. For example, it is understood that certain taxpayers engage in risk management strategies known as "global hedging." Under global hedging, the positions of one business unit of the taxpayer may be counter-balanced by positions of another separate business unit; any remaining net risk of the enterprise may then be hedged by entering into positions with unrelated third parties. It is understood that taxpayers engaging in global hedging use accounting systems that clearly identify and treat the transactions entered

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[59] It is anticipated that the Treasury regulations will permit a financial institution that is treated as a dealer under the provision and that originates evidences of indebtedness in the ordinary course of a trade or business to identify such evidences of indebtedness as held for investment based on the accounting practices of the institution, but in no event later than the date that is 30 days after the date that any such evidence of indebtedness is originated. Where appropriate, Treasury regulations may provide similar identification rules for similar debt that is acquired, rather than originated, by a financial institution. Further, it is anticipated that the Treasury regulations will permit a dealer that enters into commitments to acquire mortgages to identify such commitments as being held for investment if the dealer acquires the mortgages and holds the mortgages as investments. It is anticipated that this identification of commitments to acquire mortgages will occur within an appropriate period after the acquisition of the mortgages, but in no event later than the date that is 30 days after the date that the mortgages are acquired.

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

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

into between the separate business units as if such transactions were entered into with unrelated third parties. It is anticipated that, subject to Treasury regulations, such an accounting system generally will provide adequate evidence for purposes of determining whether, and to what extent, a hedge with a third party is (1) a hedge of a security that is subject to the mark-to-market rules or (2) a hedge of a position, right to income, or a liability that is not subject to a mark-to-market rule, for purposes of applying the mark-to-market rules and the special character rule to a hedge with a third party.

In addition to clearly identifying a security as qualifying for one of the exceptions to the mark-to-market rules listed above, a dealer must continue to hold the security in a capacity that qualifies the security for one of the exceptions listed above. If at any time after the close of the day on which the security was acquired, originated, or entered into (or such other time as the Treasury Department may specify in regulations), the security is not held in a capacity that qualifies the security for one of the exceptions listed above, then the mark-to-market rules are to apply to any changes in value of such security that occur after the security no longer qualifies for an exception.[61]

Improper identification

The bill provides that if (1) a dealer identifies a security as qualifying for an exception to the mark-to-market rules but the security does not qualify for that exception, or (2) a dealer fails to identify a position that is not a security as a hedge of a security but the position is a hedge of a security, then the mark-to-market rules are to apply to any such security or position, except that loss is to be recognized under the mark-to-market rules prior to the disposition of the security or position only to the extent of gain previously recognized under the mark-to-market rules (and not previously taken into account under this provision) with respect to the security or position.

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[61] Any gain or loss that is attributable to the period that the security was not subject to the mark-to-market rules generally is to be taken into account at the time that the security is actually sold (rather than treated as sold by reason of the mark-to-market rules).

Conversely, different rules apply to a security that originally is held by the taxpayer in a capacity that subjects the security to the mark-to-market rules, but later becomes otherwise eligible for an exception from the mark-to-market rules. For example, assume that a security to which the mark-to-market rules apply is hedged (and thus the hedge is subject to the mark-to-market rules) and the security (but not the hedge) is sold before year end. In such case, the "naked" hedge generally will be subject to the mark-to-market rules at the year end.

However, the Treasury Department has authority to issue regulations that would allow the taxpayer to identify, on the date the security is sold, the "naked" hedge as a security to which one of the exceptions to the mark-to-market rules (assuming the "naked" hedge otherwise qualifies for the exception). In making this identification, it is anticipated that the taxpayer would be required to apply the mark-to-market rules to the "naked" hedge as of the date of the sale of the security, take any resulting gain or loss into account for the taxable year of sale, and treat the "naked" hedge as a security to which the exceptions to the mark-to-market rules apply.

Whether or not the taxpayer is allowed under regulations to make the identification described above (and whether or not the taxpayer makes the identification), any gain or loss attributable to the period after the date of sale of the security will not be subject to the special character rule of the bill if the hedge is not held by the taxpayer in its capacity as a dealer during such period. Thus, if the "naked" hedge is a capital asset in the hands of the taxpayer, any gain or loss recognized with respect to the "naked" hedge that is attributable to the period after the date of sale of the security will be capital gain or loss.

Other rules

The bill provides that the uniform cost capitalization rules of section 263A of the Code and the rules of section 263(g) of the Code that require the capitalization of certain interest and carrying charges in the case of straddles do not apply to any security to which the mark-to-market rules apply because the fair market value of a security should include the costs that the dealer would otherwise capitalize.

In addition, a security subject to the provision is not to be treated as sold and reacquired for purposes of section 1091 of the Code. Section 1092 of the Code will apply to any loss recognized under the mark-to-market rules (but will have no effect if all the offsetting positions that make up the straddle are subject to the mark-to-market rules).

Furthermore, the bill provides that (1) the mark-to-market rules do not apply to any section 988 transaction (generally, a foreign currency transaction) that is part of a section 988 hedging transaction, and (2) the determination of whether a transaction is a section 988 transaction is to be made without regard to whether the transaction would otherwise be marked-to-market under the bill.

The bill also authorizes the Treasury Department to promulgate regulations which provide for the treatment of a hedge that reduce a dealer's risk of interest rate or price changes or currency fluctuations with respect to securities that are subject to the mark-to-market rules as well as with respect to securities, positions, rights to income, or liabilities that are not subject to the mark-to-market rules. It is anticipated that the Treasury regulations may allow taxpayers to treat any such hedge as not subject to the mark-to-market rules provided that such treatment is consistently followed from year to year.

Finally, the bill authorizes the Treasury Department to promulgate such regulations as may be necessary or appropriate to carry out the provisions of the bill, including rules to prevent the use of year-end transfers, related persons, or other arrangements to avoid the provisions of the bill. Such authority includes coordinating the mark-to-market rules with the original issue discount rules.

Other hedging transactions

The special character rule generally does not apply to any gain or loss with respect to any security allocable to any period during which the security is held by the taxpayer other than in connection with its activities as a dealer in securities. Thus, the special character rule generally applies to an instrument or position that is held as a hedge of a security to which the special character rule applies (so long as the hedge also meets the other requirements of the special character rule.)

The committee understands that hedging transactions are also important to the management of risks by businesses that are not subject to these mark-to-market rules. The committee also understands that there may be uncertainty concerning the tax treatment of such hedging transactions following a decision by the United States Supreme Court in 1988, *Arkansas Best Corp. v. Commissioner*, 485 U.S. 212 (1988). Despite subsequent litigation, (e.g., *Federal National Mortgage Association v. Commissioner*, 100 T.C.

No. 36 (June 17, 1993)), the scope of the United States Supreme Court decision, and its effect on hedging transactions, may be unclear in some instances.

The level of uncertainty regarding the tax treatment of hedging transactions is a matter of concern to the committee. Such uncertainty may have a dampening effect on taxpayers entering into a variety of desirable business hedging transactions. The committee believes that this is a significant issue and hopes that appropriate steps can be taken to address this matter.

Effective Date

In general

The provision applies to taxable years ending on or after December 31, 1993. A taxpayer that is required to change its method of accounting to comply with the requirements of the provision is treated as having initiated the change in method of accounting and as having received the consent of the Treasury Department to make such change. The net amount of the section 481(a) adjustment is to be taken into account ratably over a 5-taxable year period beginning, with the first taxable year ending on or after December 31, 1993.

The principles of section 8.03(1) and (2) of Rev. Proc. 92-20, 1992-12 I.R.B. 10, are to apply to the section 481(a) adjustment. It is anticipated that section 8.03(1) of Rev. Proc. 92-20 will be applied by taking into account all securities of a dealer that are subject to the mark-to-market rules (including those securities that are not inventory in the hands of the dealer). In addition, it is anticipated that net operating losses will be allowed to offset the section 481(a) adjustment, tax credit carryforwards will be allowed to offset any tax attributable to the section 481(a) adjustment, and, for purposes of determining liability for estimated taxes, the section 481(a) adjustment will be taken into account ratably throughout the taxable year in question.

In determining the amount of the section 481(a) adjustment for taxable years beginning before the date of enactment of the mark-to-market rules, the identification requirements are to be applied in a reasonable manner. It is anticipated that any security that was identified as being held for investment under section 1236(a) of the Code as of the last day of the taxable year preceding the taxable year of change is to be treated as held for investment for purposes of the mark-to-market rules. It is also anticipated that any other security that was held as of the last day of the taxable year preceding the taxable year of change is to be treated as properly identified if the dealer's records as of such date support such identification.[62]

Special rule for certain floor specialists and market makers

To the extent that a portion of the section 481(a) adjustment of a taxpayer is attributable to the use of the LIFO inventory method

[62] In addition, it is anticipated that in order for any security that is held on the date of enactment of the mark-to-market rules to qualify for one of the exceptions to the mark-to-market rules, the security must be identified as being described in one of the exceptions within a reasonable period after the date of enactment but in no event later than the date that is 30 days after the date of enactment.

of accounting for at least five taxable years for any qualified security, such portion of the adjustment is taken into account ratably over a 15-taxable year period, beginning with the first taxable year ending on or after December 31, 1993. For this purpose, "qualified security" means any security acquired (1) by a floor specialist (as defined in section 1236(d)(2)) in connection with the specialist's duties as a specialist on an exchange, but only if the security is one in which the specialist is registered with the exchange or (2) by a taxpayer who is a market maker in connection with the taxpayer's duties as market maker, but only if (a) the security is included on the National Association of Security Dealers Automated Quotation System, (b) the taxpayer is registered as a market maker in such security with the National Association of Security Dealers, and (c) as of the last day of the taxable year preceding the taxpayer's first taxable year ending on or after December 31, 1993, the taxpayer (or a predecessor of the taxpayer) has been actively engaged as a market maker in such security for a 2-year period ending on such date (or, if shorter, the period beginning 61 days after the security was listed in such quotation system and ending on such date.) The portion of the section 481(a) adjustment that is attributable to the use of the LIFO inventory method of accounting for any qualified security is determined under the rules described in section 312(n)(4) (without regard to the effective date of such section). In addition, the portion of the section 481(a) adjustment that is eligible to be taken into account over the 15-year period may not exceed the taxpayer's overall section 481(a) adjustment for all securities under the proposal.

4. Tax treatment of certain FSLIC financial assistance (sec. 8224 of the bill and secs. 165, 166, 585, and 593 of the Code)

Present Law and Background

A taxpayer may claim a deduction for a loss on the sale or other disposition of property only to the extent that the taxpayer's adjusted basis for the property exceeds the amount realized on the disposition and the loss is not compensated for by insurance or otherwise (sec. 165 of the Code). In the case of a taxpayer on the specific charge-off method of accounting for bad debts, a deduction is allowable for the debt only to the extent that the debt becomes worthless and the taxpayer does not have a reasonable prospect of being reimbursed for the loss. If the taxpayer accounts for bad debts on the reserve method, the worthless portion of a debt is charged against the taxpayer's reserve for bad debts, potentially increasing the taxpayer's deduction for an addition to this reserve.

A special statutory tax rule, enacted in 1981, excluded from a thrift institution's income financial assistance received from the Federal Savings and Loan Insurance Corporation (FSLIC)[63], and

[63] Until it was abolished by the Financial Institutions Reform, Recovery and Enforcement Act of 1989 (FIRREA), FSLIC insured the deposits of its member savings and loan associations and was responsible for insolvent member institutions. FIRREA abolished FSLIC and established the FSLIC Resolution Fund (FRF) to assume all of the assets and liabilities of FSLIC (other than those expressly assumed or transferred to the Resolution Trust Corporation (RTC)). FRF is administered by the Federal Deposit Insurance Corporation (FDIC). The term "FSLIC" is used hereafter to refer to FSLIC and any successor to FSLIC.

prohibited a reduction in the tax basis of the thrift institution's assets on account of the receipt of the assistance. Under the Technical and Miscellaneous Revenue Act of 1988 (TAMRA), taxpayers generally were required to reduce certain tax attributes by one-half the amount of financial assistance received from the FSLIC pursuant to certain acquisitions of financially troubled thrift institutions occurring after December 31, 1988. These special rules were repealed by FIRREA, but still apply to transactions that occurred before May 10, 1989.

Prior to the enactment of FIRREA, the FSLIC entered into a number of assistance agreements in which it agreed to provide loss protection to acquirers of troubled thrift institutions by compensating them for the difference between the book value and sales proceeds of "covered assets." "Covered assets" typically are assets that were classified as nonperforming or troubled at the time of the assisted transaction but could include other assets as well. Many of these covered assets are also subject to yield maintenance guarantees, under which the FSLIC guaranteed the acquirer a minimum return or yield on the value of the assets. The assistance agreements also generally grant the FSLIC the right to purchase covered assets. In addition, many of the assistance agreements permit the FSLIC to order assisted institutions to write down the value of covered assets on their books to fair market value in exchange for a payment in the amount of the write-down.

Under most assistance agreements, one or more Special Reserve Accounts are established and maintained to account for the amount of FSLIC assistance owed by the FSLIC to the acquired entity. The assistance agreements generally specify the precise circumstances under which amounts with respect to covered assets are debited to an account. Under the assistance agreements, these debit entries generally are made subject to prior FSLIC direction or approval. When amounts are so debited, the FSLIC generally becomes obligated to pay the debited balance in the account to the acquirer at such times and subject to such offsets as are specified in the assistance agreement.

In September 1990, the Resolution Trust Corporation (RTC), in accordance with the requirements of FIRREA, issued a report to Congress and the Oversight Board of the RTC on certain FSLIC-assisted transactions (the "1988/89 FSLIC transactions"). The report recommended further study of the covered loss and other tax issues relating to these transactions. A March 4, 1991 Treasury Department report ("Treasury report") on tax issues relating to the 1988/89 FSLIC transactions concluded that deductions should not be allowed for losses that are reimbursed with exempt FSLIC assistance. The Treasury report states that the Treasury view is expected to be challenged in the courts and recommended that Congress enact clarifying legislation disallowing these deductions.[64]

Reasons for Change

Allowing tax deductions for losses on covered assets that are compensated for by FSLIC assistance gives thrift institutions a per-

[64] Department of the Treasury, *Report on Tax Issues Relating to the 1988/89 Federal Savings and Loan Insurance Corporation Assisted Transactions*, March, 1991 at pp. 16-17.

verse incentive to minimize the value of these assets when sold. The FSLIC, and not the institution, bears the economic burden corresponding to any reduction in value because it is required to reimburse the thrift institution for the loss. However, the tax benefit to the thrift institution and its affiliates increases as tax losses are enhanced. The thrift institution, therefore, has an incentive to minimize the value of covered assets in order to maximize its claimed tax loss and the attendant tax savings.

It is desirable to clarify, as of the date of the Treasury Report, that FSLIC assistance with respect to certain losses is taken into account as compensation for purposes of the loss and bad debt deduction provisions of the Code.

Explanation of Provision

General rule

Any FSLIC assistance with respect to any loss of principal, capital, or similar amount upon the disposition of an asset shall be taken into account as compensation for such loss for purposes of section 165 of the Code. Any FSLIC assistance with respect to any debt shall be taken into account for purposes of determining whether such debt is worthless (or the extent to which such debt is worthless) and in determining the amount of any addition to a reserve for bad debts. For this purpose, FSLIC assistance means any assistance or right to assistance with respect to a domestic building and loan association (as defined in section 7701(a)(19) of the Code without regard to subparagraph (C) thereof) under section 406(f) of the National Housing Act or section 21A of the Federal Home Loan Bank Act (or under any similar provision of law).[65]

Thus, if a taxpayer disposes of an asset entitled to FSLIC assistance, no deduction is allowed under section 165 of the Code for a loss (if any) on the disposition of the asset to the extent the assistance agreement contemplates a right to receive FSLIC assistance with respect to the loss. Similarly, if a loan held by a taxpayer constitutes an asset entitled to FSLIC assistance, the thrift institution shall not charge off any amount of the loan covered by the assistance agreement against the bad debt reserve and no charge-off will be taken into account in computing an addition to the reserve under the experience method, to the extent the assistance agreement contemplates a right to receive FSLIC assistance on a write-down of such asset under the agreement or on a disposition. The institution also shall not be allowed to deduct such amount of the loan under the specific charge-off method.[66]

It is intended that the right to FSLIC assistance for purposes of this provision is to be determined by reference to the gross amount of FSLIC assistance that is contemplated by the assistance agreement with respect to the sale or other disposition, or write-down, without taking into account any offsets that might reduce the net

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[65] FSLIC assistance for purposes of the provision does not include "net worth assistance". "Net worth assistance" is generally computed at the time of an acquisition, without targeting loss coverage to ultimate dispositions or write-downs with respect to particular assets.

[66] It is expected that, for purposes of the adjusted current earnings adjustment of the corporate alternative minimum tax, there will not be any net positive adjustment to the extent that FSLIC assistance is taken into account as compensation for a loss or in determining worthlessness and there is, therefore, no deductible loss or bad debt charge-off.

amount FSLIC is obligated to pay under the agreement. For example, under an assistance agreement an institution's right to be reimbursed for a loss on the disposition or write-down of an asset may be reflected as a debit to a Special Reserve Account, while certain other items that will reduce the ultimate amount of assistance to be paid may be reflected as credits to the account. In such a case, the gross amount of FSLIC assistance contemplated by the agreement is the amount represented by the debit, without regard to any offset.

Financial assistance to which the FIRREA amendments apply

The provision does not apply to any financial assistance to which the amendments made by section 1401(a)(3) of FIRREA apply.

No inference

No inference is intended as to prior law or as to the treatment of any item to which this provision does not apply.

Effective Date

In general

The provision applies to financial assistance credited on or after March 4, 1991, with respect to (1) assets disposed of and charge-offs made in taxable years ending on or after March 4, 1991; and (2) assets disposed of and charge-offs made in taxable years ending before March 4, 1991, but only for purposes of determining the amount of any net operating loss carryover to a taxable year ending on or after March 4, 1991.

For this purpose, financial assistance generally is considered to be credited when the taxpayer makes an approved debit entry to a Special Reserve Account required to be maintained under the assistance agreement to reflect the asset disposition or write-down. An amount will also be considered to be credited prior to March 4, 1991 if the asset was sold, with prior FSLIC approval, before that date.

An amount is not deemed to be credited for purposes of the provision merely because the FSLIC has approved a management or business plan or similar plan with respect to an asset or group of assets, or has otherwise generally approved a value with respect to an asset.

As an example of the application of the effective date of the provision, assume that a thrift institution is subject to a FSLIC assistance agreement that, through the use of a Special Reserve Account, operates to compensate the institution for the difference between the book and fair market values of certain covered assets upon their disposition or write-down. Further assume that on February 1, 1991 the thrift institution wrote down a covered asset that has a book value and tax basis of $100 to $60, the asset's fair market value. With FSLIC approval, the institution debited the Special Reserve Account prior to March 4, 1991, to reflect the write-down of $40, and properly submitted to the FSLIC a summary of the account that reflected that debit, along with other debits for the quarter ended March 31, 1991. The provision would not apply to a loss claimed by the thrift institution with respect to the write-

down of the covered asset on February 1, 1991. The same result would apply if the institution had sold the asset for $60 on February 1 with prior FSLIC approval. In the sale case, the provision would not apply even if there were no debit to the Special Reserve Account prior to March 4, 1991, so long as the FSLIC approved the amount of the reimbursable loss for purposes of providing assistance under the agreement.

Application to certain net operating losses

The provision applies to the determination of any net operating loss[67] carried into a taxable year ending on or after March 4, 1991, to the extent that the net operating loss is attributable to a loss or charge-off for which the taxpayer had a right to FSLIC assistance which had not been credited before March 4, 1991.

For example, assume a calendar year thrift institution is a party to a FSLIC assistance agreement that compensates the institution for the amount that covered loans are written down or charged off pursuant to the agreement. The agreement provides that the institution must receive the prior approval of the FSLIC to write down a loan for purposes of this compensation. Further assume that the institution uses the experience method to account for bad debts for tax purposes, and that in 1990 it charged off $100 with respect to a covered loan. Assume that this charge-off initially reduced the taxpayer's bad debt reserve balance by $100 and allowed the taxpayer to increase its addition to its reserve by $100 to bring the reserve to an appropriate balance. The taxpayer deducted this amount and utilized $20 for the year ended in 1990 (i.e., the last taxable year of the taxpayer ending before March 4, 1991). This produced a net operating loss of $80 for the remainder. The net operating loss is carried forward to 1991 (a taxable year of the taxpayer ending on or after March 4, 1991). Assume that the taxpayer did not debit the Special Reserve Account prior to March 4, 1991. The net operating loss carried to 1991 would be redetermined taking into account the provision. Applying the provision to 1990 would result in disallowing the charge-off of the $100 loan against the experience method reserve, in effect disallowing the $100 addition to the reserve. In such case, the taxpayer would continue to owe no tax for 1990, but the $80 net operating loss would be disallowed. However, the taxpayer's tax liability for 1990 would not be redetermined under the provision.

As a further example, assume that the net operating loss described in the example directly above were carried back to, and absorbed in, an earlier year ending prior to March 4, 1991 (rather than being carried forward). In that case, the provision would not apply to reduce the net operating loss carryback.

Estimated taxes

Finally, in accordance with the general estimated tax penalty provisions of the bill, no addition to tax is to be made under section 6654 or 6655 of the Code for any period before March 16, 1994 in the case of a corporation (April 16, 1994 in the case of an individ-

[67] For purposes of determining any alternative minimum tax net operating loss carryover to periods ending on or after March 4, 1991, it is expected that the principles described in the preceding footnote will apply.

ual). However, in providing this relief, no inference is intended as to prior law, the effect of the provision on prior law, or the treatment of any item to which this provision does not apply.

5. Modification of corporate estimated tax rules (sec. 8225 of the bill and sec. 6655 of the Code)

Present Law

A corporation is subject to an addition to tax for any underpayment of estimated tax. For taxable years beginning after June 30, 1992, and before 1997, a corporation does not have an underpayment of estimated tax if it makes four equal timely estimated tax payments that total at least 97 percent of the tax liability shown on its return for the current taxable year. A corporation may estimate its current year tax liability prior to year-end by annualizing its income through the period ending with either the month or the quarter ending prior to the estimated tax payment due date. For taxable years beginning after 1996, the 97-percent requirement becomes a 91-percent requirement.

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

Reasons for Change

The committee believes that corporate estimated tax requirements should be increased to require corporations to remit more timely their current year tax liabilities. In addition, the committee believes that in order to rationalize the calculation of annualized income for corporate estimated tax purposes, an additional set of annualization periods should be provided and applied consistently.

Explanation of Provision

In general

For taxable years beginning after December 31, 1993, a corporation that does not use the 100 percent of last year's liability safe harbor for its estimated tax payments is required to base its estimated tax payments on 100 percent (rather than 97 percent or 91 percent) of the tax shown on its return for the current year, whether such tax is determined on an actual or annualized basis.

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

Annualization periods

In addition, the bill modifies the rules relating to income annualization for corporate estimated tax purposes. In general, the bill (1) adds a new, third set of periods over which corporations may elect to annualize income and (2) requires corporations to an-

nually elect which of the three periods they will use to annualize income for the year.

Specifically, under the bill, annualized income is to be determined based on the corporation's income for the first 3 months of the taxable year (in the case of the first and second estimated tax installments); the first 6 months of the taxable year (in the case of the third estimated tax installment); and the first 9 months of the taxable year (in the case of the fourth estimated tax installment). Alternatively, a corporation may elect to determine its annualized income based on the corporation's income for either: (1) the first 2 months of the taxable year (in the case of the first estimated tax installment); the first 4 months of the taxable year (in the case of the second estimated tax installment); the first 7 months of the taxable year (in the case of the third estimated tax installment); and the first 10 months of the taxable year (in the case of the fourth estimated tax installment); or (2) the first 3 months of the taxable year (in the case of the first estimated tax installment); the first 5 months of the taxable year (in the case of the second estimated tax installment); the first 8 months of the taxable year (in the case of the third estimated tax installment); and the first 11 months of the taxable year (in the case of the fourth estimated tax installment). An election to use either of the annualized income patterns described in (1) or (2) above must be made on or before the due date of the first estimated tax installment for the taxable year for which the election is to apply, in a manner prescribed by the Secretary of the Treasury.

Effective Date

The provision is effective for taxable years beginning after December 31, 1993.

6. Repeal the stock-for-debt exception to cancellation of indebtedness income (sec. 8226(a) of the bill and sec. 108 of the Code)

Present Law

Gross income generally includes cancellation of indebtedness (COD) income. Taxpayers in title 11 cases and insolvent taxpayers, however, generally exclude COD income from gross income but reduce tax attributes by the amount of COD income. The amount of COD income that an insolvent taxpayer excludes cannot exceed the amount by which the taxpayer is insolvent.

The amount of COD income generally is the difference between the adjusted issue price of the debt being cancelled and the amount of cash and the value of any property used to satisfy the debt. Thus, for purposes of determining the amount of COD income of a debtor corporation that transfers stock to a creditor in satisfaction of its indebtedness, the corporation generally is treated as realizing COD income equal to the excess of the adjusted issue price of the debt over the fair market value of the stock. However, if the debtor corporation is in a title 11 case or is insolvent, the excess of the debt discharged over the fair market value of the transferred stock generally does not constitute COD income (the "stock-for-debt ex-

ception").[68] Thus, a corporate debtor that qualifies for the stock-for-debt exception is not required to reduce its tax attributes as a result of the debt discharge. The stock-for-debt exception does not apply to the issuance of certain preferred stock, nominal or token shares of stock, or stock to unsecured creditors on a relatively disproportionate basis. In the case of an insolvent debtor not in a title 11 case, the exception applies only to the extent the debtor is insolvent.

Reasons for Change

The committee believes that the present-law stock-for-debt exception distorts the proper measurement of economic income. In addition, because the stock-for-debt exception results in the forgiveness of tax related to COD income without a corresponding reduction in tax attributes, a corporation emerging from bankruptcy may enjoy a significant tax advantage not enjoyed by either a comparable solvent firm that restructures its debt outside bankruptcy or a start-up company. Finally, the ancillary rules surrounding the eligibility for, and the mechanics of, the stock-for-debt exception are complex and cumbersome.

Explanation of Provision

The provision repeals the stock-for-debt exception. Thus, regardless of whether a debtor corporation is insolvent or in bankruptcy, the transfer of its stock in satisfaction of its indebtedness is treated as if the corporation satisfied the indebtedness with an amount of money equal to the fair market value of the stock that had been transferred. Under the provision, a bankrupt or insolvent corporation may exclude from income all or a portion of the COD income created by the transfer of its stock in satisfaction of indebtedness by reducing tax attributes.

Effective Date

The provision is effective for stock transferred in satisfaction of any indebtedness after June 17, 1993, unless (1) the transfer is in a title 11 or similar case filed on or before June 17, 1993; (2) the transfer occurs on or before December 31, 1993, and the transfer is pursuant to a binding contract in effect on June 17, 1993; or (3) the transfer occurs on or before December 31, 1993, and the taxpayer had filed with the SEC on or before June 17, 1993, a registration statement which proposed a stock-for-debt exchange with respect to such indebtedness, and which discussed the possible application of the stock-for-debt exception to such exchange.

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[68] In addition, if the debtor corporation issues both stock and other consideration to a creditor in satisfaction of indebtedness, the non-stock consideration is generally treated as satisfying an amount of debt equal to the value of such consideration, with the stock being considered as satisfying the remainder. Thus, if such transaction qualifies for the stock-for-debt exception, the entire amount of COD income realized by the debtor corporation in the transaction generally is excluded from gross income.

7. Treatment of passive activity losses and credits and alternative minimum tax credits in certain discharges of indebtedness (sec. 8226(b) of the bill and sec. 108(b) of the Code)

Present Law

The discharge of indebtedness generally gives rise to gross income to the debtor taxpayer. Present law provides exceptions to this general rule. Among the exceptions are rules providing that income from the discharge of indebtedness of the taxpayer is excluded from income if the discharge occurs in a title 11 case, the discharge occurs when the taxpayer is insolvent, or in the case of certain farm indebtedness (sec. 108(a)(1)). The amount excluded from income under these exceptions is applied to reduce tax attributes of the taxpayer. The tax attributes reduced (in order) are (1) net operating losses and carryovers, (2) general business credit carryovers, (3) net capital losses and capital loss carryovers, (4) the basis of certain property of the taxpayer, and (5) foreign tax credit carryovers (sec. 108(b)). The amount of the reduction is generally one dollar for each dollar excluded, except that the reduction in the case of credits is 33-1/3 cents for each dollar excluded.

Under 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. A similar rule applies with respect to credits from passive activities. Deductions and credits suspended under these rules are carried forward to the next taxable year, and suspended losses are allowed in full when the taxpayer disposes of his entire interest in the passive activity to an unrelated person. Passive losses and credits are not tax attributes that are reduced under the rule relating to exclusion of discharge of indebtedness income.

Present law generally allows a minimum tax credit against a taxpayer's regular tax for the taxable year, for taxpayers who paid alternative minimum tax in a prior year (sec. 53). The minimum tax credit generally is the excess of (1) the sum of the minimum tax imposed for all prior taxable years following 1986, over (2) the amount allowed as a minimum tax credit for those prior taxable years. For purposes of determining this excess, in the case of a taxpayer other than a corporation, the minimum tax imposed does not include the minimum tax attributable to exclusion preferences (i.e., adjustments and items of tax preference in sec. 56(b)(1) and sec. 57(a)(1), (5) and (6)), and is determined without regard to sec. 59(a)(2) (relating to the alternative minimum tax foreign tax credit). The minimum tax credit cannot exceed the taxpayer's regular tax liability for the taxable year (reduced by certain credits allowable and reduced by the taxpayer's tentative minimum tax for the taxable year). Minimum tax credits are not tax attributes that are reduced under the rule relating to exclusion of discharge of indebtedness income.

Reasons for Change

Reduction of tax attributes in lieu of current inclusion of certain discharge of indebtedness income provides deferral rather than permanent exclusion of such discharge of indebtedness income. The committee understands that the rationale for providing deferral of discharge of indebtedness income if the taxpayer is insolvent, bankrupt, or in the case of certain farm debt is to provide that a debtor coming out of bankruptcy (or an insolvent debtor outside bankruptcy) is not burdened with an immediate tax liability. The present-law rules were intended to carry out Congressional intent of deferring, but eventually collecting within a reasonable period, tax on ordinary income realized from debt discharge.[69] The committee believes that adding passive losses and credits and minimum tax credits to the attributes that are reduced in this circumstance is fully consistent with the purpose and operation of this deferral mechanism.

Explanation of Provision

The bill adds to the attributes that are reduced in the case of a discharge of indebtedness of the taxpayer that is excludable from income under section 108(a)(1). The attributes added are (1) minimum tax credits as of the beginning of the taxable year immediately after the taxable year of the discharge (following general business credit carryovers (present-law sec. 108(b)(2)(B))), and (2) passive activity loss and credit carryovers from the taxable year of the discharge (following basis of property (present-law sec. 108(b)(2)(D))). The amount of the reduction is generally one dollar for each dollar excluded, except that the reduction in the case of credits is 33-1/3 cents for each dollar excluded.

Effective Date

The provision is effective for taxable years beginning after December 31, 1993.

8. Limitation on section 936 credit (sec. 8227 of the bill and secs. 56, 936 and 7652 of the Code)

Present Law

Section 936 credit

Certain domestic corporations with business operations in the U.S. possessions[70] may elect the use of the section 936 credit which generally eliminates the U.S. tax on certain income related to their operations in the possessions.[71] Income exempt from U.S. tax under this provision falls into two broad categories: active business income, which in order to be exempt must be income treated

[69] Bankruptcy Tax Act of 1980, Report of the Committee on Ways and Means of the House of Reps. (Rpt. No. 96-833, 96th Cong., 2d Sess.) 9; Report of the Senate Committee on Finance (Rpt. No. 96-1035, 96th Cong., 2d Sess.) 10.

[70] Possessions to which special tax rules presently apply include Puerto Rico, Guam, American Samoa, the Commonwealth of the Northern Mariana Islands, and the U.S. Virgin Islands.

[71] In contrast to the foreign tax credit, the possessions 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.

as foreign source income derived from the active conduct of a trade or business within a U.S. possession or from the sale or exchange of substantially all of the assets that were used in such a trade or business; and investment income, which in order to be exempt must be derived from certain investments in the possessions or in certain Caribbean Basin countries. The investment income exempted under the provision is known as "qualified possession source investment income" (QPSII). For these and other purposes, income derived within a possession is encompassed within the term "foreign source income."

In order to qualify for the section 936 credit, a domestic corporation must satisfy two requirements. Under one requirement, the corporation must be treated as having derived at least 75 percent of its gross income from the active conduct of a trade or business within a possession over a three-year period. Under the other requirement, the corporation must be treated as having derived at least 80 percent of its gross income from sources within a possession during that same three-year period.

Three alternative rules are provided that relate to allocating income from intangible property between a domestic corporation that elects the section 936 credit (a "possession corporation") and its U.S. shareholders. The general rule prohibits the possession corporation from being allocated any return on intangible property. A possession corporation can instead elect to subject itself to one of two other allocation rules, if it satisfies certain conditions.

One such rule is referred to as the "cost sharing method." Use of this method requires the possession corporation to pay to the appropriate members of its affiliated group of corporations (including foreign affiliates) an amount which represents its current share of the costs of the research and development expenses of the group. The Code determines that share to be the greater of (1) the total amount of the group's research and development expenses concerning the possession corporation's product area, multiplied by 110 percent of the proportion of the corporation's product area sales as compared to total product area sales of the group; or (2) the amount of the royalty payment or inclusion that would be required under sections 367(d) and 482 with respect to intangible assets which the corporation is treated as owning under the cost sharing method, were the corporation a foreign corporation (whether or not the intangible assets actually are transferred to the corporation). By making this cost sharing payment, the possession corporation becomes entitled to include in its income a return from certain intangibles, primarily manufacturing intangibles, associated with the products it manufactures in the possessions.

The alternative elective rule is referred to as the "profit split" method. This method generally permits allocation to the possession corporation of 50 percent of the affiliated group of U.S. corporations' combined taxable income derived from sales of products which are manufactured in a possession.[72]

Dividends paid by a possession corporation to a U.S. shareholder may qualify for the deduction for dividends received from a domes-

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[72] A special allocation of research and development expenses as required by section 936(h)(5)(C)(ii)(II) can cause the proportion of the combined taxable income which is allocable to the possession corporation to be less than 50 percent.

tic corporation (sec. 243). In cases where at least 80 percent of the stock of the possession corporation is owned by a single domestic corporation, the possession corporation's possession source income generally may be distributed without the parent corporation incurring any resulting regular U.S. income tax.

Taxes paid or accrued by a possession corporation to foreign countries or possessions on income which is taken into account in determining the section 936 credit are neither deductible nor allowable for purposes of determining the foreign tax credit.

A possession corporation's income, the tax on which is allowed to be offset by the section 936 credit, is not included in the alternative minimum taxable income (AMTI) of the possession corporation. Thus, a possession corporation generally is exempt not only from the regular income tax but also from the alternative minimum tax (AMT). Moreover, dividends received by a U.S. corporation from a possession corporation generally do not constitute AMTI of the recipient corporation since, as described above, they may be offset by the dividends received deduction.

For purposes of determining a U.S. corporation's adjustment to AMTI based on adjusted current earnings (ACE), a deduction is allowed for certain dividends received. Specifically, a deduction is available (to the extent allowed under section 243 or 245) for any dividend that qualifies for the 100-percent deductions for dividends received for regular tax purposes, or that is received from a 20-percent owned corporation (as defined in section 243(c)(2)), but only to the extent that the dividend is attributable to income of the paying corporation which is subject to U.S. income tax *determined after the application of section 936*. A dividend received by a U.S. corporation from its wholly-owned possession corporation subsidiary generally does not qualify for the dividends received deduction, and thus increases the ACE of the recipient, because the income of the possession corporation typically is not taxed by the United States due to the section 936 credit.

For purposes of computing the foreign tax credit, the Code provides that dividends received from a possession corporation are characterized as foreign source income. Unless an exception applies, dividends are subject to the separate foreign tax credit limitation for passive income. In computing the AMT foreign tax credit, 75 percent of any withholding or income tax paid to a possession with respect to dividends received from a possession corporation generally is treated as a creditable tax.[73] Moreover, for such computation, taxes paid to a possession by a possession corporation are deemed to be such a withholding tax for this purpose to the extent they would be treated as taxes paid by the recipient of the dividend under rules similar to the rules of the indirect foreign tax credit (secs. 78 and 902) if the possession corporation were a foreign corporation.

Cover over of excise taxes

U.S. excise taxes generally do not apply within the possessions, including Puerto Rico and the U.S. Virgin Islands. Articles that are

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[73] The amount of tax allowable for purposes of the credit is limited to 75 percent of possessions tax paid in order to correspond to the portion of a dividend from a possession corporation that would be included in the recipient shareholder's AMTI as a result of the ACE adjustment.

manufactured in the possessions and brought into the United States for use or consumption are taxed on entry into the United States in the same manner as if the articles were imported from a foreign country. Thus, general excise tax principles tax these articles at the same rate that applies to domestically produced like articles.

In the case of excise taxes on certain articles brought into the United States from Puerto Rico and the Virgin Islands, and in the case of the distilled spirits excise tax on rum, a portion of the revenues is transferred ("covered over") to the treasuries of Puerto Rico and the Virgin Islands. This revenue cover over is significantly limited, both as to the taxes included and as to activities (e.g., manufacturing value added) that must occur in the possession from which the article comes as a condition of payment.

For example, revenues equal to $10.50 (less an administrative fee) per proof gallon of the $13.50 per proof gallon excise tax on rum imported from any foreign country is covered over to Puerto Rico and the Virgin Islands. On the other hand, cover over of tobacco excise tax revenues to Puerto Rico is limited to products where significant manufacturing value is added in the possession from which the product enters the United States, and no cover over is allowed for taxes on distilled spirits other than rum. Further, no cover over is permitted for many other excise taxes, e.g., the fuels excise taxes currently included in the Code.

Reasons for Change

The committee recognizes the importance of the possession tax credit to the possessions generally, and to Puerto Rico in particular. Although the section 936 tax credit was enacted to foster economic development in the U.S. possessions, studies have indicated that a disproportionate share of the tax benefits attributable to section 936 is realized by certain industries that create relatively few jobs in the possessions.[74] These industries tend to be those for which a large portion of taxable income is derived from the use of intangible assets (e.g., exploitation of patents, tradenames, or secret formulas). The committee is concerned, moreover, that a disproportionate share of the cost that all U.S. taxpayers bear in order to provide the section 936 credit may have inured to the benefit of the stockholders of the possession corporations, as compared to the U.S. citizens residing in the possessions. The committee is concerned, however, that some reductions in the tax benefits available to section 936 companies that have been proposed might have detrimental effects on the possessions and might influence the outcome of the scheduled plebiscite relating to the political status of Puerto Rico.

To address these concerns without causing economic dislocation in the possessions, the committee believes that a targeted approach is to limit the tax benefit available to a possession corporation based on a measure of the possession-based economic activity attributable to the corporation in the possession (e.g., a measurement

[74] See, for example, *Pharmaceutical Industry—Tax Benefits of Operating in Puerto Rico*, United States General Accounting Office Briefing Report, to the Chairman, Special Committee on Aging, U.S. Senate, GAO/GGD-92-72-BR, Appendix I, Tables I.1 and I.2, pp. 12-14.

based on the corporation's employment of persons and investment in business property in the possessions). The committee anticipates that under the economic-activity-based limit established by the bill, the section 936 credits of possession corporations will continue to be substantial, and in many cases, will not be reduced relative to present law. However, in recognition of those cases where a substantial reduction in possession corporations' section 936 credits might result under this limit (for example, in the case of a possession corporation that reports high levels of profit in relation to its levels of employment and investment in the possessions), the committee believes it appropriate to allow taxpayers the option to utilize an alternative credit limitation equal to a stated percentage of the credit allowable under present law.

The committee is concerned that the changes made by the bill may result in a temporary reduction in tax receipts by the governments of the possessions. In recognition of this possibility, the committee believes it appropriate to allow certain possession corporations to include a portion of income taxes paid to a possession in the economic-activity credit limitation base. Similarly, the committee believes it appropriate to provide a temporary increase in the level of cover over to the governments of Puerto Rico and the Virgin Islands of rum excise taxes.

The committee also recognizes the importance to certain Caribbean countries and to the financial structure of Puerto Rico of the QPSII funds that currently are held on deposit by possession corporations. As of year-end 1986, the Treasury Department reported that possession corporations held approximately $15 billion in Puerto Rican financial assets.[75] The committee is concerned that reliance on an economic-activity-based limit on the portion of section 936 credit attributable to QPSII might not provide sufficient incentive to prevent taxpayers with possession corporation subsidiaries from liquidating their financial investments in Puerto Rico. Thus, the bill places no limitation on the effective U.S. tax exemption for QPSII.

Explanation of Provision

Section 936 credit

In general, the bill provides that the section 936 credit allowed to a possession corporation for a taxable year against U.S. tax on its active business income (i.e., income derived from the active conduct of a possession-based business, or from the sale of assets used in such a business) is determined as under present law, but is subject to either of two alternative limitations. One alternative limitation is based on factors that reflect the corporation's economic activity in the possessions (the "economic-activity limitation"), and the other limitation is based on a statutorily defined percentage of the section 936 credit that would be allowable under present-law rules (the "percentage limitation").

The option of which alternative limitation to apply is left to the taxpayer. In order to utilize the percentage limitation, however, a corporation must elect use of that limitation for its first taxable

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[75] *The Operation and Effect of the Possessions Corporation System of Taxation — Sixth Report,* March 1989, p. 3.

year beginning after 1993 for which it claims a section 936 credit. Once a possession corporation elects to use the percentage limitation, it must continue to compute its section 936 credit under that limitation for all subsequent taxable years unless the election is revoked.

The bill includes a consistency rule that requires all affiliated possession corporations to utilize the same alternative limitation. If, for example, a possession corporation that uses the percentage limitation becomes a member of an affiliated group that contains a second possession corporation that uses the economic-activity limitation, then the first corporation will be deemed to have revoked its election to use the percentage limitation. The determination whether a possession corporation is part of an affiliated group generally is made by reference to the consolidated return rules, except that stock owned by attribution under the rules of section 1563 is treated as owned directly, and the exclusions from the definition of "includible corporation" listed in section 1504(b) are disregarded. The bill also grants authority to the Treasury Secretary to develop rules that would treat 2 or more possession corporations as members of the same affiliated group to prevent avoidance of the consistency rule through deconsolidation or other means.

The bill does not limit the present-law section 936 credit against U.S. tax on QPSII.

Economic-activity limitation

In general

Under the economic activity limitation, the credit allowed to a possession corporation for a taxable year against U.S. tax on its business income may not exceed the sum of the following three components: (1) 95 percent of qualified compensation; (2) an applicable percentage of depreciation deductions claimed for regular tax purposes by the corporation for the taxable year with respect to qualified tangible property—i.e., tangible property located in a possession and used there by the corporation in the active conduct of its trade or business; and (3) if the corporation does not elect the profit-split method for computing its income, a portion of the possession income taxes it incurs during the taxable year. In order to compute the U.S. tax liability (if any) on the active business income of a possession corporation under the economic-activity limitation, the sum of the three components listed above is subtracted from an amount of pre-credit U.S. tax that would be owed if taxable income of the possession corporation were grossed up by qualified possession compensation and depreciation on qualified tangible property.

Compensation

For purposes of the economic-activity limitation, qualified compensation generally is the sum of (1) the aggregate amount of the possession corporation's qualified possession wages for the taxable year, and (2) its allocable employee fringe benefit expenses for the taxable year. The bill defines "qualified possession wages" as wages paid or incurred by the possession corporation during the taxable year to any employee for services performed in a possession, but only if the services are performed while the principal place of em-

ployment of the employee is within that possession. For example, wages paid for services performed in Puerto Rico by a full-time employee of the possession corporation who resides in Puerto Rico generally would be qualified possession wages. On the other hand, wages paid by the same company to a U.S.-based employee who provides only temporary services in Puerto Rico would not meet the standard for inclusion in the wage base for determining the possession corporation's active business credit limitation.

For this purpose, the term wages refers to the Federal Unemployment Tax Act (FUTA) definition of wages, and the cumulative amount of wages for each employee that are taken into account for a taxable year in computing the credit limitation may not exceed 85 percent of the maximum earnings subject to tax under the OASDI portion of Social Security (currently $57,600). The bill specifies that the Treasury Secretary will provide rules for making appropriate adjustments to this limit in the cases of part-time employees and of employees whose principal place of employment is not within a possession for the entire year. In addition, the bill does not include in qualified possession wages amounts paid to employees who are assigned by the employer to perform services for another person, unless the principal trade or business of the employer (and any related possession corporations) is to make employees available for temporary periods to other persons in return for compensation.

Allocable employee fringe benefit expenses are equal to the aggregate amount allowable to the possession corporation as a deduction for the taxable year of the fringe benefits listed below, multiplied by a fraction the numerator of which is the aggregate amount of the corporation's qualified possession wages (as defined above) for the year and the denominator of which is the aggregate amount of the wages it pays or incurs during that year. In no event, however, may the corporation's allocable employee fringe benefit expenses for a taxable year exceed 15 percent of the aggregate amount of its qualified possession wages for that year.

Fringe benefit expenses that are taken into account for purposes of determining the credit limitation are (1) employer contributions under a stock bonus, pension, profit-sharing, or annuity plan, (2) employer-provided coverage under any accident or health plan for employees, and (3) the cost of life or disability insurance provided to employees. Fringe benefit expenses do not include any amount that is treated as wages.

Depreciation

Depreciation deductions taken into account in determining the economic-activity limitation are as follows. With respect to short-life qualified tangible property (i.e., qualified tangible property to which section 168 applies and which is 3-year or 5-year property as classified under section 168(e)), 50 percent of the depreciation deductions allowable to the possession corporation for the taxable year are taken into account. With respect to medium-life qualified tangible property (i.e., qualified tangible property to which section 168 applies and which is classified as 7-year or 10-year property under section 168(e)), 75 percent of such deductions are taken into account. With respect to long-life qualified tangible property (i.e.,

all other qualified tangible property to which section 168 applies), 100 percent of such deductions are taken into account.

Possession income tax

As a general rule for possession corporations that do not elect the profit-split method, taxes paid or accrued to a possession with respect to taxable income which is taken into account in computing the section 936 credit are factored into the credit-limitation base. However, possession income taxes paid in excess of a 9-percent effective rate of tax are not included for purposes of determining the limitation. Moreover, only the portion of taxes satisfying the effective-rate requirement that are allocable (on a pro-rata basis taking all possession income taxes into account) to nonsheltered income are so included. The portion of possession income taxes allocated to nonsheltered income is determined by computing the ratio of two hypothetical U.S. tax amounts that are computed under the assumption that no credit or deduction is allowed for possession income taxes, and then multiplying that ratio by the taxable income of the corporation, computed under the assumption that no credit or deduction is allowed for possession income taxes, and that all other deductions are allowed as under present law.

The numerator of the ratio described above is the U.S. tax liability of the possession corporation that would arise under the bill by virtue of the economic-activity limitation determined without regard to any credit or deduction for possession income taxes. The denominator of the ratio is the U.S. tax liability of the possession corporation that would be imposed on the income of the corporation (such income being computed under the rules that apply under current section 936) without regard to any credit or deduction for possession income taxes.

A possession corporation that utilizes the profit-split method for allocating any income from intangible property for the taxable year is not permitted to include any taxes in its credit-limitation base. Such a corporation, however, is allowed a deduction for a portion of its possession income taxes paid or accrued during that taxable year. The deductible portion of possession income taxes is the portion that is allocable (on a pro-rata basis) to the corporation's taxable income (computed before taking into account any deduction for such taxes), the U.S. tax on which is not offset by the section 936 credit as a result of the bill's limitation.

Denial of double benefit

For purposes of computing the pre-section 936 credit U.S. income tax liability of a possession corporation that utilizes the economic-activity limitation, the bill requires the corporation to compute taxable income by reducing its otherwise deductible amounts of compensation and depreciation by the amounts that are included in its credit-limitation base.

Election to treat affiliated corporations as one corporation

For purposes of computing the economic-activity limitation, the bill allows an affiliated group of corporations (generally as defined in sec. 1504, but treating possession corporations and foreign corporations as includible corporations) to elect to treat all affiliated

possession corporations as one corporation. For a group so electing, the available consolidated credit amount is to be allocated among the possession corporations of the group under rules prescribed by the Treasury Secretary. Any election to consolidate applies to the taxable year for which made and to all succeeding taxable years unless revoked with the consent of the Treasury Secretary.

Example

To illustrate the operation of the economic-activity limitation, consider a U.S. corporation that has elected the application of section 936. Assume that the corporation has neither elected to use the percentage limitation nor to use the profit-split method for computing its income. Further assume that the corporation pays cash wages of $18, of which $15 are qualified possession wages, and the corporation makes pension, accident, health and life insurance payments of $3 with respect to its employees for the taxable year. Assume also that the corporation is entitled to $5 in depreciation deductions for short-life qualified tangible property and $2 for long-life qualified tangible property and that it pays $6 in possession income taxes.

Assume that the corporation has $100 of taxable income for the year, computed in accordance with the present-law rules for determining the taxable income of a possession corporation (that is, taking into account compensation and depreciation deductions otherwise allowed by the Code, but no deduction for possession income taxes). Assume that this $100 is comprised of $90 of active business income, $5 of QPSII, and $5 of other taxable income, if it claims compensation and depreciation deductions otherwise allowed by the Code, but no deduction for possession income taxes. But for the limitation imposed by the bill, the corporation's section 936 credit would be $33.25 (35% of $95), and it would have U.S. tax liability equal $1.75 (($100 x 35%) - $33.25).

Under the bill, the section 936 credit on U.S. tax attributable to QPSII remains at $1.75 (35% of $5). However, the remaining $31.50 of the otherwise allowable credit is subject to the economic-activity limitation.

As stated above, of the $18 of wages, $15 are qualified possession wages (i.e., they are below 85% of the applicable limit and are paid for services performed in a possession to employees whose principal place of employment is in the possession). Therefore, $2.50 in fringe benefit expenses (i.e., 15/18 of $3) potentially are includible in the credit-limitation base. However, allocable fringe benefit expenses are limited to 15% of qualified possession wages, which in this case equals $2.25 (15% of $15). The total of qualified possession wages and allocable employee fringe benefit expenses therefore is $17.25, and the compensation component of the credit-limitation base thus is $16.39 (95% of $17.25).

The depreciation component of the credit-limitation base is $4.50—i.e., the sum of (1) 50% of the $5 depreciation on the short-life property, and (2) 100% of the $2 depreciation on the long-life property.

The sum of the depreciation and compensation components of the credit-limitation base therefore is $20.89.

The $6 of possession income taxes paid by the corporation represents a 6-percent effective rate of possession tax. Thus, none of these taxes are disqualified from inclusion in the credit-limitation base as a result of the 9-percent-effective-tax-rate provision of the bill. However, only the portion of the $6 that is allocated to nonsheltered income is includible in the credit-limitation base. This portion is determined by comparing the increase in tax attributable to the compensation and depreciation components of the credit limitation (as well as the associated denial of deductibility) to the tax that the corporation would pay in the absence of the section 936 credit and the deductibility denial provision.

The increase in tax attributable to the compensation and depreciation components of the credit limitation and the associated denial of deductibility is determined as follows. Without the limitation, the corporation's U.S. tax liability would be $1.75 as computed above. With the limitation and the denial of deductions (not considering the possession income tax component of the credit limitation), the corporation's U.S. tax liability would be calculated in the following manner. The corporation's taxable income would be $100, plus qualified compensation ($17.25) and depreciation ($7.00), yielding $124.25. The U.S. tax would be 35% of this amount, or $43.49. That amount would be reduced by (1) the active-business section 936 credit ($20.89) and (2) the QPSII credit ($1.75). Therefore, net U.S. tax liability would be $20.85. Thus, the limitation results in an increase in the corporation's U.S. tax liability of $19.10. This $19.10 must be compared to the U.S. tax which the corporation would pay in the absence of the credit and the deductibility denial provision. That tax would be $35 (35% of $100). The amount of possession income taxes which can be included in the credit limitation thus is $3.27 ((19.10/35) x $6).

The total limitation on the active-business credit is $24.16 (i.e., compensation ($16.39) plus depreciation ($4.50) plus possession income taxes ($3.27)). In addition, the corporation can also claim a full credit of $1.75 against its U.S. tax on QPSII. Therefore, the corporation's total section 936 credit for the year may not exceed $25.91. After applying that credit, the corporation's net U.S. tax liability is $17.58 ($43.49 - $25.91).

Percentage limitation

Under the percentage limitation, the section 936 credit allowed to a possession corporation against U.S. tax on business income for a taxable year is limited to an applicable percentage (40 percent once fully phased in) of the credit that would be allowable under present-law rules. Under a transition rule that provides a 5-year phase in, the applicable percentage is as follows:

Taxable years beginning in	Applicable percentage
1994	60%
1995	55
1996	50

Taxable years beginning in	Applicable percentage
1997	45
1998 and thereafter	40%

Thus, for example, if a possession corporation's section 936 credit on business income for a taxable year beginning after 1997, as computed under present law would be $1,000,000, the bill limits the allowable credit for that year to $400,000.

A taxpayer that utilizes the percentage limitation is permitted a deduction for a portion of its possession income taxes paid or accrued during the taxable year. The portion of the taxes so deductible is the portion that is allocable (on a pro-rata basis) to the corporation's taxable income (computed before taking into account any deduction for possession tax), the U.S. tax on which is not offset by the section 936 credit as a result of the limitation.

To illustrate the operation of this rule, assume that for a taxable year beginning after 1997, a possession corporation that has elected the use of the percentage limitation has active business income from its possession-based operations of $900,000 and QPSII of $100,000, yielding pre-credit U.S. tax amounts of $315,000 and $35,000, respectively. Further assume that the corporation incurs possession taxes in the amount of $50,000 for that year. The corporation's section 936 credit for the year would be limited to $161,000 (i.e., a full credit against tax on QPSII and a 40-percent credit against tax on active business income). In this case, $27,0045 ($50,000 x (189,000/350,000)) of possession tax may be deducted by the possession corporation, thereby reducing its taxable income to $973,000. Thus, its pre-section 936 credit U.S. tax liability is $340,550, and its post-credit U.S. tax liability is $179,550.

Foreign tax credit limitation for dividends from possession corporations

The bill also creates a new separate foreign tax credit limitation category for purposes of computing the AMT foreign tax credit. The new category includes the portion of dividends received from a possession corporation for which the dividends received deduction is disallowed, and thus is included in alternative minimum taxable income.

Excise tax cover over

The bill also temporarily increases the cover over of rum excise taxes to Puerto Rico and the Virgin Islands from $10.50 per proof gallon to $11.30 per proof gallon. This increased cover over rate applies for excise taxes imposed in 1994 through 1998. This temporary increase in cover over applies only to excise taxes on rum. Further, it is not the committee's intent in increasing the rum excise tax cover over amount that this action be cited as precedent for any future cover over of either other present excise taxes or taxes that may be enacted as part of this bill or future legislation.

Effective Date

The provision is effective for taxable years beginning after December 31, 1993.

9. Enhance earnings stripping rules (sec. 8228 of the bill and sec. 163(j) of the Code)

Present Law

Interest deductions in general

Interest expenses of a U.S. corporate taxpayer are generally deductible, whether or not the interest is paid to a related party and whether or not the interest income is subject to U.S. taxation in the hands of the recipient. For example, interest income may be exempt from U.S. tax if the recipient generally is exempt under Code section 401 or section 501. As another example, the income may be exempt from U.S. tax if the recipient is a foreign person and either the Code imposes no tax or a treaty eliminates the U.S. tax that otherwise would apply under the Code.

Interest paid to certain related persons

In certain cases where interest is paid by a corporation to a related person, and no U.S. tax is imposed on the recipient's interest income, the so-called "earnings stripping rules" in the Code provide for denial of interest deductions by the debtor to the extent that the corporation's net interest expense exceeds 50 percent of its adjusted taxable income (sec. 163(j)). The disallowance cannot exceed the amount of tax-exempt interest paid to related persons; such interest is known as "disqualified interest." The disallowance does not apply to interest on debt with a fixed term that was issued on or before July 10, 1989, or that was issued after that date pursuant to certain written binding contracts in effect on that date.

For this purpose, a taxpayer's adjusted taxable income generally is its taxable income computed without regard to net interest expense, net operating loss carryovers, or any deduction allowable for depreciation, amortization, or depletion, and computed with such other adjustments as are provided by regulations. An interest recipient is considered to be related to the debtor if the recipient and debtor would be treated as related under the rules of section 267(b) or would be subject to the controlled partnership rules of section 707(b)(1).

A corporation's interest deductions for a taxable year are not limited under the earnings stripping provision unless the ratio of debt to equity of the corporation as of the close of the taxable year (or on such other days during the taxable year as regulations may prescribe) exceeds 1.5 to 1. The ratio of debt to equity means the ratio that the total indebtedness of the corporation bears to the sum of its money and all other assets, reduced (but not below zero) by such total indebtedness, taking into account such adjustments as the Secretary may prescribe in regulations. For this purpose, the amount taken into account with respect to any asset is that asset's adjusted basis for purposes of determining gain.

Any amount of interest disallowed under the earnings stripping provision is permitted to be carried forward as disqualified interest

to a subsequent taxable year. In addition, a taxpayer is permitted to carry forward any excess limitation from its three most recent taxable years. The term excess limitation means the excess (if any) of 50 percent of the debtor's adjusted taxable income over its net interest expense. The excess limitation carried forward reduces the disallowance that would otherwise occur in the year to which the excess is carried.

If a treaty between the United States and any foreign country reduces, but does not eliminate, the 30-percent U.S. tax prescribed by the Code with respect to interest that the taxpayer pays to a related person, the interest is subject to disallowance in the same proportion that the treaty's rate reduction (from the 30-percent statutory rate) bears to 30 percent.

The question of whether a payment to a pass-through entity (such as a partnership, regulated investment company, or real estate investment trust) is treated as a payment to a person related to the debtor generally is determined at the entity level. However, if interest paid to a pass-through entity is treated as paid to a related person, the question of whether the recipient is tax-exempt is determined at the partner (or other beneficial owner) level.

In the case of corporations that form part of a U.S. affiliated group (whether or not such corporations file a consolidated return), the earnings stripping limitation generally applies on a group basis.

Interest paid to an unrelated person on debt guaranteed by a related person

The Treasury is authorized to provide such regulations as may be appropriate to prevent the avoidance of the purposes of the earnings stripping rules, including regulations that disallow deductions for interest paid to unrelated creditors in certain cases: for example, certain cases involving guarantees of the debt by parties related to the debtor, and cases involving so-called "back-to-back loans." The legislative history accompanying the bill enacting the provision, however, indicates an intent that regulations generally not subject third-party interest to disallowance whenever a guarantee is given in the ordinary course.[76] The legislative history further indicates an expectation that any regulations applying the earnings

[76] The conference report on the Omnibus Budget Reconciliation Act of 1989, which added the earnings stripping rules to the Code, includes the following language:

Some have argued that the House report's discussion of parent-guaranteed debt would potentially have made ordinary third-party financing transactions subject to the disallowance rule, in view of the common practice of having parents guarantee the debt of their subsidiaries in order to reduce the cost of third-party borrowings. The conferees intend to clarify that the provision is not to be interpreted generally to subject third-party interest to disallowance under the rule whenever such a guarantee is given in the ordinary course. On the other hand, the conferees do not intend to preclude Treasury from disallowing interest on a guaranteed third-party debt, in appropriate circumstances where the use of guaranteed third-party debt is a device for avoiding the operation of the earnings stripping rules, just as Treasury is not precluded from disallowing interest on a back-to-back loan.

House Rept. No. 101-386, 101st Cong., 1st Sess. 567 (1989). The conference report reference to back-to-back loans echoes language in the House Report on the 1989 Act:

Under current law, back-to-back loans that have no substance are collapsed. See Rev. Rul. 84-152, 1984-2 C.B. 381, Rev. Rul. 84-153, 1984-2 C.B. 383, and Rev. Rul. 87-89, 1987-2 C.B. 195. The bill directs the Secretary to issue such regulations as may be appropriate to prevent the avoidance of the purposes of the bill. The committee intends that such regulations will treat back-to-back loans through third parties (whether related or unrelated), as well as similar arrangements, like direct loans to related parties.

House Rept. No. 101-247, 101st Cong., 1st Sess. 1246 (1989).

stripping rules to third-party debt guaranteed by a person related to the debtor would not apply to debt outstanding prior to notice of the rule (to the extent that the regulations depart from positions the Service and Treasury might properly take under analogous principles of law that would recharacterize guaranteed debt as equity).

To date, Treasury has promulgated no proposed or final regulations that interpret the application of the earnings stripping rules to third-party debt that is guaranteed by a person related to the debtor.

Reasons for Change

Guarantees and the erosion of the U.S. tax base

Where a group of related corporations earns income that is at least in part subject to U.S. tax, the committee believes that it is important to preserve for U.S. taxing jurisdiction an appropriate share of the net income of the group. The committee is aware of provisions in the Code that are designed specifically with this purpose in mind. The committee considers the earnings stripping provision to be so designed.

The operative effect of the earnings stripping provision is to deny deductions for interest expenses deemed to be excessive under the criteria of the provision. Where the deductions are for interest paid to tax-exempt related parties, net income is shifted from the payor to the related party. The committee, like the Congress in 1989, is aware that the earnings stripping provision can be fully effective only to the extent that taxpayers are unable to circumvent its effect through the device of borrowing on the credit of persons whose assets are outside of U.S. taxing jurisdiction. The same "excess" interest deductions, and the same resultant "shifting" of net income out of U.S. taxing jurisdiction, is obtainable through borrowing by U.S. corporations on such credit.

A U.S. corporation can borrow on such credit by borrowing from an unrelated party and having the debt guaranteed by a related party that is exempt from U.S. tax. Although the interest on guaranteed debt is paid to an unrelated lender, the debt serves as a substitute for a direct related party loan to the extent that money is fungible. An affiliated group requires funding for all of its activities and assets, and has flexibility as to the source and use of its funds. Even money borrowed for a specific purpose frees up funds for other purposes.

Had the U.S. corporation borrowed from the related tax-exempt person, and the related tax-exempt person been funded in part by loans from unrelated persons and in part by equity, the earnings stripping provision by its terms might have applied. However, absent the future issuance of regulations, that provision generally does not now apply to interest paid on a guaranteed loan from the unrelated person to the U.S. corporation. Yet the two alternative funding methods are similar.

For example, assume that a foreign corporation with no U.S. operations owns all the stock of a U.S. corporation that conducts a U.S. business. Assume that, aside from its stock in the U.S. subsidiary, the foreign parent has foreign operating assets that sub-

stantially exceed the operating assets of the U.S. corporation. Assume that creditors are willing to lend to the group, and due to various types of guarantees that will be provided by the parent, the parties are indifferent (aside from tax considerations) as to the identity of the corporation that is legally considered to be the primary obligor on any single obligation.

If the primary obligor on all the loans is the parent corporation, and the parent lends to the U.S. subsidiary, then the earnings stripping rules will be implicated if the related party interest is exempt from gross basis tax and the amount of debt and interest incurred by the subsidiary is excessive under those rules. However, because all parties are indifferent as to which corporation is the primary obligor on any loan, the transactions can be structured so that the same excessive level of debt and interest is owed directly by the U.S. subsidiary to the unrelated creditors, and the earnings stripping rules will not be implicated.

The committee is concerned about the extent to which the amount of U.S. tax paid with respect to the U.S. operations of the group depends on whether, on the one hand, the creditors all lend to the parent which in turn lends to the subsidiary, or on the other hand, the creditors lend to the subsidiary. In either case, the loans from the unrelated creditors may be viewed as supporting the income-producing activities of the group as a whole. However, in each case the financing could be structured so that an excessive amount of interest deductions may be claimed against the only income of the group that is subject to U.S. tax—namely, the amount earned by the U.S. subsidiary—unless in each case a provision, such the earnings stripping provision, applies so as to prevent an inappropriate U.S. deduction of expenses of earning income outside U.S. taxing jurisdiction.[77]

How should the law treat guarantees?

When a U.S. corporation borrows on the credit of a tax-exempt person, it is the committee's view that, beyond some threshold, the interest on such a loan is properly considered to be an expense of holding the assets and generating the income of the tax-exempt person. The committee notes that other provisions of present law limit the deductions that may be taken for expenses, including interest, in analogous circumstances. These provisions adopt approaches to the limitation of deductions that differ from the one applied under the earnings stripping rules.[78]

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[77] Even in the absence of such a corrective provision, the same base erosion could not occur if both corporations, and their assets and income, were solely domestic and fully subject to U.S. tax. In that case, to the extent interest deductions offset income of the U.S. subsidiary, the deductions become unavailable to offset income of the U.S. parent that is subject to U.S. tax. If on the other hand one of the domestic corporations has income that is not subject to U.S. tax, such a corrective provision is necessary to prevent base erosion. Present law provides one. A U.S. affiliated group with foreign and domestic income that chooses the benefits of the foreign tax credit, for example, is required to compute the foreign tax credit limitation by allocating and apportioning interest expense as if the group were single corporation (sec. 864(e)).

[78] For example, assume that a foreign corporation with substantial foreign operations conducts a U.S. business in branch form. Assume further that the branch borrows money from a U.S. lender. Under regulations, the interest on this loan (extended to the single corporation that engages in worldwide operations) is not necessarily deductible in the United States. Rather, the foreign corporation may claim a deduction for interest based on that portion of its worldwide debt that corresponds to a ratio of its U.S. assets to its worldwide assets (Treas. Reg. sec. 1.882-5).

Continued

For reasons of administrability, certainty, and consistency with existing tax treaties, Congress enacted section 163(j), and thereby chose to address the erosion of the U.S. tax base through interest deductions, in the case of a U.S. corporation owned by persons exempt from U.S. tax, by limiting related party interest deductions based on an approximation of the cash flow of the corporation and on the debt-to-equity ratio of the corporation. Because the committee is not willing to abandon that approach in favor of either a less objective model or a fundamental departure from accepted practice, the committee believes that this approach generally should be preserved. The committee also now believes, however, that whatever objective standards apply to related party loans should also apply to unrelated party loans guaranteed by related persons that are exempt from U.S. tax. To the extent that lenders and borrowers are indifferent (aside from tax considerations) between the two financing methods, the committee believes that the tax law should treat the two methods with similar indifference. The committee sees little purpose in applying two different tax treatments to the two cases, if taxpayers can elect between them with little economic consequence other than tax savings.

Treatment of guaranteed loans from U.S. lenders

As discussed above, the committee believes that the purpose of the earnings stripping rules is to preserve for U.S. taxing jurisdiction an appropriate share of the net income of a group of related companies. Whether the unrelated party to whom the group member pays interest is or is not a net basis U.S. taxpayer is not relevant to the measurement of the group's U.S.-taxable income, in the committee's view.[79] Such treatment is consistent with the application of section 163(j) under present law to a related party loan in cases where the tax-exempt lender borrows from a U.S. taxpayer, which is an appropriate result, in the committee's view.[80]

The committee also notes other factors that may be taken into account in considering the justification for applying the provision to guaranteed loans from U.S. lenders. The committee is concerned

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Similarly, where a U.S. corporation with foreign income borrows on the strength of its worldwide assets and income, and a portion of its net income that is from foreign sources is effectively exempt from U.S. tax due to foreign tax credits, some of the interest expense must be treated as reducing the foreign-source portion of net income. Such treatment increases the portion of total net income that is ineligible for shelter from U.S. tax via the foreign tax credit (Treas. Reg. sec. 1.861-9T). The Code and the regulations contain rules to ensure that the same economic result follows where the assets and liabilities of such an enterprise are split up into multiple domestic corporations (sec. 864(e); Treas. Reg. sec. 1.861-11T).

[79] In other circumstances, the committee believes it appropriate that under present provisions of the Code, a deduction is denied for interest expenses that are considered to be incurred in the production of tax exempt income, in order to ensure an appropriate measurement of the net income that is not exempt from tax; and the committee further believes it to be appropriate that under those Code provisions it is immaterial that the interest is paid to an unrelated U.S. taxpayer. See Treas. Reg. sec. 1.882-5; Code sec. 265(a) (a taxpayer is denied interest deductions on indebtedness incurred or continued to purchase or carry tax-exempt municipal bonds, regardless of the fact that the taxpayer may pay that interest to another domestic taxpayer).

[80] That is, a loan made by a U.S. lender will be subject to U.S. tax on a net basis whether the loan is made to the foreign or the U.S. borrower. By contrast, a guaranteed loan from an unrelated foreign lender to a U.S. corporation, the interest payments on which are subject to gross basis U.S. tax, differs significantly from a loan by the foreign lender to the foreign parent which then loans to the U.S. subsidiary. In the second case the interest payments received by the unrelated lender are *not* subject to U.S. tax. Thus, it may be argued that it is appropriate to view the gross basis tax imposed in the first case as additional U.S. tax incurred by reason of the guaranteed loan, which in turn serves as an adequate substitute for interest deduction disallowance to the U.S. borrower.

that taxpayers not avoid the purposes of the provision through the use of conduit arrangements, including transactions in which the "conduit" is a U.S. taxpayer. Certain types of guarantees can be used to achieve results similar to those achieved with back-to-back loans. As a practical matter, it can be difficult for the IRS to identify and combat conduit arrangements on a case-by-case basis. Applying section 163(j) to all guaranteed debt avoids this difficulty.

In addition, it may be noted that a typical U.S.-taxpaying financial intermediary that might engage in (guaranteed) lending differs from other types of taxpayers in the extent to which it is itself leveraged with debt. Because of this leverage, the "spread" that generally represents a bank's net taxable income from a loan is small relative to the interest deduction that can be claimed by the debtor. The bank's depositors, in turn, may include domestic or foreign tax-exempt entities. The combined U.S. net basis tax paid by the financial intermediary and its depositors on a fixed amount of interest income may thus be substantially less than the tax saved by the taxable borrower by reason of an equal amount of interest deductions. Were that combined U.S. net basis tax to be relevant to the operation of the bill, it would be very difficult to ascertain the appropriate disallowance of interest deductions.

Taking into account the high degree to which financial intermediaries are leveraged with debt under the guarantee rules is consistent with the treatment of financial intermediaries under present law earnings stripping rules. Such leverage is taken into account under present law in that disallowance is based on the excessiveness of *net* interest expenses of a taxpayer—which generally has the effect of insulating financial intermediaries themselves from exposure to interest disallowance.

Explanation of Provision

In general

Interest may be treated as disqualified interest under the earnings stripping rules without regard to whether it is interest on a fixed-term obligation issued before, on, or after July 10, 1989. In addition, interest paid on a loan from an unrelated party generally is treated as disqualified interest if no gross-basis U.S. income tax is imposed on the interest, a related person guaranteed the loan, and the related person is either exempt from U.S. Federal income tax or is a foreign person. Thus, deductions may be disallowed for interest described above to the extent that the other conditions for disallowance under the earnings stripping rules apply.

Interest on guaranteed debt

Taxes imposed on the interest

In order for the interest paid or accrued to an unrelated person to be disqualified due to a guarantee, there must be no gross basis U.S. income tax imposed on the interest. A "gross basis tax" is a U.S. income tax that is imposed without regard to deductions. For example, the 30 percent statutory tax on interest paid to a foreign person under Code section 871(a) or 881(a) is a "gross basis tax" for this purpose. If a treaty reduces the statutory gross basis tax without eliminating it, a ratable portion of this interest would be

treated as having had no gross basis tax imposed on it. For example, if the treaty-reduced rate were 15 percent, then, as under present law in the case of a payment to a related person, half of the interest would be treated as subject to the full 30 percent gross basis tax, and the other half would be treated as subject to no gross basis tax.

Interest may be disqualified, however, whether or not it is subject to net basis U.S. income tax. (A "net basis tax" is simply a U.S. income tax that is not a gross basis tax.) For example, interest paid to a U.S. bank and reported as gross income may be treated as disqualified interest if the loan is guaranteed.

Taxes imposed on the guarantor

In order for the interest paid or accrued to an unrelated person to be disqualified due to a guarantee, the guarantor must be an organization exempt from income taxation or a foreign person, and the guarantor must not be described in either of two exceptions: one that applies where the debtor owns a controlling interest in the guarantor, and another that applies to cases, identified by regulation, where the interest on the indebtedness would have been subject to net basis tax if the interest had been paid to the guarantor.

For purposes of the controlled guarantor exception, a controlling interest in a corporation means direct or indirect ownership of at least 80 percent of the total voting power, and 80 percent of the value, of all classes of the corporation's stock. A controlling interest in any other entity means direct or indirect ownership of at least 80 percent of the profit and capital interests in the entity.

With respect to the other exception regarding cases where net basis tax hypothetically would have been imposed, the committee anticipates that the Secretary would exercise its authority to treat a foreign guarantor like a taxable U.S. person where the foreign person conducts a trade or business within the United States, and the Treasury is satisfied that income on a hypothetical loan by the foreign person to the debtor, similar to the third-party guaranteed loan, would have been effectively connected with the conduct of that U.S. trade or business, and taxed in the United States for that reason, after the application of any relevant treaty. The committee is concerned, however, that the hypothetical nature of such a test, if not designed properly, might tempt taxpayers to take aggressive reporting positions. Therefore, the committee intends that the Secretary have broad discretion to limit the scope of the exception to cases where the Secretary is fully satisfied that taxpayers are prevented from engaging in tax avoidance schemes, such as establishing an insubstantial U.S. trade or business for the purpose of qualifying for the exception.

Definition of guarantee

Except as provided in regulations, a guarantee is defined to include any arrangement under which a person directly or indirectly assures, on a conditional or unconditional basis, the payment of another's obligation. The committee intends that the term be interpreted broadly enough to encompass any form of credit support. This includes a commitment to make a capital contribution to the debtor or otherwise maintain its financial viability. It includes an

arrangement reflected in a "comfort letter," regardless whether the arrangement gives rise to a legally enforceable obligation. If a guarantee is contingent upon the occurrence of an event, the provision would apply as if the event had occurred.

Relationship to treaties

The committee understands that the impact of this provision may fall heavily on foreign-based multinational enterprises. However, the provision generally applies to guarantees provided by all tax-exempt U.S. persons and tax-exempt foreign persons. The committee does not believe that the impact of the provision on foreign-owned entities conflicts with U.S. tax treaties.

The provision does not, for example, distinguish between payments to U.S. residents on the one hand and payments to residents of other countries, on the other. In either case, deductions can be denied or not depending on the presence or absence of a disqualifying guarantee. Furthermore, the earnings stripping rules deny deductions only in cases believed to satisfy an objective standard of "thin capitalization." As set out more fully in the conference report accompanying the 1989 Act, disallowance in such cases may be consistent with treaties regardless of whether the disallowance applies only to thinly capitalized foreign-owned companies.[81] Moreover, the committee believes that the provision does not inappropriately subject similarly situated persons to dissimilar treatment. Some U.S. tax provisions under current law affect only foreign-owned U.S. businesses, but these provisions are designed solely to provide comparable treatment for these and other U.S. taxpayers in areas where the fact of foreign ownership interferes with the effective operation of domestic tax rules. In short, the committee believes that different but comparable tax treatment that reflects the different circumstances of foreign-owned and domestic-owned businesses does not necessarily constitute discrimination against foreign-owned U.S. businesses.

Effective Date

The provision applies to any interest paid or accrued in taxable years beginning after December 31, 1993.

[81] H.R. Rep. No. 101-386, 101st Cong., 1st Sess. 569-70 (1989).

C. Foreign Tax Provisions

1. Require current taxation of certain earnings of controlled foreign corporations (secs. 8231-8233 of the bill, and secs. 951(a), 954(c), 956, 959, 960(b), 1296, 1297, and new sec. 956A of the Code)

Present Law

In general

U.S. persons generally are taxed currently by the United States on their worldwide income. U.S. tax on foreign source income may be reduced by credits for foreign income taxes paid by the U.S. person. Foreign income earned by a foreign corporation, the stock of which is owned in whole or in part by U.S. persons, generally is not taxed by the United States until the foreign corporation repatriates those earnings by payment of a dividend to its U.S. stockholders. If a foreign corporation pays a dividend to a domestic corporation that owns 10 percent or more of the voting stock of the foreign corporation, the domestic corporation may receive credits for foreign income taxes paid by the foreign corporation. This is sometimes known as the "indirect" foreign tax credit.

The Code sets forth several regimes providing exceptions to the general rule that defers U.S. tax on foreign income earned through foreign corporations. One such regime applies only to certain substantial U.S. shareholders in U.S.-controlled foreign corporations. Other regimes apply to other U.S. persons owning stock in predominantly "passive" foreign corporations. Still other regimes are primarily applicable to U.S. persons owning stock in domestic corporations, but also can be applied to U.S. persons owning stock in foreign corporations.

Controlled foreign corporations

General provisions

Under the controlled foreign corporation rules of subpart F (secs. 951-964), a controlled foreign corporation is defined generally as any foreign corporation if U.S. persons own more than 50 percent of the corporation's stock, taking into account only so-called "U.S. shareholders": namely, those U.S. persons that own (directly, indirectly or by attribution) at least 10 percent of its voting stock (sec. 957).

A "U.S. shareholder," so defined, may be taxed currently by the United States on its proportionate share of the controlled foreign corporation's "subpart F income." The U.S. shareholder may claim an indirect foreign tax credit for its proportionate share of the foreign income taxes paid by the controlled foreign corporation on the subpart F income (sec. 960). Subpart F income typically is foreign income that is relatively movable from one taxing jurisdiction to another and that is subject to low rates of foreign tax relative to the U.S. rate. Subpart F income consists of foreign base company income, insurance income, and certain income relating to international boycotts and other violations of public policy. Excluded from the definition of subpart F income, among other things, are certain dividends and interest received from a related corporation

organized and operated in the same foreign country as the recipient.

Investment of earnings in U.S. property

In addition to taxation of subpart F income and taxation of actual repatriations of earnings not already taxed as subpart F income, a U.S. shareholder may also be subject to U.S. taxation on the controlled foreign corporation's current or accumulated earnings (other than earnings that were previously taxed to the U.S. shareholders as subpart F income), at the time of any increase for the year in the amount of those earnings invested by the controlled foreign corporation in certain U.S. property (as defined in section 956). Thus, for example, assume that a controlled foreign corporation has an active foreign manufacturing business. It earns no subpart F income and has no U.S. property. It has $100 of accumulated earnings, all of which are invested in the foreign business. Assume that in the current year the foreign corporation disposes of $50 worth of foreign business assets and places the proceeds in a U.S. real estate investment or lends them to its U.S. shareholders. In either case, the U.S. shareholders are required to include $50 in gross income for the current year.

Receipt of previously taxed earnings and profits

Earnings and profits of a controlled foreign corporation that have been included in the income of U.S. shareholders before actual repatriation are not included again in the shareholders' gross income when such earnings are in fact distributed to the U.S. shareholders (sec. 959(a)). Earnings actually distributed are treated as comprising first amounts that were previously taxed as investments in U.S. property under section 956 (sec. 959(c)(1)), next amounts that were previously taxed as subpart F income under section 951(a)(1)(A) (sec. 959(c)(2)), and last amounts of other earnings (sec. 959(c)(3)).

A U.S. shareholder is permitted to increase its foreign tax credit limitation in the year of the distribution of previously taxed earnings and profits (sec. 960(b)). The increase equals the excess of the amount by which its foreign tax credit limitation for the year of the income inclusion was increased as a result of that inclusion, over the amount of foreign taxes which were allowable as a credit in that year and which would not have been so allowable but for the income inclusion. The increase in the foreign tax credit limitation may not, however, exceed the amount of the foreign taxes actually paid with respect to the distribution of previously taxed earnings and profits. All such determinations are made separately for each controlled foreign corporation, for each taxable year, and for each foreign tax credit limitation category.

Passive foreign investment companies

Definitions

If any foreign corporation (including a controlled foreign corporation) is a so-called "passive foreign investment company" (PFIC), U.S. persons (including 10-percent "U.S. shareholders") that own stock in the PFIC may be subject to one of two other sets of operat-

ing rules that eliminate or reduce the benefits of deferral (secs. 1291-1297). A PFIC generally is defined as any foreign corporation if (1) 75 percent or more of its gross income for the taxable year consists of passive income, or (2) 50 percent or more of its assets consist of passive assets, defined as assets that produce, or are held for the production of, passive income (sec. 1296(a)). Assets generally are measured by their fair market value; however, a foreign corporation may elect (on a permanent basis) to have its assets measured by their adjusted bases.

Passive income does not include any income derived in the active conduct of a banking business by an institution licensed to do business as a bank in the United States, or, to the extent provided in regulations, by any other corporation (sec. 1296(b)(2)(A)). According to IRS Notice 89-81, 1989-2 C.B. 399, forthcoming Treasury regulations will provide that income effectively connected with the active conduct of a U.S. trade or business pursuant to a license to do business as a bank in the United States, as well as income derived in bona fide banking activities (as defined in Notice 89-81) conducted abroad by a U.S. licensed bank, will be treated as income other than passive income. In addition, a foreign corporation that is not licensed to do business as a bank in the United States, but that qualifies as an active foreign bank (or "qualified affiliate") under conditions set forth in Notice 89-81, will be permitted to treat its income derived in the performance of bona fide banking activities as not passive income.

Look-through rules

In determining whether foreign corporations that own subsidiaries are PFICs, look-through treatment is provided in certain cases (sec. 1296(c)). Under this look-through rule, a foreign corporation that owns, directly or indirectly, at least 25 percent of the value of the stock of another corporation is treated as owning a proportionate part of the other corporation's assets and income. Thus, amounts such as interest and dividends received from foreign or domestic subsidiaries are eliminated from the shareholder's income in applying the income test, and the stock or debt investment is eliminated from the shareholder's assets in applying the asset test.

In addition to the look-through rule applicable to 25-percent-owned subsidiaries, interest, dividends, rents, and royalties received from related persons that are not subject to section 1296(c) look-through treatment are excepted from treatment as passive income to the extent that, under regulations prescribed by the Secretary, those amounts are allocable to income of the payor that is not passive income (sec. 1296(b)(2)(C)).[82] As a corollary, the characterization of the assets that generate the income will follow the characterization of the income so that, for example, a loan to a related person will be treated as a passive asset only if the interest on the loan is treated as passive income.

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[82] A related person is defined by reference to the related person definition applicable for purposes of the controlled foreign corporation rules (that is, sec. 954(d)(3)).

Tax treatment of PFICs

Under the tax rules applicable at the election of a U.S. person owning PFIC stock, the U.S. person includes currently in gross income its share of the PFIC's total earnings, with a separate election to defer payment of tax, subject to an interest charge, on income not currently received. As under the controlled foreign corporation rules, the distribution of earnings and profits that were previously included in the income of an electing shareholder under these rules is not treated as a dividend to the shareholder (sec. 1293(c)). A nonelecting U.S. person owning PFIC stock pays no current tax on the PFIC's undistributed income. However, when realizing income earned through ownership of PFIC stock (such as certain amounts distributed by the PFIC or capital gains from selling PFIC stock), the nonelecting U.S. person may pay an additional interest charge. This interest charge is related to the value of delaying income realization, and therefore delaying tax, by investing indirectly in assets through a foreign corporation.

Accumulated earnings tax

In addition to the corporate income tax, the Code also imposes a tax, at the rate of 28 percent, on the accumulated taxable income of any corporation (with certain exceptions) formed or availed of for the purpose of avoiding income tax with respect to its shareholders (or the shareholders of any other corporation), by permitting its earnings and profits to accumulate instead of being distributed (secs. 531, 532(a)). The specified tax-avoidance purpose generally is determined by the fact that the earnings and profits of the corporation are allowed to accumulate beyond the reasonable needs of the business (sec. 533). The accumulated earnings tax acts as an approximation of the tax that would have been incurred by the shareholders on dividends actually distributed by the corporation.

The accumulated earnings tax does not apply to certain specified types of corporations, including PFICs (sec. 532(b)). The accumulated earnings tax does apply, by its terms, to most other foreign corporations including controlled foreign corporations. However, foreign earnings and profits of foreign corporations generally are not subject to the accumulated earnings tax (see Treas. reg. sec. 1.532-1(c)).

Reasons for Change

Inclusions based on excess passive assets

The committee is aware that the deferral of U.S. tax on income of U.S. persons earned through foreign corporations may tend to favor foreign investment over U.S. investment, and can provide an incentive to engage in certain tax-haven activities. The committee understands that prior enactments that permit deferral of U.S. tax on most types of active business income derived through controlled foreign corporations have been justified as enhancing the competitiveness of U.S.-owned business operations abroad. In fact, Congress referred to such concerns in rejecting the President's proposal

to eliminate all deferral in the Revenue Act of 1962.[83] The committee believes, however, that deferral of U.S. tax on accumulated active business profits is not necessary to maintain the competitiveness of business activities conducted by controlled foreign corporations where such accumulated profits are held in the form of excessive accumulations of passive assets.

The controlled foreign corporation rules impose current U.S. tax on certain passive income earned by a controlled foreign corporation. The PFIC rules restrict the benefits of deferral in the case of foreign corporations that allow undistributed earnings and profits to accumulate in passive investments to such an extent that the amount of the corporation's passive assets equals or exceeds the amount of its active business assets. The committee believes that neither of these regimes sufficiently restricts the benefits of deferral in the case of controlled foreign corporations that accumulate excessive quantities of earnings and profits, without reinvesting them in active business assets, and without subjecting them to U.S. income taxation (with proper allowance for foreign tax credits) in the hands of the U.S. shareholders.

The committee understands that, although the accumulated earnings tax nominally applies to controlled foreign corporations, its application to foreign corporations (including controlled foreign corporations) is limited. Moreover, the accumulated earnings tax of present law employs a subjective analysis to determine the reasonable business needs for accumulating earnings in the form of passive assets. The committee believes it appropriate to impose on controlled foreign corporations a new type of limitation on accumulating deferred earnings that turns on objective rather than subjective criteria.

The committee is concerned that some limitations on accumulating deferred earnings that have been proposed might have had inappropriate application to earnings accumulated by controlled foreign corporations in past years. The committee believes that a better approach is to impose a new limitation on deferral that applies to amounts earned in future years.

Modification of section 956

The committee has carefully considered how best to structure the bill's provisions as to income inclusions of earnings invested in excess passive assets. The committee believes that the provisions of present law applicable to income inclusions of earnings invested in U.S. property under section 956 could be improved, and that those provisions of present law are, in some ways, conceptually parallel to the bill's excess passive assets provisions. The committee believes that the bill's structure and operating rules for the excess passive assets provisions are also appropriate for inclusions of earnings invested in U.S. property, and, accordingly, modifies the latter provisions in the bill.

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[83] "Testimony in hearings before [the House Committee on Ways and Means] suggested . . . that to impose the U.S. tax currently on the U.S. shareholders of American-owned businesses operating abroad would place such firms at a disadvantage with other firms located in the same areas not subject to U.S. tax." H.R. Rep. No. 1447, 87th Cong., 2d Sess. 57-58 (1962).

Measurement of assets under the PFIC rules

The committee understands that many foreign corporations that are subject to the PFIC rules hold assets (such as tangible or intangible business assets) the fair market value of which is difficult to determine. This difficulty is faced primarily by those PFICs that are also controlled foreign corporations, rather than those PFICs that are foreign-controlled investment funds (which tend to hold marketable assets). The committee is aware that the process of determining the fair market value of such foreign assets is a source of complexity and administrative burden for taxpayers, and is an enforcement problem for the Internal Revenue Service.

The committee believes that measurement by adjusted basis is well established in the case of controlled foreign corporations' investments of earnings in U.S. property, and is highly appropriate to the task of measuring the earnings of a controlled foreign corporation that are invested in excess passive assets. The committee is not persuaded that a different method should apply for purposes of measuring assets when testing a controlled foreign corporation for its status as a PFIC. The committee recognizes, however, that when a controlled foreign corporation incurs research and experimental expenditures, the practical effect may be to enhance the corporation's ability to generate active business income over an extended period; yet because such expenditures are commonly deductible under section 174, these types of expenditures may affect the corporation's adjusted tax basis in its assets differently than expenditures to generate active business income over an extended period that take the form of investment in *tangible* assets. Therefore the committee believes that certain adjustments to tax basis should be made to take account of this difference. In addition, the committee believes that in certain cases it is also appropriate to make adjustments that take into account either tangible *or* intangible assets that are used by the corporation in its active business, but are not owned by the company.

Foreign securities brokers and dealers

When the PFIC rules were enacted in 1986, Congress believed that foreign corporations conducting an active business as dealers in stocks, securities and derivative financial products generally would be excluded from qualification as PFICs under both the asset and income tests. Specifically, Congress expected that foreign securities dealers would not qualify as PFICs under the asset test, because more than 50 percent of their assets would consist of inventory securities and other assets that produce income treated as not passive under the dealer exception of section 954(c). Congress also expected that foreign securities dealers would not qualify as PFICs under the gross income test, inasmuch as a substantial portion of their gross income would be commission income (not passive) from underwriting issues of stocks and securities.[84]

The committee is informed, however, that foreign securities dealers do not always earn sufficient gross income in the form of underwriting commissions to avoid qualification as PFICs under the

[84] H.R. Rep. No. 99-841, 99th Cong., 2d Sess. II-644 (1986) (Conference Report to accompany H.R. 3838, the Tax Reform Act of 1986).

gross income test. For example, securities dealers may earn substantial amounts of interest and dividend income from securities held as inventory for sale to customers. Securities dealers may also earn substantial amounts of interest income from transactions incidental to the business of dealing in securities, such as margin loans and reverse repurchase transactions.

The committee is further informed that inventory securities held by a foreign corporate securities dealer may not represent more than 50 percent of the corporation's assets. As a result, a foreign securities dealer may qualify as a PFIC under the asset test. In most cases, moreover, the committee is informed that inventory securities represent less than 75 percent of the assets of a foreign securities dealer, so that most foreign securities dealers would be considered to hold excess passive assets under the bill.

In contrast, existing provisions of the Code and IRS Notice 89-81 ensure that income and assets attributable to bona fide banking activities conducted by a foreign bank or a qualified affiliate are not treated as passive income and assets, if certain conditions are satisfied. The committee is informed, however, that there is considerable overlap between the activities designated as bona fide banking activities under Notice 89-81 and the activities conducted by foreign securities dealers. For example, foreign securities dealers may regularly arrange and engage in foreign exchange transactions, enter into interest rate and currency swaps and other hedging transactions, and underwrite issues of stock, debt obligations and other securities. Each of these activities is designated in Notice 89-81 as a bona fide banking activity.

The committee believes that it is appropriate to provide an exception, similar to that provided under section 1296(b)(2)(A), for income earned by foreign securities brokers and dealers in an active securities business. The committee believes that the availability of this exception should be restricted to U.S. shareholders of controlled foreign corporations in order to ensure that the exception cannot be used by U.S. portfolio investors to avoid the PFIC rules.

Effect on foreign tax credit limitation of distributions of previously taxed earnings

The provisions that permit an indirect foreign tax credit to be claimed in the event of a distribution of previously taxed earnings are particularly difficult to administer. This difficulty arises because taxpayers must determine the amount of excess foreign tax credit limitation associated with a distribution of previously taxed earnings on a separate category by separate category basis, on a foreign corporation by foreign corporation basis, as well as on a year by year basis. Additional complexities arise because taxpayers are required as a result of distributions to trace earnings and profits up tiers of foreign corporations. The bill simplifies present law by requiring taxpayers to establish excess limitation accounts only on a separate category by separate category basis; the taxpayer will not be required to track earnings on a controlled foreign corporation by controlled foreign corporation or a year by year basis.

In addition, the Tax Reform Act of 1986 revised the indirect foreign tax credit by providing for a multi-year "pooling" mechanism. This mechanism was designed to ameliorate the problems associ-

ated with timing mismatches of earnings and profits and foreign tax payments by placing all post-1986 earnings and profits and foreign tax payments in respective pools, and by providing for averaging of these respective amounts for purposes of claiming the indirect credit. The committee believes that the rules of section 960(b) that apply for purposes of determining adjustments to the foreign tax credit limitation should also employ the multi-year pooling concept. In addition, the committee believes it is appropriate to substitute the multi-year pooling concept for the current annual accounting rules that apply to investments of earnings in U.S. property; therefore, the bill adopts a pooling approach in its operating rules for income inclusions based on excess passive assets and income inclusions based on investments in U.S. property.

Explanation of Provision

In general

The bill limits the availability of deferral of U.S. tax on certain earnings of controlled foreign corporations. As explained in detail below, the bill generally requires current inclusions in the income of U.S. shareholders of a controlled foreign corporation to the extent of the corporation's accumulated earnings invested in excess passive assets. The bill also conforms the treatment of earnings of controlled foreign corporations invested in U.S. property to the new rules for earnings invested in excess passive assets, and makes related modifications to other rules applicable to controlled foreign corporations and PFICs.

Inclusions based on excess passive assets

Amount included

The bill adds new section 956A to the Code, which measures the amount of retained earnings of a controlled foreign corporation that is potentially subject to inclusion in the income of a U.S. shareholder of the foreign corporation as a result of the foreign corporation's investment in "excess passive assets." The amount determined under section 956A with respect to a U.S. shareholder of a controlled foreign corporation is the lesser of two amounts.

The first amount is the excess (if any) of the U.S. shareholder's pro rata share of the controlled foreign corporation's "excess passive assets," over that portion of the retained earnings of the foreign corporation that is treated as having been previously included in the income of the U.S. shareholder on account of excess passive assets.[85] The second amount, defined as the "applicable earnings" of the controlled foreign corporation, is the U.S. shareholder's pro rata share of the controlled foreign corporation's total current earn-

[85] Under the previously taxed income rules of section 959, retained earnings of the foreign corporation that are treated as having been previously included in the income of the U.S. shareholder include retained earnings that were previously included in the income of another U.S. person that is a proven predecessor in interest to the U.S. shareholder. In addition, as discussed below under "*Coordination and ordering provisions*," under the bill's rules for the treatment of previously taxed income, the amount of earnings treated as having been previously included in the income of the shareholder on account of excess passive assets (i.e., the amount of earnings described in section 959(c)(1)(B)) includes not only earnings that actually resulted in an inclusion of income under section 951(a)(1)(C), but also earnings that would have resulted in such an inclusion but for being attributable to earnings that had been previously taxed as subpart F income under section 951(a)(1)(A).

ings and profits (but not reduced by a deficit in accumulated earnings and profits) and earnings and profits to the extent accumulated in taxable years beginning after September 30, 1993,[86] reduced by the portion of such post-1993 retained earnings of the foreign corporation that was previously included in the income of the U.S. shareholder on account of either investments in U.S. property or investments in excess passive assets. Under this definition, a controlled foreign corporation can never have a deficit in applicable earnings.

The income inclusion for a U.S. shareholder of the controlled foreign corporation is the amount determined as above under new section 956A; less retained earnings of the controlled foreign corporation that are treated as having been previously taxed to the U.S. shareholder as subpart F income of the controlled foreign corporation under section 951(a)(1)(A), to the extent that such previously taxed earnings were accumulated in taxable years beginning after September 30, 1993 (new sec. 951(a)(1)(C)). (See the discussion of the bill's rules for the treatment of previously taxed income under "*Coordination and ordering provisions*," below.)

Excess passive assets

"Excess passive assets" are defined as the excess (if any) for the taxable year of the average amount of passive assets held by the controlled foreign corporation as of the close of each quarter of its taxable year, over 25 percent of the average amount of total assets held by the controlled foreign corporation as of the close of each quarter of its taxable year. For this purpose, an asset is measured generally by its adjusted basis as determined for purposes of computing earnings and profits.[87] The bill provides a special rule to take into account research and experimental expenditures, and to take into account assets leased or licensed to the foreign corporation, in computing adjusted basis (see description below of certain modifications to the PFIC rules). The committee intends that the measurement of assets as of the close of each quarter of the taxable year shall disregard short-term loans or other temporary arrangements with regard to the corporations's assets, where one of the principal purposes of such an arrangement was to avoid taking passive assets into account for purposes of this provision.

Passive assets are defined generally as under the PFIC rules, *i.e.*, assets held by the controlled foreign corporation that produce passive income (as defined in sec. 1296(b)) or that are held for the production of passive income. The PFIC look-through rules applicable to 25-percent-owned subsidiaries and certain payments received from related persons apply for this purpose. The bill modifies certain definitions of assets and income for purposes of the PFIC rules (see description below of certain modifications of the PFIC rules).

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[86] Earnings and profits generally are computed in the foreign corporation's functional currency, in accordance with the rules of sections 986 and 964. Earnings and profits with respect to pre-1987 taxable years are initially computed in U.S. dollars in accordance with the rules of Treas. reg. sec. 1.964-1, and are then translated into the foreign corporation's functional currency at the "spot" rate that prevailed on the first day of the foreign corporation's first taxable year beginning after December 31, 1986, as provided in IRS Notice 88-70, 1988-2 C.B. 369.

[87] Unlike the PFIC rules of present law, the bill offers no option to measure assets by fair market value.

These modifications are also applicable for purposes of determining excess passive assets under section 956A.

Coordination and ordering provisions

Passive assets for purposes of the excess passive assets provisions do not include any assets that are treated as U.S. property for purposes of section 956.

The bill provides that actual distributions during the taxable year and their effects on the determination of earnings and profits, previously taxed amounts, or any other item are taken into account prior to the determination of amounts under section 956 that are subject to income inclusion under section 951(a)(1)(B), and amounts under section 956A that are subject to income inclusion under section 951(a)(1)(C).[88]

The bill further provides that all amounts of assets, earnings included in income, previously taxed amounts, and any other item determined for purposes of the excess passive assets provisions are to be determined after the application of section 956 (and income inclusions thereunder) for the taxable year.

Previous income inclusions under section 956A are treated similarly to previous income inclusions under section 956 for purposes of the ordering rules applicable to the different categories of previously taxed income under section 959(c). Thus, when the controlled foreign corporation makes an actual distribution of its earnings to its shareholders, the earnings distributed are treated as first attributable to the retained earnings that were required in prior years to be included in income as investments in excess passive assets under section 956A (amounts of earnings described in sec. 959(c)(1)(B)), together with the retained earnings that were required in prior years to be included in income as investments in U.S. property under section 956 (amounts of earnings described in sec. 959(c)(1)(A)). The attribution between the two categories is made on a pro rata basis. As under present law, distributed earnings are treated as next attributable to the retained earnings that were required in prior years to be included in income as subpart F income under section 951(a)(1)(A) (amounts of earnings described in sec. 959(c)(2)), and last attributable to other earnings and profits (amounts of earnings described in sec. 959(c)(3)). As under present law, distributions of earnings described in section 959(c)(2) are treated as attributable to more recent years first. The same present-law rule also applies to earnings described in section 959(c)(3).

Amounts that would be included in income as investments in U.S. property under section 956 are treated as first attributable to the retained earnings that were required to be included in income as subpart F income under section 951(a)(1)(A) (amounts of earnings described in sec. 959(c)(2)), and then attributable to other earnings and profits. Amounts that would be included in income as investments in excess passive assets under section 956A are treated as first attributable to the retained earnings that were required to be included in income as subpart F income under section

[88] As under current law, actual distributions are taken into account after the application of section 951(a)(1)(A).

951(a)(1)(A) (amounts of earnings described in sec. 959(c)(2)) to the extent that such earnings were accumulated in taxable years beginning after September 30, 1993, then attributable to earnings and profits that were not required to be included in income as subpart F income (amounts of earnings described in sec. 959(c)(3)).

As under present law in the case of investments in U.S. property, to the extent that an amount would be included in income as either an investment in U.S. property or an investment in excess passive assets, but for being attributable to earnings that had been previously taxed as subpart F income under section 951(a)(1)(A), that amount of earnings is converted from an amount treated as previously taxed under section 951(a)(1)(A) (amounts of earnings described in sec. 959(c)(2)), to an amount treated as previously taxed under subparagraph (B) or (C) of section 951(a)(1) (amounts of earnings described in subparagraph (A) or (B) of sec. 959(c)(1)), as the case may be. Therefore, for example, the amount of earnings treated as having been previously included in the income of the shareholder on account of excess passive assets (*i.e.*, the amount of earnings described in section 959(c)(1)(B)) includes not only earnings that actually resulted in an inclusion of income under section 951(a)(1)(C), but also earnings that would have resulted in such an inclusion but for being attributable to earnings that had been previously taxed as subpart F income under section 951(a)(1)(A).

Example

The above rules are illustrated by the following multi-year example:[89]

Year 1.—Assume that a U.S. corporation owns all the stock of a controlled foreign corporation, which is not (and has never been) a PFIC. The foreign corporation holds an average of 100 of assets, of which 35 are passive, and no U.S. property. Further assume that the foreign corporation has accumulated earnings and profits of 25 at the close of year 1, none of which is subpart F income or has otherwise previously been included in the income of a U.S. shareholder under subpart F, and 15 of which was earned in taxable years beginning after September 30, 1993. Under the bill, the foreign corporation is treated as having excess passive assets of 10. The amount determined under section 956A is also 10: that is, the lesser of the 10 of excess passive assets or the 15 of post-1993 accumulated earnings. Therefore, for year 1, 10 is included in the U.S. corporation's income as earnings invested in excess passive assets under section 951(a)(1)(C). Also, 10 of the foreign corporation's earnings is treated as previously taxed and described in subsection (c)(1)(B) of section 959 (as income previously taxed under section 951(a)(1)(C)), attributable to taxable years beginning after September 30, 1993. The controlled foreign corporation's accumulated earnings of 25 are unchanged by the inclusion in income under section 951(a)(1)(C).

Year 2.—Next assume that in year 2, the controlled foreign corporation still has average total assets of 100, but now 40 (rather than 35) of these assets are passive. Also assume that the foreign

[89] This example assumes that all years at issue begin after the effective date of the bill, i.e., after September 30, 1993.

corporation earns 5 of subpart F interest income in year 2, and makes no actual distributions of earnings and profits. (For simplicity, assume for this purpose that the new earnings have been taken into account in arriving at the figure of 100 for average assets.) As a result, the foreign corporation holds accumulated earnings and profits of 30 at the close of year 2, 20 of which was earned in taxable years beginning after September 30, 1993. The interest income of 5 is included in the U.S. corporation's income as subpart F income under sec. 951(a)(1)(A).

Under the bill, before computing whether there is an additional income inclusion on account of excess passive assets, the 5 of subpart F earnings is treated as previously taxed and described in subsection (c)(2) of section 959 (as income previously taxed under section 951(a)(1)(A)), attributable to taxable years beginning after September 30, 1993. The year 2 amount determined under section 956A is 5. It is the lesser of two amounts. The first amount is 5, or the difference between the 15 of excess passive assets in year 2 and the 10 of previous inclusions of earnings invested in excess passive assets. The second amount is 10, or the difference between the 20 of post-1993 accumulated earnings and the 10 of previous inclusions of excess passive assets. The amount included in the U.S. corporation's year 2 income on account of its (increased) investment in excess passive assets, however, is zero. This results from the 5 of subpart F income under section 951(a)(1)(A) that the foreign corporation earned in year 2, and the ordering rules of section 959 as modified by the bill. Under the bill, there is no excess of the amount determined under section 956A (5, as noted above) over the amount of the foreign corporation's retained earnings that have been included in the U.S. corporation's income under section 951(a)(1)(A), attributable to taxable years beginning after September 30, 1993 (also 5). The bill also provides, in this case, that the earnings in the amount of 5 that would have been included in income under section 951(a)(1)(C) but for the previously taxed subpart F income are to be treated as described in section 959(c)(1)(B) (*i.e.*, as earnings previously taxed as investments in excess passive assets) rather than in section 959(c)(2) (*i.e.*, as earnings previously taxed as subpart F income under section 951(a)(1)(A)). Therefore, at the end of year 2, 15 is the total amount of earnings (10 from year 1 plus 5 from year 2) treated as described in section 959(c)(1), and the accumulated earnings of 30 are unaffected by the income inclusions.

Year 3.—Assume that, as in year 2, the foreign corporation has an average of 40 of passive assets and 100 of total assets. Assume further that the foreign corporation earns another 5 of subpart F interest income, earns 10 of other income, and makes an actual distribution of 20 to the U.S. corporation. (Again, for simplicity, assume that the new earnings and the distribution have been taken into account in arriving at the figure of 100 for total assets.) The foreign corporation thus holds accumulated earnings and profits of 45 at year end, before taking the current-year distribution into account, of which 35 are attributable to taxable years beginning after September 30, 1993.

As in year 2, the year 3 subpart F interest income of 5 is included in the U.S. corporation's income (under sec. 951(a)(1)(A)).

Also as in year 2, under the bill, before computing whether there is an income inclusion for year 3 on account of excess passive assets, the subpart F earnings of 5 are treated as previously taxed and described in section 959(c)(2) (as income previously taxed under section 951(a)(1)(A)), attributable to taxable years beginning after September 30, 1993.

The bill provides that the actual distribution of 20 is accounted for next. The distribution of earnings is treated as attributable first to the cumulative earnings described in section 959(c)(1) (15, in this case all described in section 959(c)(1)(B), and all attributable to taxable years beginning after September 30, 1993), and next to the cumulative earnings described in section 959(c)(2) (5, in this case all from year 3, all attributable to taxable years beginning after September 30, 1993). Thus, the distribution of 20 is treated as fully attributable to previously taxed earnings, and, after the distribution, no portion of the foreign corporation's retained earnings is treated as previously taxed income described by subsection (c)(1) or (c)(2) of section 959.

Next, if the foreign corporation had invested any of its earnings in U.S. property under section 956, the amount of the income inclusion under section 951(a)(1)(B) would be determined. In this case, there is none.

Last, the income inclusion (if any) under section 956A is determined. The amount determined under section 956A is 15. This is the lesser of 15 (the amount of excess passive assets, unreduced because no portion of the foreign corporation's retained earnings is treated as previously taxed under section 951(a)(1)(C)), and 15 (the amount of post-1993 accumulated earnings, unreduced because no portion of the foreign corporation's retained earnings is treated as previously taxed under subparagraph (B) or (C) of section 951(a)(1)). The amount included in the U.S. corporation's income for year 3 under section 951(a)(1)(C) is the 15 determined under section 956A, again unreduced because no portion of the foreign corporation's retained earnings is treated as previously taxed under section 951(a)(1)(A). The U.S. corporation has a total income inclusion under subpart F of 20 for year 3: 5 under section 951(a)(1)(A) plus 15 under section 951(a)(1)(C). As of the end of year 3, the taxpayer treats 15 of earnings as described in section 959(c)(1)(B) (*i.e.*, as earnings previously taxed as investments in excess passive assets), and has accumulated earnings of 25, of which 15 are attributable to taxable years beginning after September 30, 1993.

Special rules for decontrolled foreign corporations

Proper adjustments are to be made to the measurement of assets and earnings in the case of any foreign corporation that ceases to be U.S.-controlled during the taxable year. The determination of the pro rata share held in such a corporation by any U.S. shareholder is to be made on the basis of stock ownership on the last day during the taxable year on which the foreign corporation is a controlled foreign corporation. The determination of excess passive assets for such a taxable year is made by taking into account only those quarters of the taxable year that end prior to such day, and averaging only over such reduced number of quarters. The determination of current earnings and profits for such a taxable year is

made by taking into account only a pro rata portion of the corporation's current earnings and profits for that entire year, based on the part of that year during which the foreign corporation is a controlled foreign corporation.

Aggregation and anti-abuse rules

The bill provides an aggregation rule applicable to any chain of controlled foreign corporations that are connected through stock ownership, where more than 50 percent, by vote or value, of the stock of each member of the chain (other than the top-tier controlled foreign corporation) is owned, directly or indirectly, by one or more other controlled foreign corporations that are members of the chain ("CFC chain"). Under this rule, the amount of excess passive assets for the CFC chain would be determined on the basis of the sum of the assets of each controlled foreign corporation in the CFC chain and the sum of the passive assets of each controlled foreign corporation in the CFC chain. The total applicable earnings for the CFC chain would be determined as the sum of the applicable earnings of each controlled foreign corporation in the CFC chain.[90] Each controlled foreign corporation in the CFC chain would be treated as holding its pro rata share of the excess passive assets of the CFC chain, on the basis of that controlled foreign corporation's percentage share of the total applicable earnings of the CFC chain.

The bill provides regulatory authority under which the Treasury is instructed to prescribe such regulations as may be necessary to carry out the purposes of the excess passive assets provisions, and to prevent their avoidance. Within this authority, the committee intends that the Treasury prescribe regulations under which the earnings and assets of two or more controlled foreign corporations that are related but are not part of the same CFC chain may be treated as if they were part of the same CFC chain, if one of the principal purposes for separately organizing, acquiring, or maintaining such multiple corporations is to avoid an inclusion under the excess passive assets provision. In making the determination as to purpose, the committee expects that the regulations may take into account various presumptions, including (but not limited to) those set forth in temporary Treas. reg. sec. 1.954-1T(b)(4).

Modification of section 956

The bill treats earnings invested by a controlled foreign corporation in U.S. property under revised rules that parallel those that govern the treatment of excess passive assets, as described above. Under the revised rules, the amount determined under section 956 with respect to a U.S. shareholder of a controlled foreign corporation is the lesser of two amounts.

The first amount is the excess (if any) of the U.S. shareholder's pro rata share of the U.S. property of the controlled foreign corporation, over that portion of the retained earnings of the foreign corporation that is treated as having been previously included in

[90] Inasmuch as the amount of a controlled foreign corporation's applicable earnings can never be less than zero, a corporation with no current earnings and an accumulated deficit is not taken into account in determining the sum of the applicable earnings of all controlled foreign corporations in the CFC chain.

the income of the U.S. shareholder on account of earnings invested in U.S. property.[91] The second amount is the U.S. shareholder's pro rata share of the controlled foreign corporation's current and accumulated earnings and profits (but not reduced by a deficit in accumulated earnings and profits), reduced by the portion of the retained earnings of the foreign corporation that was previously included in the income of the U.S. shareholder on account of either investments in U.S. property or investments in excess passive assets.

The income inclusion for a U.S. shareholder of the controlled foreign corporation is the amount determined as above under section 956, less retained earnings of the controlled foreign corporation that are treated as having been previously taxed to the U.S. shareholder as subpart F income of the controlled foreign corporation under section 951(a)(1)(A) (see sec. 951(a)(1)(B), as modified by the bill). (See the discussion of the bill's rules for the treatment of previously taxed income under "*Coordination and ordering provisions*," above.)

As noted above, the bill provides that actual distributions during the taxable year and their effects on the determination of earnings and profits, previously taxed amounts, or any other item, are taken into account prior to the determination of amounts under section 956 that are subject to income inclusion under section 951(a)(1)(B), and amounts under section 956A that are subject to income inclusion under section 951(a)(1)(C).

The controlled foreign corporation's U.S. property is measured as the average of the adjusted basis (as determined for purposes of calculating earnings and profits) of such property held (directly or indirectly) by the controlled foreign corporation as of the close of each quarter of its taxable year, less any liability to which the property is subject (as under present law). The committee intends that the measurement of assets as of the close of each quarter of the taxable year shall disregard short-term loans or other temporary arrangements with regard to the corporations's assets, where one of the principal purposes of such an arrangement was to avoid taking assets into account for purposes of this provision. Examples of what the IRS views as such arrangements are discussed in Rev. Rul. 89-73 (1989-1 C.B. 258), interpreting present law.

The bill is not intended to change the measurement of U.S. property that may apply, for example, in the case of certain short-term obligations, as provided in IRS Notice 88-108 (1988-2 C.B. 445), interpreting present law. Obligations subject to the special treatment of IRS Notice 88-108 are those that are collected within 30 days of their issuance, but the exclusion of such short-term obligations

[91] As noted above, under the previously taxed income rules of section 959, retained earnings of the foreign corporation that are treated as having been previously included in the income of the U.S. shareholder include retained earnings that were previously included in the income of another U.S. person that is a proven predecessor in interest to the U.S. shareholder. In addition, as discussed above under "*Coordination and ordering provisions*," under the bill's rules for the treatment of previously taxed income, the amount of earnings treated as having been previously included in the income of the shareholder on account of investments of earnings in U.S. property (i.e., the amount of earnings described in section 959(c)(1)(A)) includes not only earnings that actually resulted in an inclusion of income under section 951(a)(1)(B), but also earnings that would have resulted in such an inclusion but for being attributable to earnings that had been previously taxed as subpart F income under section 951(a)(1)(A).

does not apply if the controlled foreign corporation holds obligations that would constitute U.S. property if held by the controlled foreign corporation on the date of measurement (determined without regard to this 30-day rule) for aggregate periods totalling at least 60 days in the taxable year, without regard to whether any such obligations are held on the date of measurement.

Same-country dividend rule

The bill limits the application of the same-country exception to the determination of subpart F income in the case of certain dividends received by controlled foreign corporations. Amounts distributed with respect to stock owned by the controlled foreign corporation do not qualify for the same-country exception to the extent that the distributed earnings and profits were accumulated by the distributing corporation during periods when the controlled foreign corporation did not hold the stock. The bill's limitation applies, and thus the same-country exception does not apply, even in cases where the controlled foreign corporation receiving the distribution did not exist at the time the distributed earnings and profits were accumulated, but the stock of the distributing corporation was held by the shareholders of the receiving corporation at such time.

The committee intends that no inference be drawn from the bill as to the proper interpretation of temporary Treas. reg. sec. 1.954-2T(b)(3)(iii) (which also imposes limitations on the same-country exception from the treatment of dividends as subpart F income).

Effect on foreign tax credit limitation of distributions of previously taxed earnings

Under the bill, receipt of a distribution of previously taxed income by a U.S. shareholder of one or more controlled foreign corporations increases the U.S. shareholder's foreign tax credit limitation to the extent of the aggregate amount in a single "excess limitation account" maintained by that U.S. shareholder for each of its separate foreign tax credit limitation categories. That account reflects the cumulative amount by which the U.S. shareholder's foreign tax credit limitation had been increased on account of subpart F income inclusions (in excess of the foreign taxes allowed as a credit on account of such inclusions) in taxable years beginning after September 30, 1993, less the total amount by which the account was used to increase the U.S. shareholder's foreign tax credit limitation upon prior distributions of previously taxed earnings and profits.

The treatment described in the paragraph above applies to a taxpayer that (1) chose to have the benefits of the foreign tax credit for a taxable year beginning after September 30, 1993, in which that taxpayer had an inclusion of subpart F income (if there were creditable foreign taxes paid or accrued for that year); (2) chooses to have the benefits of the foreign tax credit for any taxable year in which earnings that were so included are actually distributed and treated as previously taxed; and (3) pays, is deemed to pay, or accrues creditable foreign taxes for the year in which the distribution is received. The committee intends that any distribution in a taxable year beginning after September 30, 1993, be treated as comprising earnings attributable to taxable years beginning after

September 30, 1993, to the extent of such earnings, then earnings attributable to taxable years beginning prior to October 1, 1993. The committee anticipates that Treasury regulations will provide guidance as to the application of these provisions in the case of taxpayers that choose to have the benefits of the foreign tax credit in some but not all years.

In the case of a foreign tax credit carryback to a taxable year beginning after September 30, 1993, the increase in the excess limitation account resulting from subpart F income inclusions for that taxable year is reduced by the amount of foreign taxes allowed as a credit by reason of the carryback, if such foreign taxes would not have been allowed as a credit for that year but for the subpart F income inclusions for that year.

Modification of certain PFIC rules in the case of U.S. shareholders of controlled foreign corporations

Measurement of assets

The bill modifies the present-law rules for applying the PFIC asset test in the case of U.S. shareholders of controlled foreign corporations. In testing a controlled foreign corporation for PFIC status with respect to its "U.S. shareholders," under the bill, assets generally are measured by adjusted basis as determined for purposes of calculating earnings and profits, with no option to use fair market value.

Adjusted basis for this purpose is modified to take into account certain research and experimental expenditures and certain payments for the use of intangible property that is licensed to the controlled foreign corporation. First, the aggregate adjusted basis of the total assets of the controlled foreign corporation is increased by the total amount of research and development expenditures made by the controlled foreign corporation, for qualified research or experimental expenditures (as defined for purposes of Code section 174 and the Treasury regulations thereunder), taking into account payments and expenditures (including cost-sharing payments) made in the current taxable year and the two most recent preceding taxable years. In addition, the aggregate adjusted basis of the total assets of the controlled foreign corporation is increased by the amount of three times the total payments made during the taxable year to unrelated persons and related U.S. persons for the use of intangible property with respect to which the controlled foreign corporation is a licensee, and which the controlled foreign corporation uses in the active conduct of its trade or business. Payments made to related foreign persons are not taken into account. For purposes of this rule, intangible property is defined as under section 936(h)(3)(B) of the Code.

Treatment of certain securities dealers

The bill excludes from the definition of passive income under the PFIC rules income derived in the active conduct of a securities business by certain corporations registered in the United States as brokers or dealers in securities, and, to the extent provided in Treasury regulations, income so derived by any other corporation engaged in the active conduct of a trade or business as a broker

or dealer in securities. As with the asset-valuation rule above, this exclusion applies only to a controlled foreign corporation, and only for purposes of the treatment of its U.S. shareholders. The bill provides that similar rules apply in determining whether the income of a related person is passive (whether or not the related person is a corporation), solely for purposes of classifying amounts paid to a controlled foreign corporation as passive or not pursuant to the PFIC related-person rule (sec. 1296(b)(2)(C)).[92]

The committee anticipates that Treasury regulations will provide guidance as to what constitutes the active conduct of a trade or business as a broker or dealer in securities. The committee further anticipates that such regulations will provide that income derived from the performance of bona fide securities-related activities in the course of the active conduct of such a business generally will be treated as income other than passive income.

The committee intends that, in practice, the effect of this provision shall be only to mitigate the effect of the PFIC rules and the excess passive assets rules on a company insofar as it is actively engaged in the business of providing the services of a financial intermediary to unrelated parties, rather than used as a vehicle for investment in stock, securities, or other financial products on behalf of its shareholders or other related parties. There are other instances in the Code and regulations where it is necessary to draw similar distinctions, and the Treasury is invited to consider whether any tests employed in those provisions are suitable in light of the purposes of this provision.

For example, the controlled foreign corporation rules may require a determination as to whether a foreign corporation is a regular dealer (within the meaning of section 954(c)(1)(B)) in stocks, securities, or derivative financial products during its taxable year. As another example, the PFIC rules exempt a foreign corporation, to the extent provided in regulations, from passive characterization of its income from the active conduct of a banking business. Guidance has been issued under that provision analogous to the guidance that might be issued under this provision of the bill. As a third example, guidance has been issued under the foreign tax credit limitation regulations for identifying financial services entities.

As in the cases of the PFIC bank rules and the foreign tax credit limitation rules on financial services entities, the committee believes that the Treasury could consider a variety of activities that may indicate the existence of an active securities business.[93]

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[92] For example, in the case of U.S. shareholders of a controlled foreign corporation that is engaged in the active conduct of a trade or business as a broker or dealer in securities, and that receives interest, dividends, rent, or royalties from a related person (which may or may not be a corporation), the determination of the amount of such income that is allocable to income of the related person other than passive income is made by applying the exception for certain income of securities brokers and dealers to the income of the related person, whether or not the related person is a corporation, solely for purposes of applying the PFIC income test to income earned by the controlled foreign corporation through the related person.

[93] Such activities might include: (a) purchasing or selling inventory securities such as stock, debt obligations, commodity futures or other securities or derivative financial products (including notional principal contracts) from or to unrelated persons, arranging such purchases or sales on behalf of unrelated persons who are customers in the course of a business as a securities broker, and holding stock, debt obligations and other securities as inventory for sale to such customers; (b) arranging notional principal contracts and other hedging transactions for, or entering into such transactions or any other derivative financial products with, unrelated persons who are customers; (c) arranging foreign exchange transactions for, or engaging in foreign exchange

Continued

In addition, in appropriate circumstances, the Treasury might consider it relevant that a foreign corporation is or is not registered or authorized in the country in which it conducts its principal securities broker or dealer operations to conduct the bona fide securities activities that it performs in that country, and is subject to the appropriate securities regulatory authorities of that jurisdiction.[94]

The foregoing list of possible approaches and factors to take into account is not intended to be exclusive of other approaches or factors not mentioned. Nor is it intended to suggest that the presence of any of the factors mentioned above, or the passing or failing of any test existing under present law, must be used by Treasury to determine the outcome of the question whether a foreign corporation is engaged in the active conduct of a trade or business as a broker or dealer in securities. The committee does not intend to limit the Treasury's discretion to fashion rules suitable to the purposes of the provision. The committee does intend, however, that Treasury clarify the issue of what income qualifies as derived in the active conduct of a trade or business as a broker or dealer in securities, by issuing guidance in time for taxpayers to file returns

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transactions with, unrelated persons who are customers; (d) underwriting issues of stocks, debt obligations or other securities under best-efforts or firm-commitment agreements with unrelated persons; (e) purchasing, selling, discounting, or negotiating on a regular basis for unrelated persons notes, drafts, checks, bills of exchange, acceptances or other evidences of indebtedness; (f) lending inventory stocks or securities to unrelated persons; (g) engaging in hedging activities directly related to bona fide securities activities described in items (a) through (f) of this list; (h) servicing mortgages; (i) investment banking activities; (j) providing financial or investment advisory services, investment management services, fiduciary services, trust services, or custodial services to unrelated persons; (k) providing margin or other financing for unrelated persons who are customers, secured by securities or money market instruments, including repurchase agreements, or financing in connection with any of the bona fide securities activities described in items (a) through (j) of this list; (l) disposing of any property (whether tangible or intangible, personal or real) that was used or acquired in the active conduct of the securities business, but only to the extent that the property was held in connection with a bona fide securities activity; and (m) any other activity that the Secretary may determine to be a bona fide securities activity that is commonly conducted by active foreign securities dealers in the ordinary course of their securities business.

[94] One approach that the Treasury may wish to consider in drafting regulations under this provision would be to treat a controlled foreign corporation as an active foreign securities broker or dealer for a taxable year if it satisfies a securities-related activity test, a gross income test and a licensing requirement. To satisfy the securities-related activity test, the foreign corporation could be required to qualify as (i) a "regular dealer" in stocks, securities and derivative financial products within the meaning of section 954(c) and the regulations thereunder, (ii) a "qualified affiliate" or (iii) to the extent provided in the regulations, a qualified foreign securities broker. Under the gross income test of the regulations, the foreign corporation could be required to derive at least 60 percent of its total gross income for the taxable year from bona fide securities-related activities. The PFIC look-through rules of sections 1296(b)(2)(C) and 1296(c) would not apply for purposes of this test. Under the licensing requirement of the regulations, a controlled foreign corporation (other than a qualified affiliate) that is not registered as a securities broker or dealer under the Securities Exchange Act of 1934 could be required to be licensed or authorized in the country in which it conducts its principal securities dealer operations (or, in the case of a qualified foreign securities broker, its principal securities broker operations) to conduct the bona fide securities-related activities that it performs in that country. These activities would be required to be subject to the appropriate securities regulatory authorities of that country.

A "qualified affiliate" could be defined as a foreign corporation that regularly performs in the ordinary course of its trade or business at least one bona fide securities-related activity, and that is also a member of an affiliated group that (1) derives 50 percent or more of its total gross income for the year from bona fide securities-related activities, and (2) includes a corporation that either actively conducts business in the United States as a registered securities broker or dealer or qualifies as a "regular dealer" in stock, securities and derivative financial products under section 954(c) and the regulations thereunder or (to the extent provided in regulations) as a qualified foreign securities broker. The regulations could also require that the gross income of the registered securities broker or dealer, "regular dealer" or qualified foreign securities broker represent at least 20 percent of the total gross income of the affiliated group for the year. It might be necessary for Treasury regulations to modify the definition of affiliated group provided in section 1504 in order to carry out the purposes of this provision, such as to accommodate the inclusion of foreign corporations and the ownership of stock by U.S. shareholders that are U.S. partnerships.

reporting subpart F income inclusions on account of excess passive assets.

As under the exceptions for active banking and insurance income of Code section 1296(b)(2), the committee intends that the Secretary's regulatory authority under the bill be exercised so as to apply the PFIC provisions to any income derived by persons engaged in bona fide securities-related activities where necessary to prevent individuals from earning what is essentially tax-deferred portfolio investment income through a foreign corporation. Also, as under section 1296(b)(2), the committee intends that income derived by persons engaged in bona fide securities-related activities that are basically widely-held incorporated investment vehicles will be treated as passive for purposes of the PFIC definition. Under existing law, any allocation of passive income earned by, or passive assets held by, a foreign corporation to stock held by particular shareholders of the corporation (*e.g.*, to foreign shareholders that are not subject to the PFIC provisions) is not respected for purposes of the application of the PFIC provisions to that foreign corporation and its shareholders. Accordingly, in the case of a controlled foreign corporation that is eligible for the securities exception, the committee intends that any allocation of particular items of income or assets to stock held by particular shareholders of the foreign corporation not be respected for purposes of the application of the PFIC and excess passive asset provisions to that foreign corporation and its shareholders.

Treatment of certain income inclusions as distributions

Under the bill, inclusions of income on account of investments of earnings of a controlled foreign corporation in U.S. property, or ownership of excess passive assets, are treated as distributions for purposes of computing the interest charge on excess distributions to the U.S. shareholders of PFICs that are controlled foreign corporations. Accordingly, such inclusions of income are subject to treatment as excess distributions under section 1291(b) of the PFIC rules. Such inclusions of income are taken into account as amounts received with respect to the PFIC stock (*e.g.*, in prior years) in the determination of whether or not there is an excess distribution for the taxable year.

Treatment of certain leased assets for PFIC purposes

The bill treats certain leased property as assets held by the foreign corporation for purposes of the PFIC asset test. This rule applies to tangible personal property with respect to which the foreign corporation is the lessee under a lease with a term of at least 12 months. Under the bill, the measure of leased property for purposes of applying the asset test is the unamortized portion of the present value of the payments under the lease. The committee intends that regulations provide guidance for determining the unamortized portion of the present value of the payments. Present value is to be determined, under regulations, as of the beginning of the lease term, and, except as provided in regulations, by using a discount rate equal to the applicable Federal rate determined under the rules applicable to original discount instruments (sec. 1274(d)), substituting under those rules the term of the lease for

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the term of the debt instrument. In applying those rules, options to renew or extend the lease are not to be taken into account. Also, the special rule to be applied under section 1274(d)(2) in the case of a sale or exchange is disregarded. Property leased by a corporation is not taken into account in testing for PFIC status under the asset test either if the lessor is a related person (as that term is defined under the foreign base company rules) with respect to the lessee, or if a principal purpose of leasing the property was to avoid the PFIC provisions.

Effective Date

The provision generally is effective for taxable years of foreign corporations beginning after September 30, 1993, and for taxable years of domestic shareholders in which or with which such taxable years end.

The provision modifying the rules for increasing the foreign tax credit limitation upon distributions of previously taxed income is effective for actual distributions of earnings that are included under subpart F in taxable years of U.S. shareholders beginning after September 30, 1993. In the case of any distributions of earnings that were included under subpart F in taxable years of U.S. shareholders beginning prior to October 1, 1993, the rules of present law will continue to apply.

2. Allocation and apportionment of research and experimental expenditures (sec. 8234 of the bill and sec. 864(f) of the Code)

Present Law

Foreign tax credit and source rules

Under the Code, each item of income is assigned either a U.S. source or a foreign source. The foreign tax credit for foreign taxes paid on foreign source income is limited to the amount of U.S. tax otherwise payable on foreign source income. The foreign tax credit is not available against U.S. tax on U.S. source income. (This is known as the foreign tax credit limitation.) A shift in the source of income from foreign to U.S. may increase net U.S. tax for some taxpayers by reducing the foreign tax credit limitation.

In determining foreign source taxable income for purposes of computing the foreign tax credit limitation, and for other tax purposes, taxpayers are required to allocate and apportion expenses between foreign source income and U.S. source income (Code secs. 861-864). A shift in the allocation and apportionment of expenses from U.S. source to foreign source gross income decreases foreign source taxable income, and may increase U.S. tax by reducing the foreign tax credit limitation.

Research and experimental expense allocation regulation

Treasury regulation section 1.861-8 (promulgated in 1977) sets forth detailed rules for allocating and apportioning several categories of expenses, including deductible research and experimental expenditures ("research expense"). The regulation provides that research expense is ordinarily considered definitely related to all

gross income reasonably connected with one or more of 32 product categories based on two-digit classifications of the Standard Industrial Classification ("SIC") system. Research expense is not traced solely to the income generated by the particular product which benefitted from the research activity. Instead, it is associated with all the income within the SIC product group in which the product is classified.

The Treasury regulation contemplates that taxpayers will sometimes undertake research solely to meet legal requirements imposed by a particular governmental entity with respect to improvement or marketing of specific products or processes. In some cases, such research cannot reasonably be expected to generate income (beyond de minimis amounts) outside that governmental entity's jurisdiction. If so, the deductions allowable for the associated research expense are allocated solely to gross income from the geographic source that includes that jurisdiction.

After research expense incurred to meet legal requirements is allocated under the above rule, any remaining research expense generally is apportioned to foreign source income based on the ratio of total foreign source sales receipts in the SIC product group with which the expense is identified to the total worldwide sales receipts in that product group (the "sales" or "gross receipts" method). In computing this fraction, sales by a party controlled or uncontrolled by the taxpayer may be taken into account if the party can reasonably be expected to benefit from the research expense. However, the regulation provides that a taxpayer using the sales method may first apportion at least 30 percent of research expense remaining after allocation to meet legal requirements exclusively to income from the geographic source where over half of the taxpayer's research and development is performed.

Thus, for example, a taxpayer that performs more than 50 percent of its research and development in the United States may automatically apportion at least 30 percent of its remaining research expense to U.S. source income. A taxpayer can choose to apportion to the geographic source where more than 50 percent of its research and development is performed a percentage of research expense significantly greater than 30 percent if the taxpayer establishes that the higher percentage is warranted because the research and development is reasonably expected to have a very limited or long-delayed application outside that geographic source.

Alternatively, subject to certain limitations, a taxpayer may elect to apportion its research expense remaining after any allocation to meet legal requirements under one of two optional gross income methods. Under these optional methods, a taxpayer generally apportions its research expense on the basis of relative amounts of gross income from U.S. and foreign sources. If a taxpayer makes an automatic place-of-performance apportionment, the taxpayer may not use either optional gross income method.

The basic limitation on the use of the optional gross income methods is that the respective portions of a taxpayer's research expense apportioned to U.S. and foreign source income using these methods can not be less than 50 percent of the respective portions that would be apportioned to each income grouping using sales method (including the place-of-performance apportionment).

If this 50-percent limitation is satisfied with respect to both income groupings, the taxpayer may apportion the amount of its research expense that remains after allocation under the legal requirements test ratably on the basis of foreign and U.S. gross income. If the 50-percent limitation is not satisfied with respect to one of the income groupings, then the taxpayer must apportion to that income grouping 50 percent of the amount of its research expense which would have been apportioned to that income grouping under the sales/place-of-performance method. A taxpayer electing an optional gross income method may be able then to reduce the amount of its research expense apportioned to foreign source income to as little as one-half of the amount that would be apportioned to foreign source income under the sales method.

For example, consider a taxpayer with $110 of U.S.-performed research expense and equal U.S. and foreign sales. Assume that $10 of the research expense is to meet U.S. legal requirements and is allocated to U.S. source income. Of the remaining $100, 30 percent ($30) is exclusively apportioned to U.S. source income under the automatic place-of-performance rule and the remaining $70 is divided evenly between U.S. and foreign source income, using the sales method. Thus, under this method $35 would be allocated to foreign source income and $75 would be allocated to U.S. source income. Under the optional gross income methods, the $35 of research expense allocated to foreign sources can be reduced as much as 50 percent, to $17.50. This can occur, for example, if the foreign sales were made by a foreign subsidiary that did not repatriate earnings to the U.S. corporation, and thus a disproportionately high fraction of the U.S. corporation's income is from U.S. sources.

Statutory allocation of research and experimental expense

The Economic Recovery Tax Act of 1981 (ERTA) provided that, for a taxpayer's first two taxable years beginning within two years after the date of its enactment (August 13, 1981), all research and experimental expenditures (within the meaning of sec. 174) paid or incurred in those years for research activities conducted in the United States were to be allocated or apportioned to income from sources within the United States (sec. 223 of ERTA).

This two-year moratorium on the research expense allocation regulation was effectively extended for two additional years by the Tax Reform Act of 1984 (the "1984 Act"). Under section 126 of the 1984 Act, for taxable years beginning generally after August 13, 1983, and on or before August 1, 1985, all of a taxpayer's research and experimental expenditures (within the meaning of sec. 174) attributable to research activities conducted in the United States were to be allocated to income from sources within the United States.

One reason Congress cited for enacting the original two-year moratorium was that some foreign countries do not allow deductions under their tax laws for expenses of research activities conducted in the United States. Taxpayers argued that this disallowance caused U.S.-based research to be disadvantaged. First, U.S.-based research expense is deemed to be allocated to income from a foreign country which may not recognize that such amount is deductible. The allocation of this U.S.-based research expense to for-

eign source income had the effect of reducing the foreign tax credit of U.S. taxpayers. Because those taxpayers could take their deductions if the research occurred in the foreign country, taxpayers argued that there was an incentive to shift their research expenditures to those foreign countries whose laws disallow tax deductions for research activities conducted in the United States but allow tax deductions for research undertaken locally.

Accordingly, Congress concluded that the Treasury Department should study the impact of the allocation of research expense under the 1977 regulation on U.S.-based research activities and on the availability of the foreign tax credit. Pending the outcome of the study, Congress concluded that research expense should be charged to the cost of generating U.S. source income, regardless of whether the research was a direct or indirect cost of producing foreign source income.

On the ground that a reduction in research and development might adversely affect the competitive position of the United States, the 1983 Treasury report recommended the two-year extension of the moratorium that was ultimately enacted by Congress in 1984. The extension was intended to allow Congress to consider further the results of the Treasury study.

The Consolidated Omnibus Budget Reconciliation Act of 1985 (the "1985 Act") extended the moratorium on the application of the research expense allocation regulation generally for one additional taxable year beginning after August 1, 1985, and on or before August 1, 1986.

The Tax Reform Act of 1986 (the "1986 Act") permitted the moratorium on application of the research expense allocation regulation to expire. However, for taxable years beginning after August 1, 1986, and on or before August 1, 1987, application of the regulation was liberalized by the 1986 Act in three respects, which were intended by Congress to provide an additional tax incentive to conduct research in the United States while Congress analyzed whether any additional permanent incentive was necessary.

The first liberalization under the 1986 Act was that for the specified one-year period, 50 percent of all remaining amounts allowable as a deduction for qualified research and experimental expenditures (that is, research and experimental expenditures within the meaning of section 174 that are attributable to activities conducted in the United States) after allocation of legally required research expense could be apportioned to U.S. source income. The 1986 Act thus had the effect of increasing the automatic place-of-performance apportionment percentage for U.S.-based research expense from 30 percent to 50 percent.

The 1986 Act further provided that, for the specified one-year period, the portion of those amounts allowable as a deduction for qualified research and experimental expenditures that remained after any legal requirements allocation and the 50 percent automatic place-of-performance apportionment were apportioned either on the basis of sales or gross income. Thus, the 1986 Act's second effective liberalization of the regulation was to allow the automatic place-of-performance apportionment temporarily to taxpayers who elected to apportion research expense using the optional gross in-

come method, rather than only to taxpayers that used the standard sales method of apportionment.

Third, the 1986 Act had the effect of temporarily suspending the regulatory rule that prohibits taxpayers from using the optional gross income method to reduce allocation of research expense to foreign source income by more than 50 percent of the amount that would be allocated to foreign source income under the sales method.

The temporary modifications made by the 1986 Act to the research allocation regulation applied for purposes of computing taxable income from U.S. sources and taxable income from sources outside the United States. The modifications applied only to the allocation of expenditures for research and experimental activities conducted in the United States, and only for the purposes of geographic sourcing of income; the modifications did not apply for other purposes such as the computation of combined taxable income of a FSC (or DISC) and its related supplier. Also, the modifications did not apply to any expenditure for the acquisition or improvement of land, or for the acquisition or improvement of depreciable or depletable property to be used in connection with research or experimentation.

The Technical and Miscellaneous Revenue Act of 1988 (the "1988 Act") further modified, again on a temporary basis, the rules for sourcing research expense. These modifications were effective only for the first four months of a taxpayer's first taxable year beginning after August 1, 1987 (treating all applicable expenditures in that taxable year as if they were incurred ratably over the year). Generally, for the remainder of a taxpayer's first taxable year beginning after August 1, 1987, (and for subsequent taxable years), the research expense allocation regulation was applicable. Under the 1988 Act, the treatment of research expense incurred to meet certain legal requirements was unchanged. After applying the legal requirements rule, however, the 1988 Act modifications provided that 64 percent of the remaining U.S.-based research expense was allocated to U.S. source income and 64 percent of the remaining foreign-based research expense was allocated to foreign source income. Following that allocation, the remaining research expense was allocated and apportioned either on the basis of sales or gross income. However, if the gross income method of apportionment was utilized, the amount apportioned to foreign source income could be no less than 30 percent of the amount that would have been apportioned to foreign source income had the sales method been used.

The Omnibus Budget Reconciliation Act of 1989 (the "1989 Act") extended, again on a temporary basis, the rules for sourcing research expenditures that were contained in the 1988 Act. The 1989 Act also codified these rules in section 864(f) of the Internal Revenue Code. As codified in 1989, these rules were effective only for the first nine months of a taxpayer's first taxable year beginning after August 1, 1989, and before August 2, 1990 (treating all applicable expenditures in that taxable year as if they were incurred ratably over the year). Under the 1989 Act, for the remainder of a taxpayer's first taxable year beginning after August 1, 1989, and before August 2, 1990 (and for subsequent taxable years), the research expense allocation regulation was to apply.

The Omnibus Budget Reconciliation Act of 1990 (the "1990 Act") further extended the statutory allocation rules that were codified in the 1989 Act. Under the 1990 Act, the rules of section 864(f) applied to the taxpayer's first two taxable years beginning after August 1, 1989, and on or before August 1, 1991.

The most recent statutory extension of the rules of section 864(f) was included in the Tax Extension Act of 1991, which was applicable generally for the first six months of the first taxable year beginning after August 1, 1991. For this purpose total research expenses for the year were deemed to be incurred evenly throughout the year. For expenses deemed paid or incurred during the remainder of the year, the research expense allocation regulation applied.

On June 24, 1992, it was announced that the Treasury Department and the IRS had undertaken a review of the research expense allocation regulation, and that in light of this review, the IRS temporarily would not require that taxpayers apply the regulation (Rev. Proc. 92-56, 1992-28 I.R.B. 7, amplified by Rev. Proc. 92-69, 1992-36 I.R.B. 18). According to these Revenue Procedures, taxpayers would not be required to apply the regulation with respect to research expenses incurred during what would ordinarily be an 18-month transition period—that is, the last six months of the taxpayer's first taxable year beginning after August 1, 1991 and the immediately succeeding taxable year—provided that such expense was allocated and apportioned in accordance with a method based on the temporary statutory provision, described above, applicable generally through the first six months of the first taxable year beginning after August 1, 1991. The Revenue Procedures stated that this transition method was not intended to suggest any views about the proper allocation and apportionment of research expense, and that it was intended solely to provide taxpayers with transition relief and to minimize audit controversy and facilitate business planning during the conduct of the regulatory review.

Reasons for Change

In the 12 years since the first temporary moratorium on the 1977 regulation was enacted, Congress, the Treasury Department, and representatives of affected industries have intensely scrutinized the effects of the research expense allocation rules on research activities.[95] That scrutiny has not resulted in an unambiguous recommendation regarding the appropriateness of allocating U.S.-based research expense to U.S. source income under either the 1977 regulation, the complete moratorium, or the partial moratoria of the 1986 and subsequent Acts. On the one hand, there are those who argue that the moratorium and the partial moratoria had a beneficial effect on U.S. research activity and on U.S. competitiveness in world-wide markets. On the other hand, there are those whose studies prompt them to conclude otherwise. Furthermore, the tax costs of both the total and the partial moratoria have been significant, and the tax benefits they have bestowed are distributed somewhat arbitrarily among taxpayers. At the same time, these

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[95] See, e.g., *Interaction Between U.S. Tax Policy and Domestic Research and Development: Hearing on S.58 and S 716 Before the Subcomm. on Taxation and Debt Management of the Senate Comm. on Finance*, 100th Cong., 1st Sess. (1987).

taxpayers have faced a prolonged period of uncertainty as to the research expense allocation rules that will apply in the coming years, making it more difficult for them to predict the after-tax costs of the research in which they generally must engage, if at all, over extended future periods.

The committee continues to believe that settling the rules for allocation of research expense would enhance the research activities of U.S. companies. However, the committee has chosen not to settle the rules permanently at this time. In the interim, the committee is persuaded that it is appropriate to continue to apply the substantive rules temporarily applicable under section 864(f) for another year.

Explanation of Provision

The bill temporarily extends the research allocation rules set forth in Code section 864(f), except that the portion of research expense automatically allocated and apportioned to income sourced in the place of performance of the research is 50 percent, rather than 64 percent. Thus, for research expense other than amounts incurred to meet certain legal requirements, and thus allocable to one geographical source, 50 percent of U.S.-incurred research expense is allocated and apportioned to U.S. source income, and 50 percent of foreign-incurred research expense is allocated and apportioned to foreign source income. The remaining research expense is allocated and apportioned either on the basis of sales or gross income, but subject to the condition that if income-based apportionment is used, the amount apportioned to foreign source income can be no less than 30 percent of the amount that would have been apportioned to foreign source income had the sales method been used.

The bill provides regulatory authority for the implementation of certain adjustments regarding section 936 companies. In addition, the bill authorizes the Treasury to prescribe such regulations as may be appropriate to carry out the purposes of this provision, including regulations relating to the determination of whether research activities are conducted inside or outside the United States and making such adjustments as may be appropriate in the case of cost sharing arrangements and contract research.

Effective Date

The provision applies to the first taxable year (beginning before August 1, 1994) that commences immediately following the taxpayer's last taxable year to which Rev. Proc. 92-56 applies, or would have applied had the taxpayer been in existence and elected the benefits of that Revenue Procedure.

3. Eliminate working capital exception for foreign oil and gas and shipping income (sec. 8235 of the bill and secs. 904(d), 907, and 954 of the Code)

Present Law

Foreign tax credit separate limitations

Foreign tax credit limitations are computed separately for certain categories of foreign source income, including passive income, high

withholding tax interest, financial services income, shipping income, dividends from each noncontrolled section 902 corporation, certain distributions from DISCs and FSCs, certain types of income earned by a FSC, and all other (i.e., "overall basket" or "general basket") income. Passive income generally includes income which is of a kind that would be foreign personal holding company income as defined under Code section 954(c) (e.g., interest and dividends) and typically is not subject to high levels of foreign tax. The separate limitation for passive income generally prevents the cross-crediting of high foreign taxes on income which falls in the general basket against the residual U.S. tax on passive income.

The separate foreign tax credit limitation for passive income was enacted in 1986 and replaced the prior law separate foreign tax credit limitation for passive interest income.[96] Prior law excluded from the passive interest separate limitation category interest derived from any transaction which is directly related to the active conduct by the taxpayer of a trade or business in a foreign country. Regulations under prior law expressly treated certain types of interest on working capital as interest derived from a transaction which is directly related to the active conduct of a trade or business.[97] No such general working capital exception exists under the passive income definition as established in 1986. As a result of the interaction of the Code and Treasury regulations originally developed prior to 1987, however, the working capital exception has been retained for the oil and gas and shipping industries.[98]

Special limitation on credits for foreign extraction taxes and taxes on foreign oil related income

In addition to the foreign tax credit limitations that apply to all foreign tax credits, a special limitation is placed on the creditability of foreign income taxes on foreign oil and gas extraction income (FOGEI). Under this special limitation, amounts claimed as taxes paid on FOGEI of a U.S. corporation qualify as creditable taxes (if they otherwise so qualify) only to the extent they do not exceed the

[96] P.L. 99-514, sec. 1201(a) (1986).

[97] Former Treas. Reg. sec. 1.904-4(b).

[98] Section 904(d)(2)(A)(iii)(IV) provides that the separate foreign tax credit limitation for passive income does not include foreign oil and gas extraction income as defined in section 907(c). Regulations promulgated under section 907 include in the definition of foreign oil and gas extraction income certain interest earned on working capital (i.e., interest on bank deposits or on any other temporary investment which is not in excess of funds reasonably necessary to meet the taxpayer's working capital requirements and specifically anticipated business needs) that is related to activities with respect to which the taxpayer derives foreign oil and gas extraction income (Treas. Reg. sec. 1.907(c)-1(f)(3)).

Treasury Reg. sec. 1.907(c)-1(f)(3) also includes certain interest on working capital within the definition of foreign oil related income if the working capital is required for the taxpayer's business operations which generate foreign oil related income. Section 954(b)(8) provides that income which is foreign base company oil related income (defined under sec. 954(g) to include foreign oil related income) is *not* considered foreign personal holding company income. Only interest that is of a kind which would be foreign personal holding company income is passive for foreign tax credit limitation purposes (sec. 904(d)(2)(A)). Like interest on working capital related to foreign oil and gas extraction income, therefore, interest on working capital related to foreign oil related income is excluded from the separate foreign tax credit limitation for passive income.

Similarly, income which is treated as foreign base company shipping income under section 954(f) is *not* considered foreign personal holding company income (sec. 954(b)(6)), and interest income on working capital associated with a taxpayer's foreign base company shipping operations is treated as foreign base company shipping income under regulations (Treas. Reg. secs. 1.954-6(e)(2)(ii) and 1.955A-2(b)(2)(i)). Moreover, the statutory foreign tax credit separate limitation provisions contain a special overlap rule under which income described in any other separate limitation category (in this case, the separate limitation for shipping income) is not considered passive income (secs. 904(d)(2)(A)(iii)(I) and 904(d)(2)(D)).

product of the highest marginal U.S. tax rate on corporations (presently 34 percent) multiplied by such extraction income. Foreign taxes paid in excess of that amount on such income are, in general, neither creditable nor deductible (unless a credit carryover provision applies).

A similar special limitation may apply to foreign taxes paid on foreign oil related income (FORI) in certain cases where that type of income is subjected to a materially greater level of tax by a foreign jurisdiction than non oil and gas income generally would be. Under this limitation, a portion of the foreign taxes on FORI may be deductible, but not creditable.

As previously described, regulations define FOGEI and FORI to include interest on working capital related to oil and gas extraction or oil related activities, as the case may be.[99] Thus, under current regulations, FOGEI and FORI include what generally would be considered as passive income for foreign tax credit limitation purposes.

Reasons for Change

The committee understands that for taxpayers not engaged in oil and gas or shipping operations, present law treats interest income on working capital as subject to the separate foreign tax credit limitation for passive income. For the reasons stated in connection with the adoption of the separate foreign tax credit limitation for passive income in 1986, the committee believes that this treatment is appropriate.[100] The committee also believes that the foreign tax credit rules should operate fairly and uniformly to all taxpayers. Thus, the committee believes it is appropriate to conform the rules that apply to the treatment of passive income earned by taxpayers with oil and gas and shipping operations with the rules that apply to similar income earned by other taxpayers.

Similarly, as a general principle, the statutory FOGEI and FORI rules are intended to prevent the crediting of high foreign taxes on FOGEI and FORI against the residual U.S. tax on other types of lower-taxed foreign source income. However, for example, if a taxpayer has both high-taxed FOGEI, and also FOGEI which bears little or no foreign income tax, such as interest income on working capital, the current rules permit high FOGEI taxes to be credited against the residual U.S. tax on that interest income. The committee believes that this result is inappropriate.

Explanation of Provision

In general

The bill prevents the cross-crediting of foreign taxes on FOGEI, FORI, and shipping income by placing certain passive income related to oil and gas and shipping operations in the passive category for foreign tax credit limitation purposes. In addition, the bill excludes certain passive income related to foreign oil and gas extrac-

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[99] Treas. Reg. sec. 1.907(c)-1(f)(3). The current version of this regulation, adopted in 1991 (see T.D. 8338), was preceded by Treas. Reg. sec. 1.907(c)-1A(e)(3) (see T.D. 7961; T.D. 8160).

[100] See, e.g., Staff of the Joint Committee on Taxation, 100th Cong., 1st Sess., *General Explanation of the Tax Reform Act of 1986*, at 863 (1987).

tion or other foreign oil related activities from the computation of the FOGEI and FORI foreign tax credit limitations.

Foreign tax credit separate limitations

With respect to the separate foreign tax credit limitation for passive income, the bill eliminates the present-law exclusion of FOGEI from the definition of passive income. Thus, if a taxpayer has gross income that falls within the definition of passive income under section 904, and also satisfies the definition of FOGEI under section 907, the income would be treated as passive income in determining the taxpayer's foreign tax credit.

In addition, the bill amends the present-law rule applicable to income which by definition qualifies both as foreign personal holding company income under section 954(c) and as foreign base company oil related income under section 954(g). The bill provides that such income is to be treated as foreign personal holding company income. As such, the income generally would be passive income for foreign tax credit purposes.

Likewise, the bill specifies that dividend or interest income that by definition qualifies as both foreign personal holding company income and foreign base company shipping income is to be treated as foreign personal holding company income. Thus, for foreign tax credit purposes, the income would fall in the passive basket rather than in the separate basket for shipping income.

Special FOGEI and FORI limitations

The bill provides that the term "foreign oil and gas extraction income" does not include any dividend or interest income which is passive income as defined for foreign tax credit limitation purposes. Since, as discussed above, the bill treats gross interest income on working capital related to foreign oil and gas extraction activities, for example, as passive income, such income is not considered FOGEI for purposes of computing the special limitation for foreign taxes paid on FOGEI.

In addition, the bill specifies that the term "foreign oil related income" does not include any dividend or interest income which is passive income as defined under the foreign tax credit provisions. As a result, for example, gross interest income on working capital related to activities which generate foreign oil related income would not be treated as FORI for purposes of computing the special limitation for foreign taxes paid on FORI.

Effective Date

The provision applies to income earned in taxable years beginning after December 31, 1992.

4. Transfer pricing initiative (sec. 8236 of the bill and sec. 6662 of the Code)

Present Law

Penalties for valuation misstatements

Valuation questions are frequently central to disputes between taxpayers and the IRS. Certain types of valuation misstatements

are subject to penalty. A "substantial" valuation misstatement may result in a penalty of 20 percent of the underpayment of tax attributable to the misstatement (sec. 6662(a) and (b)(2)). The penalty for a "gross" valuation misstatement is 40 percent of the tax underpayment (sec. 6662(h)).

As in the case of accuracy-related penalties generally under section 6662, no valuation misstatement penalty is imposed if it is shown that there was reasonable cause for the underpayment of tax and that the taxpayer acted in good faith (see sec. 6664(c)). No valuation misstatement penalty is imposed if the portion of the underpayment for the taxable year attributable to substantial valuation misstatements does not exceed $5,000 ($10,000 in the case of a corporation other than an S corporation or a personal holding company).

The term "substantial valuation misstatement" includes three types of misstatement (sec. 6662(e)). It includes claiming on a tax return that the value of any property is 200 percent or more of the amount determined to be correct. The term "gross valuation misstatement" refers to three similar, but more extreme, forms of misstatement (sec. 6662(h)). It includes claiming on a tax return that the value of any property is 400 percent or more of the amount determined to be correct.

Misstatement penalties and section 482 adjustments

The two other types of substantial valuation misstatement and gross valuation misstatement are defined by provisions enacted in the Omnibus Budget Reconciliation Act of 1990 (the "1990 Act"). These provisions address certain cases involving transactions between persons under common ownership or control, as those terms are used in section 482. The IRS Commissioner has the authority in such cases to distribute, apportion, or allocate income, deductions, credits, or allowances between or among such persons where the Commissioner determines it to be necessary in order to prevent evasion of taxes or clearly to reflect income.

Under the 1990 Act, a substantial valuation misstatement includes claiming a price for any property or services (or use of property), in connection with any transaction between persons described in section 482, that is 200 percent or more (or 50 percent or less) of the amount determined under section 482 to be the correct amount of the price.[101] In addition, under the 1990 Act there is a substantial valuation misstatement if the net section 482 transfer price adjustment for the taxable year exceeds $10 million.[102] The net section 482 transfer price adjustment is the net increase in taxable income for a taxable year resulting from adjustments under section 482 in the price for any property or services (or use of property).

Certain increases in taxable income resulting from section 482 adjustments are disregarded in determining whether a taxpayer's net section 482 transfer price adjustment exceeds the $10 million or $20 million thresholds. A net increase in taxable income attrib-

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[101] The analogous "gross valuation misstatement" is defined in the same terms, except for replacing "200" with "400" and replacing "50 percent" with "25 percent."

[102] The analogous "gross valuation misstatement" involves a net section 482 transfer price adjustment of $20 million.

utable to a price redetermination is disregarded, for example, if it is shown that there was a reasonable cause for the taxpayer's determination of the price, and that the taxpayer acted in good faith with respect to the price (sec. 6662(e)(3)(B)(i)).[103]

Regulations under sections 482, 6662, and 6664: Final, temporary, and proposed

Current penalty regulations

There are no temporary or final regulations specifically addressed to the 1990 Act valuation misstatement penalties relating to section 482 adjustments. There is a final regulation under the reasonable cause/good faith exception that applies generally to all valuation misstatement penalties and other accuracy-related penalties under Code section 6662 (Treas. Reg. sec. 1.6664-4). Under this regulation, the determination of whether a taxpayer acted with reasonable cause and in good faith is made on a case-by-case basis, taking into account all pertinent facts and circumstances. The most important factor in making the determination is the extent of the taxpayer's effort to assess its proper tax liability. Circumstances that may or may not indicate reasonable cause and good faith are described in the regulation.

Proposed penalty regulations on net section 482 transfer price adjustments

In January 1993 the Treasury Department published a proposed regulation specifically addressed to the 1990 Act valuation misstatement penalty provisions (58 Fed. Reg. 5304 (Jan. 21, 1993)). The proposed regulation would provide exclusive rules for determining the circumstances in which reasonable cause and good faith would and would not reduce or eliminate penalties that would otherwise apply to net section 482 transfer price adjustments in excess of $10 million or $20 million.[104] By its terms, the proposed regulation would apply to taxable years beginning after April 21, 1993.

Under the proposed regulation, there are two elements to the reasonable cause and good faith exclusion from the definition of a net section 482 transfer price adjustment.[105] Both elements must be satisfied by the taxpayer to prevent imposition of the penalty.

The proposed regulations state that the first element is a reasonable effort by the taxpayer to accurately determine its proper tax

[103] In addition, any portion of the net increase in taxable income attributable to a transaction solely between foreign corporations is disregarded (unless the treatment of that transaction affects the determination of any such foreign corporation's income from sources within the United States or taxable income effectively connected with the conduct of a trade or business in the United States).

[104] These exclusive rules are contained in proposed Reg. sec. 1.6662-5(j)(5). According to the preamble to the proposed regulation, a net section 482 transfer price adjustment for which the rules of sec. 1.6662-5(j)(5) are *not* satisfied will also *not* satisfy the general reasonable cause and good faith exception under section 6664(c). 58 Fed. Reg. at 5305.

By contrast, the preamble indicates that a valuation misstatement involving a related party transfer price 200 percent or more (or 50 percent or less) of the amount determined under section 482 to be the correct price is subject to the general reasonable cause/good faith regulations under section 6664(c). In addition, according to the preamble, if such a valuation misstatement satisfies the reasonable cause and good faith exclusion provisions under proposed sec. 1.6662-5(j)(5), then the taxpayer will be considered to have acted with reasonable cause and good faith for purposes of the general rules.

[105] Prop. Reg. sec. 1.6662-5(j)(5), 58 Fed. Reg. at 5308.

liability. This determination must be made no later than the time the return is filed for the tax year, and documentation must be contemporaneous with that determination. The documentation must include an analysis indicating that the result was an arm's length result within the meaning of the regulations promulgated under section 482. It is presumed that the taxpayer did not make a reasonable effort to accurately determine its proper tax liability if it possesses contemporaneous documentation of how a transfer price was determined, but does not provide the documentation to the IRS within 30 days of an IRS request.

The second element of the reasonable cause and good faith exclusion is whether the taxpayer reasonably believed that its transfer pricing methodology produced an arm's length result. The proposed regulation states that the determination of whether the taxpayer has such a reasonable belief is made in light of the experience and knowledge of the taxpayer. Various factors are discussed that may be taken into account in making that determination.

Section 482 regulations

Final regulations under section 482 are in force, and have not been amended since 1988. In January 1993, however, the Treasury Department promulgated temporary regulations under section 482, generally effective for taxable years beginning after April 21, 1993. These temporary regulations amend aspects of the existing final section 482 regulations.

The temporary regulations would, for example, revise the circumstances under which taxpayers may use a method *not* specified in these regulations, in order to establish the arm's length consideration for a "controlled transaction"—a transaction between members of a commonly controlled group of taxpayers—involving the transfer of tangible or intangible property. (Any method *not* specified in the section 482 regulations has popularly been referred to in the past as a "fourth method," in light of the fact that many cases involve transactions for which the final regulations specify only three methods.)

Under the temporary section 482 regulations, a taxpayer may use such an unspecified method only if three conditions are satisfied (Treas. Reg. secs. 1.482-3T(e)(2) and 1.482-4T(d)(2)). First, the taxpayer must disclose the use of the method by attaching an appropriate disclosure statement to the timely filed U.S. income tax return for the taxable year of the controlled transaction. Second, the taxpayer must prepare contemporaneous supporting documentation setting forth (a) the specific analysis adopted, (b) an analysis of why the method used provides the most accurate measure of an arm's length price, and (c) the data supporting its application. Third, within 30 days of a written request, the taxpayer must furnish this documentation to the IRS district director.

Reasons for Change

The committee is aware that section 482 disputes between taxpayers and the IRS continue to impose significant administrative burdens on the parties; and the committee continues to be concerned about the amount of revenue that is potentially lost by the

Treasury due to difficulties in exercising the Secretary's authority to adjust income under section 482.

The committee is concerned, for example, about any case where a taxpayer uses related party transfer prices or other arrangements with no apparent consideration as to whether the taxable income reported, and the tax paid, conforms with the standards made applicable by section 482. The committee believes that the threat of penalties for substantial and gross valuation misstatements, as amended in 1990, might discourage such behavior, so long as the conditions under which the penalties may be imposed are sufficiently broad and well-defined.

The committee believes that current law is deficient in this respect, however. According to the Administration, the IRS has not attempted to apply the transfer pricing related penalties since their enactment in 1990.[106] Moreover, the minimum amount of net section 482 transfer price adjustment necessary before a penalty can apply is too great in the committee's view. In addition, the committee questions the usefulness of the debate that ensues upon audit as the IRS examiner seeks to determine a reasonable intercompany price and the taxpayer and its representatives attempt to create post hoc arguments to justify a tax return position that was taken with little or no regard whether it could be justified under section 482 standards. The committee is instead inclined to agree with the view, expressed in the past, that administration of, and compliance with, section 482 will be improved by encouraging taxpayers "to document the methodology used in establishing intercompany transfer prices prior to filing the tax return" and to provide such documentation within a reasonable time after request.[107] The committee does not believe that a section 482 adjustment that exceeds the threshold generally should escape the penalty unless the taxpayer can show that the return position was arrived at after bestowing a reasonable amount of attention to the issue.

Explanation of Provision

In general

The bill creates new thresholds based on gross receipts for imposing the substantial valuation and gross valuation misstatement penalties in the case of a net section 482 transfer price adjustment. It also lowers the fixed dollar threshold for imposing the substantial valuation misstatement penalty in the case of a net section 482 transfer price adjustment. Finally, the provision replaces the statutory reasonable cause/good faith exception to the definition of the term "net section 482 transfer price adjustment" with a more objective exception that can be met by taxpayers that attend to potential section 482 issues at the time they file their tax returns. Taxpayers that do not meet the standard may not escape the penalties attached to a net section 482 transfer price adjustment by recourse

[106] Department of the Treasury, *Summary of the Administration's Revenue Proposals* 55 (February 1993).

[107] Notice 88-123 ("A Study of Intercompany Pricing under Section 482 of the Code"), 1988-2 C.B. 458, 462; *Tax Underpayments by U.S Subsidiaries of Foreign Companies: Hearings Before the Subcomm. on Oversight of the House Comm. on Ways and Means*, 101st Cong., 2d Sess 124, 125 (1990) (testimony of Edward Romoff, IRS).

to the general reasonable cause/good faith exception from the accuracy and fraud-related penalties.

Penalty thresholds

The threshold amount of net section 482 transfer price adjustment that generally triggers a substantial valuation misstatement penalty is lowered from $10,000,000 to $5,000,000. In addition, the term substantial valuation misstatement is expanded to include a case where the net section 482 transfer price adjustment for the taxable year exceeds 10 percent of the taxpayer's gross receipts. Under the bill the term gross valuation misstatement includes a case where the net section 482 transfer price adjustment exceeds 20 percent of gross receipts.

Definition of a net section 482 transfer price adjustment

In measuring the amount of a taxpayer's net section 482 transfer price adjustment, a net increase in taxable income attributable to a section 482 adjustment is to be disregarded only if the taxpayer satisfies one of two sets of statutory requirements. One such penalty "safe harbor" applies where the taxpayer determined a transfer price using a method specified in regulations; the other penalty safe harbor applies where the method used was not specified in the regulations. Satisfying the conditions for such a safe harbor does not affect the Commissioner's authority to make a section 482 adjustment.

Use of a specified method

The taxpayer meets the first set of requirements if it establishes that each of three criteria were met.

First, the taxpayer must establish that the price it used was determined under a pricing method specified in the section 482 regulations. For example, in a year governed by the temporary regulations under section 482 published in January 1993, a controlled transfer of tangible property could be subject to one of four "specified methods": the comparable uncontrolled price method, the resale price method, the cost plus method, or the comparable profits method (Treas. Reg. sec. 1.482-3T(a)(1)-(4)). Any other method would not be a "specified" method for purposes of this penalty provision. The committee is aware that there are various other types of transactions, such as the performance of services which are an integral part of the business activity of the renderer, as described in Treas. Reg. sec. 1.482-2A(b)(7), that generally are not the subject of any pricing methods specified in the present section 482 regulations. In these cases, the Committee understands that it will not be possible for the taxpayer to avoid the penalty by establishing that it had met the criteria for using the safe harbor applicable to prices determined under a specified method, unless such regulations are subsequently revised to incorporate specific pricing methods.

Second, the taxpayer must establish that it applied the specified method reasonably. In order for the application of the method to have been reasonable, the committee intends that any procedural or other requirements imposed under the regulations must have been observed. For example, if adjustments required under a par-

ticular method were not made, the application of that method would not be reasonable. In addition, if more than one method is potentially applicable, the committee intends that in order to be applied reasonably, the method applied must be chosen under appropriate criteria (currently, the so-called "best method rule" set forth in Treas. Reg. sec. 1.482-1T(b)(2)).

Third, the taxpayer must establish that it had documentation, in existence as of the time of filing its original return, setting forth the reasonable determination of the price as described above. Upon an IRS request for the documentation, the taxpayer is required to provide it to the IRS within 30 days.

Use of an unspecified method

A taxpayer that did not apply a specified method in accordance with the above criteria may nevertheless have its net increase in taxable income attributable to a section 482 adjustment disregarded in determining the amount of its net section 482 transfer price adjustment. In order to do so, the taxpayer must meet each of three criteria.

First, the taxpayer must establish that none of the methods specified in the section 482 regulations was likely to result in a price that would clearly reflect income. With respect to those various types of transactions, such as the performance of services which are an integral part of the business activity of the renderer, as described in Treas. Reg. sec. 1.482-2A(b)(7), that generally are not the subject of any pricing methods specified in the section 482 regulations, it will be unnecessary to establish that no specified method would be likely to lead to a clear reflection of income; rather, it will be necessary to establish that no specified methods potentially apply.

Second, the taxpayer must establish that it used another method that *was* likely to result in a price that would clearly reflect income. Third, the taxpayer must establish that it had documentation, in existence as of the time of filing its original return, setting forth the determination of the price, establishing that the specified methods were not likely to result in a price that would clearly reflect income, and establishing that the method used was likely to result in a price that would clearly reflect income. Upon an IRS request for the documentation, the taxpayer is required to provide it within 30 days.

In establishing that no specified method was likely to result in a clear reflection of income, and that an unspecified method was likely to so result, the committee anticipates that it will be necessary for the taxpayer to set forth good and sufficient reasons why it reached these conclusions. For example, one reason that a particular specified method would not be likely to result in a clear reflection of income might be the unavailability of data relating to comparable uncontrolled transactions that would be necessary in order to apply that method. One reason that a particular unspecified method would be likely to result in a clear reflection of income might be that it properly took into account the significant factors which unrelated parties engaged in transactions at arm's length would have considered, and accorded appropriate weight to such factors.

Another reason that might be relevant in some cases would be the prior development by the IRS and the taxpayer, after a thorough review of the factors that account for a clear reflection of income under the particular circumstances that pertain to a particular taxpayer, of a particular agreed unspecified method. Such a method may be embodied, for example, in an advance pricing agreement. If the taxpayer's documentation establishes the prior agreement of the IRS, establishes that the taxpayer applied the agreed method reasonably and consistently with its prior application, and establishes that the facts and circumstances surrounding the use of the method have not materially changed since the time of the agreement, the committee anticipates that, for purposes of applying the penalty, the taxpayer generally will be treated as having established adequate justification for failure to use a specified method and its use instead of the unspecified method.

Rules applicable to uses of either a specified or unspecified method

In the case of a valuation misstatement due to a net section 482 transfer price adjustment, no penalty would be excused for reasonable cause and good faith unless the above requirements are met.

The committee intends that the application of any method would not be considered reasonable if the taxpayer became aware prior to filing its tax return that such application more likely than not did not result in a clear reflection of income.

Since the transfer pricing method that the taxpayer selects is to be applied prior to filing the tax return for the current taxable year, in some cases it only will be possible to apply such method based on data from a preceding year or years. Sole reliance on such data is acceptable (solely for purposes of section 6662(e)) unless more current reliable data becomes available prior to filing the tax return.

Effective Date

The provision is effective for taxable years beginning after December 31, 1993.

5. Deny portfolio interest exemption for contingent interest (sec. 8237 of the bill and secs. 871(h) and 881(c) of the Code)

Present Law

Deductibility of interest

As a general rule, a deduction is allowed for all interest paid or accrued on indebtedness. Whether a financial instrument is treated as debt for Federal income tax purposes depends on the facts of the particular case. Under existing law, an instrument may qualify as debt even if it provides the holder with significant equity participation rights. For example, the IRS has ruled that in certain cases, contingent interest paid on a shared appreciation mortgage loan used to finance the purchase of a personal residence may be de-

ductible by a cash basis payor.[108] As another example, contingent interest based on a share of the borrower's profits has been determined to be deductible in certain cases.[109]

Interest received by foreign persons

The Internal Revenue Code provides that U.S. source interest income earned by a nonresident alien individual or a foreign corporation that is not effectively connected with the conduct of a U.S. trade or business generally is subject to a gross-basis 30-percent withholding tax. A significant statutory exemption from that tax applies to so-called "portfolio interest" received by foreign persons.

Portfolio interest generally is defined as any U.S. source interest (including original issue discount) that is not effectively connected with the conduct of a trade or business and (1) is paid on an obligation that satisfies certain registration requirements or specified exceptions thereto, and (2) is not received by a 10-percent owner of the issuer of the obligation, taking into account shares owned by attribution.[110]

Foreign investment in U.S. real property—shared appreciation debt

A foreign person's gain on the disposition of a U.S. real property interest (USRPI) is treated as income that is effectively connected with the conduct of a U.S. trade or business, and thus is subject to net-basis tax at ordinary U.S. income tax rates pursuant to the Foreign Investment in Real Property Tax Act of 1980 (FIRPTA). USRPIs include interests (other than solely as a creditor) in (1) real property, and (2) domestic corporations that are U.S. real property holding corporations (USRPHCs).

Whether a financial instrument is considered debt under any provisions of the Code is not determinative of whether it constitutes an "interest solely as a creditor" for purposes of FIRPTA. Regulations provide that an interest in real property other than an interest solely as a creditor includes any right to share in the appreciation in the value of, or in the gross or net proceeds or profits generated by, the real property. Similarly, an interest in an entity (such as a USRPHC) other than an interest solely as a creditor includes any right to share in the appreciation in the value of an interest in, or the assets of, the entity, or a right to share in the gross or net proceeds or profits derived by, the entity.

Regulations further provide that amounts otherwise treated for tax purposes as principal and interest payments on debt obligations of all kinds (including obligations that are interests other than solely as a creditor) do not give rise to gain or loss that is subject to U.S. tax under FIRPTA.[111] Thus, a foreign owner of a note that pays interest contingent on appreciation in U.S. real property in-

[108] Rev. Rul. 83-51, 1983-1 C.B. 48.

[109] See, e.g., *Dorzback v. Collison*, 195 F.2d 69 (3d Cir. 1952).

[110] Certain additional exceptions to this general rule apply only in the case of a corporate recipient of interest. In such a case, the term portfolio interest generally excludes (1) interest received by a bank on a loan extended in the ordinary course of its business (except in the case of interest paid on an obligation of the United States), and (2) interest received by a controlled foreign corporation from a related person.

[111] Treas. Reg. sec. 1.897-1(h). FIRPTA applies in the case of a "disposition" of a USRPI. Treasury Reg. sec. 1.897-1(h) generally defines a disposition as a transaction that gives rise to gain under section 1001 of the Code. Section 1001 does not apply to interest received on indebtedness.

curs U.S. income tax if he disposes of the note, but may not incur U.S. income tax if he holds the note and receives interest payments under its terms.

Reasons for Change

The committee is concerned that the complete exemption from U.S. tax granted by the portfolio interest rules may give foreign investors a strong incentive to structure their U.S. investments which provide equity participation rights so that the returns therefrom will be characterized as interest income as opposed to other, taxable forms of income. The committee believes that such structuring of investments results in a significant erosion of the U.S. tax base, and that in such cases, allowance of the tax exemption is not appropriate. For example, the committee believes that the tax exemption should not apply in cases where a debt instrument held by a foreign investor pays interest that is contingent on profits generated from the disposition of U.S. real property held by the borrower.

Congress enacted the tax exemption for portfolio interest earned by foreign persons in 1984.[112] The exemption was enacted because Congress believed it important that U.S. businesses have direct access to the Eurobond market as a source of capital. In addition, Congress did not want withholding taxes on interest paid on portfolio debt or the necessity for U.S. borrowers to create uneconomic corporate structures in order to make the interest exempt from U.S. tax to impair borrowers' ability to utilize that market.[113] The committee believes that the limits placed on the scope of the portfolio interest exemption by the bill do not depart from the original purposes of the exemption.

Explanation of Provision

The bill makes the portfolio interest exemption inapplicable to certain contingent interest income received by foreign persons. In the case of an instrument on which a foreign holder earns both contingent and non-contingent interest, denial of the portfolio interest exemption applies only to the portion of the interest which is contingent interest.

Under the bill, contingent interest includes interest determined by reference to any of the following attributes of the debtor or any related person: receipts, sales, or other cash flow; income or profits; or changes in the value of property.[114] Thus, for example, the receipt by a foreign person of interest that is computed as a percentage of the borrower's profits would not be entitled to the tax exemption for portfolio interest. The bill does not treat interest as contingent merely because its payment can be impaired by a default on the debt obligation by the borrower.

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[112] Sec. 127 of P.L. 98-369.

[113] Staff of the Joint Committee on Taxation, *General Explanation of the Revenue Provisions of the Deficit Reduction Act of 1984*, (JCS-41-84), December 31, 1984, pp. 391-392.

[114] For purposes of determining whether interest is contingent interest under the bill, the term related person means any person who is related to the borrower under Code section 267(b) or 707(b)(1). In addition, a related person, for this purpose, includes a party to an arrangement undertaken for a purpose of avoiding the application of this provision of the bill.

In addition, contingent interest includes interest determined by reference to any dividend, partnership distribution, or similar payment made by the debtor or a related person. For example, interest is contingent under the bill where its receipt by the foreign investor is contingent upon the payment of a dividend to the shareholders of the corporate borrower.

The bill provides a number of exceptions to the general definition of contingent interest as detailed above. Under one such exception, interest is not considered contingent solely because the timing of the interest or any related principal payment is subject to a contingency. For example, assume that a debt obligation accrues fixed interest at a competitive market rate. If in any period prior to the instrument's maturity date the debtor has insufficient cash to make an interest payment, the debt agreement allows the borrower to defer the payment, but does not eliminate the borrower's liability for the deferred amount (or for interest that accrues on that amount). In this case, the interest is not considered contingent interest under the bill.

As another example, assume a debt obligation that is a regular interest in a Real Estate Mortgage Interest Conduit (REMIC) pays fixed interest at a competitive market rate. However, the period during which the debt obligation is to remain outstanding depends on the extent to which the qualified mortgages held by the REMIC are prepaid (and on other contingencies related to the income earned or expenses incurred by the REMIC). The interest received from the REMIC would not, because of this feature, be treated as contingent interest.

Portfolio interest treatment is not denied under the bill solely because the interest is paid with respect to nonrecourse or limited recourse indebtedness. For example, this exception would apply where a corporation issues a limited recourse debt instrument that pays fixed interest at a competitive market rate and is secured by trade receivables of the corporation.

Interest also is not denied portfolio treatment under the bill if all or substantially all of it is determined by reference to certain other amounts of interest that is *not* described as contingent above (or by reference to the principal amount of indebtedness on which such other interest is paid). An example of what is intended to be covered by this exception is a regular interest in a REMIC which pays annual amounts of interest equal to a percentage of the interest earned by the REMIC on qualified mortgages, where the interest earned by the REMIC is not considered contingent interest under the rules of the provision.

In determining whether all or substantially all of an amount of interest payable on a debt obligation is computed by reference to another amount of interest that is not contingent interest, other factors that affect the amount of interest payable on the debt obligation, but which are not contingencies as contemplated by the bill, are not taken into account. For example, assume a regular interest in a REMIC pays annual amounts of interest equal to the interest received by the REMIC on qualified mortgages in excess of an established threshold—the outstanding principal amounts on the qualified mortgages multiplied by a variable rate based on

LIBOR[115] that is subject to a cap. Under the bill, the fact that the amount of interest paid by the REMIC varies inversely with LIBOR does not cause the interest to be treated as contingent interest.

Another of the bill's exceptions provides that interest is not denied portfolio treatment solely because the debtor or a related person enters into a hedging transaction to reduce the risk of interest rate or currency fluctuations with respect to such interest. Interest also is not denied portfolio treatment under the bill if it is determined by reference to changes in the value of (or any index of the value of) actively traded property other than a USRPI. For this purpose, the term "property" includes stock, and the term "actively traded" has the meaning given to that term under section 1092(d) of the Code. In general, portfolio treatment also is not denied if the interest is determined by reference to the yield (or any index of the yield) on such actively traded property. However, this exception for interest contingent on the yield of actively traded property does not apply if the property is a debt instrument that itself pays contingent interest as described above, or the actively traded property is stock or other property that represents a beneficial interest in the debtor or a related person.

By adding this set of exceptions, the committee intends to clarify that, for example, portfolio treatment is not denied in the case of a debt instrument that pays interest in an amount determined by reference to the value of a commodities index merely because the debtor hedges its interest rate risk on the debt by acquiring an offsetting position in commodities which produces a cash flow that correlates with the interest payments. As another example, portfolio treatment is not denied in the case of a debt instrument that pays interest in an amount determined by reference to the value of a stock market index merely due to the fact that an affiliate of the debtor holds stock which is publicly traded on that market.

The committee intends that the exceptions to the provision not be utilized by taxpayers to inappropriately avoid its application. For example, assume a corporation issues a nonrecourse debt obligation that accrues interest at a rate significantly in excess of the market rate. Pursuant to the provisions of that instrument, if in any period prior to the date of maturity of the obligation the debtor has insufficient cash flow to pay the interest, the obligation to pay the interest is deferred, but not eliminated. However, at the time of issuance of the obligation, the debtor and creditor reasonably expect that a significant portion of the accrued interest will be deferred, and ultimately will never be paid. In such a case, the committee intends that the exceptions to the application of the provision for nonrecourse indebtedness and for the timing of principal or interest payments should not apply. Thus, the interest received on the obligation would not qualify for portfolio treatment.

The bill provides that application of the provision may be extended to any type of contingent interest not specifically described in the bill, if identified by the Treasury Secretary in regulations. The Secretary is granted authority under the bill to issue such regulations to supplement the statutory description of contingent in-

[115] The London Inter-Bank Offered Rate.

terest in order to address cases where a denial of the portfolio interest exemption is necessary or appropriate to prevent avoidance of U.S. income tax. The bill additionally provides that the Secretary may by regulation exempt any type of interest from denial, under the bill, of portfolio treatment.

The committee intends that the provision not override existing treaties that reduce or eliminate U.S. withholding tax on interest paid to foreign persons.

Effective Date

The provision applies to interest received after December 31, 1993. It does not apply, however, to any interest paid or accrued with respect to any indebtedness with a fixed term that was issued on or before April 7, 1993, or was issued after such date pursuant to a written binding contract in effect on such date and at all times thereafter before such indebtedness was issued.

6. Regulatory authority to address multiple-party financing arrangements (sec. 8238 of the bill and new sec. 7701(l) of the Code)

Present Law

The tax treatment of a transaction may depend on the identity of the parties to the transaction. For example, a loan by a controlled foreign corporation to a related U.S. borrower is treated as an investment in U.S. property under Code section 956, and as such, may result in an inclusion of income to U.S. shareholders of the foreign corporation. On the other hand, an income inclusion to the U.S. shareholders of the foreign corporation would not have resulted had the loan been made by the same foreign corporation to an unrelated foreign borrower.

Under the Code, payments of interest by U.S. persons to related foreign persons may be subject to 30-percent gross-basis withholding tax. On the other hand, no such tax applies to payments by U.S. persons to unrelated foreign persons of so-called portfolio interest. Under treaties, payments of interest by U.S. persons to related foreign persons who are resident in the treaty country may be subject to little or no U.S. gross-basis tax. By contrast, if the related recipient of interest is resident in a country with respect to which no U.S. income tax treaty is in force, the 30-percent gross-basis tax would be imposed.

Courts have stated that the incidence of taxation depends upon the substance of a transaction as a whole.[116] In certain cases, courts have recharacterized transactions in order to impose tax consistent with this principle. For example, where three parties have engaged in a chain of transactions, the courts have at times ignored the "middle" party as a mere "conduit," and imposed tax as if a single transaction had been carried out between the parties at the ends of the chain.

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[116] See, e.g., *Commissioner v. Court Holding Co.*, 324 U.S. 331 (1945).

In *Aiken Industries, Inc. v. Commissioner,*[117] the Tax Court recharacterized an interest payment by a U.S. person on its note held by a related treaty-country resident, which in turn had a precisely matching obligation to a related non-treaty-country resident, as a payment directly by the U.S. person to the non-treaty-country resident. The transaction in its recharacterized form resulted in a loss of the treaty protection that would otherwise have applied on the payment of interest by the U.S. person to the treaty-country resident, and thus subjected the interest payment to 30-percent U.S. tax.

The IRS has taken the position that it will apply a similar result in cases where the back-to-back related party debt obligations are less closely matched than those in *Aiken Industries*, so long as the intermediary entity does not obtain complete dominion and control over the interest payments.[118] The IRS has taken an analogous position where an unrelated financial intermediary is interposed between the two related parties as lender to one and borrower from the other, as long as the intermediary would not have made or maintained the loan on the same terms without the corresponding borrowing.[119] In a recent technical advice memorandum, the IRS has taken the position that interest payments by a U.S. company to a related, treaty-protected financial intermediary may be treated as payments by the U.S. company directly to the foreign parent of the financial intermediary even though the matching payments from the intermediary to the parent are not interest payments, but rather are dividends.[120]

Reasons for Change

The committee is concerned that taxpayers may be inappropriately avoiding U.S. tax by intricately structuring financial transactions which utilize multiple entities, where one or more of those entities serve as a conduit. The committee believes that the above-cited IRS rulings appropriately ignore conduit entities and properly recharacterize the transactions described therein. However, the committee does not intend that the Secretary be bound, in developing regulations, by the standards on which those rulings are based, if the Secretary deems it necessary or appropriate to adopt other standards in order to properly recharacterize a financing transaction. In legislating in this area, it is not the intent of the committee to cast a negative inference on positions taken by the IRS under present law.

By granting regulatory authority to provide detailed rules in this complicated area, the committee seeks to bolster the Treasury's ability to prevent unwarranted avoidance of tax through multiple-party financial engineering, as well as to provide a mechanism for issuing additional guidance to taxpayers entering into financial transactions.

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[117] 56 T.C. 925 (1971), *acq. on another issue*, 1972-2 C.B. 1.
[118] Rev. Rul. 84-152, 1984-2 C.B. 381; Rev. Rul. 84-153, 1984-2 C.B. 383.
[119] Rev. Rul. 87-89, 1987-2 C.B. 195.
[120] Tech. Adv. Mem. 9133004 (May 3, 1991).

Explanation of Provision

The bill authorizes the Treasury Secretary to promulgate regulations that set forth rules for recharacterizing any multiple-party financing transaction as a transaction directly among any two or more of such parties where the Secretary determines that such recharacterization is appropriate to prevent avoidance of any tax imposed by the Internal Revenue Code.

The committee intends that the provision apply not solely to back-to-back loan transactions, but also to other financing transactions. For example, it would be within the proper scope of the provision for the Secretary to issue regulations dealing with multiple-party transactions involving debt guarantees or equity investments.

Effective Date

The provision is effective on date of enactment.

7. Amend certain provisions relating to the export of certain unprocessed timber (sec. 8238 of the bill and secs. 861-65, 921-927, 951-964, and 991-996 of the Code)

Present Law

Rules for sourcing income

Subject to significant exceptions, income from the sale of personal property generally is sourced on the basis of the residence of the seller. One set of exceptions apply to sales of inventory property. Income derived from the purchase of inventory property within the United States and its sale outside the United States constitutes foreign source income. Similarly, income derived from the purchase of inventory property outside the United States and its sale within the United States constitutes domestic source income. Income attributable to the marketing of inventory property by U.S. residents in other cases may also have its source determined to be the place of sale. For this purpose, the place of sale generally is the place where title to the property passes to the purchaser (the "title passage" rule).

Income derived from the production of property in the United States and its sale elsewhere is treated as having a divided source. When a U.S. producer sells part of its output to wholly independent distributors or other selling concerns in such a way as to establish fairly the independent factory or production price unaffected by considerations of tax liability, the division of the income between foreign and domestic source must be based on that independent price (Treas. Reg. sec. 1.863-3(b)(2), *Example (1)*; *Phillips Petroleum Co. v. Commissioner*, 97 T.C. 30 (1991); Notice 89-10, 1989-1 C.B. 631). Under the independent factory price (IFP) method the portion of income attributable to production activity is determined by reference to the IFP and is sourced in the country of production (the United States in the case of a U.S. exporter). The balance of taxable income is attributed to sales activity and is presumed to arise outside the country of production (the United states). When the IFP method cannot be used, Treasury regulations permit the source of 50 percent of export income to be based on the location

of the property held or used in the production or sale of the property exported (generally the United States) and the source of the other 50 percent to be determined under the title passage rule.

Income earned by foreign corporations

The United States exerts jurisdiction to tax all income, whether derived in the United States or elsewhere, of U.S. citizens, residents, and corporations. By contrast, the United States taxes nonresident aliens and foreign corporations only on income with a sufficient nexus to the United States. In the case of income earned by a U.S.-owned foreign corporation, generally no U.S. tax is imposed until that income is distributed to the U.S. shareholders as a dividend.

When a U.S.-controlled foreign corporation earns so-called "subpart F income," the United States generally taxes the corporation's 10-percent U.S. shareholders currently on their pro-rata share of that income regardless of whether the income is actually distributed currently to the shareholders. Included among the types of income deemed distributed (generally referred to as "subpart F income") is foreign base company sales income.

Certain subpart F income derived by a controlled foreign corporation that is an export trade corporation (ETC) from certain export activities is exempt from current taxation. Under this exemption, the subpart F income of an ETC is reduced by certain amounts that constitute export trade income (as defined in section 971). No foreign corporation may qualify as an ETC unless it has so qualified generally since 1971.

Foreign sales corporations

A portion of the income of an eligible foreign sales corporation (FSC) that is generated from export property is exempt from Federal income tax. If the income earned by the FSC is determined under special administrative pricing rules, then the exempt foreign trade income generally is 15/23 of the foreign trade income the FSC derives from the transaction. 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. Thus, there generally is no corporate level tax imposed on a portion of the income from exports of a FSC.

Foreign trade income is defined as the gross income of a FSC attributable to foreign trading gross receipts. Foreign trade income includes both the profits earned by the FSC itself from exports and commissions earned by the FSC from products exported by others and services related thereto. In general, the term foreign trading gross receipts means the gross receipts of a FSC which are attributable to the export of certain goods and services. Foreign trading gross receipts are the gross receipts of the FSC that are attributable to the following types of transactions: the sale of export property, the lease or rental of export property, services related and subsidiary to the sale or lease of export property, engineering and architectural services, and export management services.

Export property, for purposes of the FSC rules, is defined as property that is (1) manufactured, produced, grown, or extracted in the United States by a person other than a FSC, (2) held primarily

for sale, lease, or rental, in the ordinary conduct of a trade or business by, or to, a FSC, for direct use, consumption, or disposition outside the United States, and (3) not more than 50 percent of the fair market value of which is attributable to articles imported into the United States.

Domestic International Sales Corporations

Prior law provided for a system of tax deferral for corporations known as Domestic International Sales Corporations, or "DISCs," and their shareholders. Under this system, the profits of a DISC were not taxed to the DISC but were taxed to the shareholders of the DISC when distributed or deemed distributed to them. Each year, a DISC was deemed to have distributed a portion of its income, thereby subjecting that income to current taxation in its shareholders' hands. Federal income tax could generally be deferred on the remaining portion of the DISC's taxable income until the income was actually distributed to the shareholders.

Under current law, a DISC is permitted to continue to defer income attributable to $10 million or less of qualified export receipts. However, unlike the prior-law DISC rules, an interest charge is imposed on the shareholders of the DISC. The amount of the interest is based on the tax otherwise due on the deferred income computed as if the income were distributed. Taxable income of the DISC attributable to qualified export receipts that exceed $10 million is deemed distributed to the DISC's shareholders.

To qualify for DISC treatment, at least 95 percent of a domestic corporation's gross receipts must consist of qualified export receipts. In general, qualified export receipts are receipts, including commission receipts, derived from the sale or lease for use outside the United States of export property, or from the furnishing of services related or subsidiary to the sale or lease of export property. Export property must be manufactured, produced, grown, or extracted in the United States.

Reasons for Change

The committee believes that the justification for any tax benefit should be based on the amount of desired behavior induced by the benefit. In this instance, the committee believes that taxpayers are bearing the cost of a tax benefit that may be inducing little, if any, desired behavior, and may if anything be having an undesirable effect on the nation's economic well-being. In particular, the committee is concerned about features of the Code that may tend to accelerate the removal of old-growth forests, and the committee understands that the export of raw logs may in effect cause American milling jobs to be exported overseas.

Explanation of Provision

The provision amends certain provisions of the Code as they apply to activities that generated income from unprocessed timber which is a softwood. For this purpose, the term "unprocessed timber" means any log, cant, or similar form of timber.

The provision excludes from the definition of "export property" for purposes of the FSC rules any unprocessed timber which is a

softwood. Similarly, the provision excludes from the definition of "export property" for purposes of the DISC rules any unprocessed timber which is a softwood.

The provision also amends the sales source rules as they apply to inventory property. In this case, the bill provides that any income from the sale of any unprocessed timber which is a softwood and which was cut from an area located in the United States would be domestic source income.

Finally, the provision treats as subpart F foreign base company sales income any income derived by a controlled foreign corporation in connection with the sale of any unprocessed timber which is a softwood and was cut from an area located in the United States. In addition, the provision treats as subpart F foreign base company sales income any income derived by a controlled foreign corporation from the milling of any such timber outside the United States. Any income treated as subpart F income under the proposal that is earned by an export trade corporation would not be subject to reduction by the export trade income of the corporation.

Effective Date

The provision is effective for transactions occurring after date of enactment of the proposal.

D. Transportation Fuels Tax Provisions

1. Transportation fuels tax (sec. 8241 of the bill and secs. 4041, 4042, 4081, 4091, 6416, 6421, 6427, 9502, 9503 of the Code)

Present Law

Several separate Federal excise taxes are imposed on specified transportation fuels. Taxable fuels include motor fuels (gasoline, diesel fuel and special motor fuels[121]) used for highway transportation; gasoline used in motorboats; diesel fuel used in trains; fuels used in inland waterways transportation; and, aviation fuel (gasoline and jet fuel) used in most aviation.

In general, gasoline and special motor fuels used in highway vehicles and motorboats are taxed at a total rate of 14.1 cents per gallon; highway diesel fuel is taxed at a total rate of 20.1 cents per gallon; noncommercial aviation gasoline is taxed at a total rate of 15.1 cents per gallon; noncommercial aviation jet fuel is taxed at a total rate of 17.6 cents per gallon; commercial aviation fuels are taxed at a total rate of 0.1 cent per gallon; railroad diesel fuel is taxed at a total rate of 2.6 cents per gallon; and inland waterways fuels are taxed at a total rate of 17.1 cents per gallon in 1993 (increasing to 19.1 cents per gallon in 1994 and 20.1 cents per gallon in 1995 and thereafter).

Revenues from most of these excise taxes are deposited in various trust funds to finance specific Federal public works and environmental programs. The set of fuels subject to each tax generally reflects the purposes of the trust fund to which the revenues are dedicated. The above rates also include a general deficit reduction tax (in effect through September 30, 1995[122]) imposed on highway motor fuels, motorboat gasoline and special motor fuels, and train diesel fuel. Revenues from this deficit reduction tax are retained in the General Fund of the Treasury.

One of the dedicated excise taxes is a 0.1 cent per gallon tax (0.05 cent per gallon for qualified ethanol and methanol fuels) imposed on all of the fuels listed above, except liquefied petroleum gas. This tax, in effect through 1995, is deposited into the Leaking Underground Storage Tank ("LUST") Trust Fund, which is used to fund cleanup costs associated with leaking underground storage tanks containing petroleum products.

Certain fuel uses are exempt from the LUST excise tax. Exempt uses include No. 2 residual fuel oil[123] used as heating oil; gasoline and diesel fuel used on farms for farming purposes; off-highway business uses of fuel (for example, fuel used to operate pumps, generators, compressors, forklift trucks, or bulldozers, or fuel used in vessels used by fisheries or whaling businesses); fuels used by State and local governments; fuels used by nonprofit educational organizations; exported fuels, including fuels used in international

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[121] Special motor fuels include benzol, benzene, naphtha, liquefied petroleum gas, casing head and natural gasoline, and any other liquid (other than kerosene, gas oil, fuel, or gasoline) sold for use in motor vehicles or motorboats.

[122] See Item II.D.3., below, for the extension and transfer of the deficit reduction tax rate.

[123] No. 2 residual fuel oil can be used either as diesel fuel or as home heating oil.

aviation and international shipping; and fuel for military ships and aircraft.

The gasoline excise tax (including the LUST rate on gasoline) is imposed when the fuel leaves terminal storage facilities (i.e., at the terminal rack). The diesel fuel excise tax is imposed on the wholesale sale of that fuel.

Reasons for Change

The committee believes that deficit reduction is critical to the nation's economic well-being and that responsible actions must be taken to address growing annual budget deficits and the increasing balance of federal government debt. It is the committee's view that the revenues raised by a broad-based transportation fuels excise tax will make an important contribution toward reducing the deficit.

The committee also believes that a transportation fuels tax should further other important objectives. The committee understands that in 1992, approximately two-thirds of domestic consumption of petroleum was for transportation uses.[124] By providing an incentive to reduce motor fuel consumption, this tax should tend to improve environmental problems that result from the transport, storage and burning of petroleum products to power motor vehicles, vessels, and aircraft. In addition, reduced consumption of petroleum products should decrease U.S. reliance on imported oil.

Explanation of Provision

In general

The bill imposes an additional, permanent, deficit reduction excise tax of 4.3 cents per gallon on all transportation fuels currently subject to the LUST excise tax (i.e., highway, rail, aviation, and inland waterway fuels), on liquefied petroleum gases currently taxable as special motor fuels, and on diesel fuel used in noncommercial motorboats.[125] Ethanol, methanol and their ether derivatives are fully taxable at the 4.3-cent rate. The committee recognizes, however, that the impact of the transportation tax on ethanol, methanol, and their derivative ethers, as well as on other alternative fuels, requires further analysis, and the committee intends that these matters be addressed in the conference on this legislation.

The new deficit reduction tax is to be collected in the same manner as the existing excise taxes on these fuels (although, as described in Item II.D.2., below, a separate provision in the bill changes the point of collection for the present-law diesel fuel excise tax).

Fuel uses that are exempt from the current LUST excise tax will be exempt from the new tax.

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[124] In 1992, the United States consumed approximately 33,000 quadrillion Btu of petroleum-based energy. Transportation accounted for approximately 22,000 quadrillion Btu. See, U.S. Department of Energy, Energy Information Agency, *Monthly Energy Review*, May 1993.

[125] A separate provision in the bill (described in Item I.E.2.) extends the current 20.1-cents-per-gallon diesel fuel excise tax (including the LUST rate) to diesel fuel used by noncommercial motorboats.

Disposition of revenues

Revenues from the new transportation fuels excise tax will be retained in the General Fund of the Treasury.

Effective Date

The transportation fuels tax provisions are effective on October 1, 1993. Floor stocks taxes are imposed on taxable products held for sale or for use (other than in an exempt use) as a fuel beyond the applicable product's tax collection point on October 1, 1993.

2. Modification of the collection of the diesel fuel excise tax (secs. 8242-8243 of the bill and secs. 4041, 4081 and 4091 of the Code)

Present Law

Diesel fuel tax collection

Excise taxes totalling 20.1 cents per gallon generally are imposed on the sale of highway diesel fuel by a producer or importer. A reduced rate of 3.1 cents per gallon applies to sales of diesel fuel for use in certain intercity buses. A rate of 2.6 cents per gallon applies to sales of diesel fuel for use in trains.

Diesel fuel may be sold without the payment of tax in the following cases: (1) sales of heating oil, (2) sales to other producers, and (3) sales for nontaxable uses including (a) use other than as fuel in a diesel-powered highway vehicle or diesel-powered train (such as use in any boat), (b) use in off-highway business use, (c) use on a farm for farming purposes, (d) exclusive use by a State or local government, (e) export, (f) exclusive use by a nonprofit educational organization, (g) use by certain aircraft museums, and (h) use in certain qualified local buses. A sale may be made without the payment of tax only if certain prescribed conditions are satisfied, which may include registration by the buyer and seller and certification of exempt use by the buyer to the seller.

The producer making a taxable sale generally is liable for the tax. The term producer generally includes refiners, compounders, blenders, wholesale distributors of diesel fuel and dealers selling any diesel fuel exclusively to producers of diesel fuel. Producers must be registered with the Treasury Department to purchase without payment of tax and, as a condition of registration, may be required to post a bond. Thus, in general, most diesel fuel tax is collected at the wholesale distributor level.

Exempt and reduced-rate users who buy diesel fuel after tax has been paid on the fuel may file a claim for credit or refund. These users must, however, keep business records that will enable the Treasury Department to verify the amount claimed.

Gasoline tax collection

Taxes totalling 14.1 cents a gallon generally are imposed on (1) the removal of gasoline from any refinery, (2) the removal of gasoline from any terminal, (3) the entry of gasoline into the United States, and (4) the sale to any unregistered person unless there was a prior taxable removal or entry of the gasoline under (1), (2), or (3) above. The tax, however, does not apply to any entry or re-

moval of gasoline transferred in bulk to a terminal if all the persons involved (including the terminal operator) are registered. Thus, tax generally is imposed when gasoline is removed by truck from a terminal (this is called removal at the "terminal rack"). Taxpayers who use gasoline for an exempt use, such as for farming or for off-highway business use, are eligible to claim a credit or refund of the excise tax included in the price of the gasoline.

Under Treasury Department regulations, the person liable for the tax imposed on gasoline removed from a terminal rack is the "position holder," which, in general, is the person that holds the inventory position to gasoline as reflected on the records of the terminal operator (i.e., has a contract with the terminal operator for the use of storage facilities and terminaling services at a terminal). In addition, the terminal operator may be jointly and severally liable for the tax if the position holder is not registered with Treasury. As a condition of registration, terminal operators, position holders, and other persons involved in bulk transfers of gasoline, may be required to post a bond in such sum as the Treasury determines.

Reasons for Change

Recent reports have suggested that there may be substantial levels of diesel fuel tax evasion. In particular, at a hearing in 1992 on shortfalls in Highway Trust Fund collections, the Department of Transportation estimated that the level of diesel fuel tax evasion is between 15 and 25 percent of total gallons consumed.[126] Advancing the collection point of the diesel fuel taxes reduces the number of times the fuel changes ownership prior to tax, and reduces the number of taxpayers. As a result, the diesel fuel taxes should be easier to collect and payments of tax should be easier to monitor.

In addition, the committee intends to minimize the additional burden that may be imposed on exempt users of diesel fuel as a result of the collection point change. Thus, the committee intends that the collection point change be accomplished in a manner that would preserve the present exemptions from the diesel fuel tax and the ability of exempt users to buy diesel fuel (including heating oil) without payment of tax.

Explanation of Provision

Point of collection

The bill provides that the full 20.1 cents per gallon diesel fuel excise tax will be imposed on removal from a terminal (i.e., at the terminal rack) under generally the same rules as the gasoline tax currently is collected.[127] Thus, tax generally will be imposed when diesel fuel is removed by truck from a registered terminal. However, unlike the gasoline tax, removal of diesel fuel that is destined for an exempt use will not be taxed as the fuel is removed from the terminal if the dyeing requirements described below are satisfied.

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[126] Statement of Eugene R. McCormick, Federal Highway Administration, Department of Transportation, Hearing on Shortfall in Highway Trust Fund Collections, Subcommittee on Investigations and Oversight of the House Committee on Public Works and Transportation (May 5, 1992).

[127] The 4.3 cents-per-gallon deficit reduction rate that is included in this bill also will be collected on removal of diesel fuel from a terminal. All rates described below will be increased by the new deficit reduction rate, unless a specific exemption is provided.

Any diesel fuel that is destined for an exempt use that is not dyed (as required below) will be subject to tax on removal.[128]

Thus, for example, removal of diesel fuel that is destined for use as heating oil or for off-highway farming purposes will not be taxed as the fuel is removed from the terminal if the dyeing requirements are satisfied. In addition, removal of diesel fuel that is destined for use by certain intercity buses and by trains will not be taxed as the fuel is removed from the terminal if the dyeing requirements are satisfied. The special tax rates of 3.1 cents per gallon for diesel fuel used by intercity buses and of 2.6 cents per gallon for diesel fuel used by trains (other than certain State and local governmentally owned and operated trains) will continue to be imposed on the sale of the fuels at the time that the fuel is sold to these reduced-rate users.

As stated above, in order to permit diesel fuel to be removed from a terminal without payment of tax, the bill requires the fuel to be indelibly dyed in accordance with regulations to be prescribed by the Treasury Department. The committee expects the Treasury Department to coordinate the dyeing that will be required for purposes of the highway diesel tax with the dyeing that will be required for purposes of the Clean Air Act. For fuel that is not dyed under the Clean Air Act, the color of the dye may be chosen by the person who is dyeing the fuel but the color must be approved by the Treasury Department or selected from a list of approved colors (in order to distinguish diesel fuel that has been removed without payment of tax from that which has been removed with payment of tax). The committee expects that one color that will be approved for purposes of dyeing for the highway diesel tax is the color that is used for purposes of dyeing for the Clean Air Act.

The Treasury Department is expected to enforce the dyeing requirement vigorously and to check regularly to ensure that terminal operators maintain removal systems that prevent undyed fuel from being removed without payment of tax, that any fuel that is removed without payment of tax is dyed, and that dyes are maintained in a secure location.

As under present law, most exempt or reduced-rate users that use tax-paid undyed diesel fuel are permitted a refund if the user establishes that a prior tax was paid with respect to the fuel and that the fuel has been used for an exempt or reduced-rate use. Thus, for example, an intercity bus company that qualified for the 3.1-cents-per-gallon reduced rate could apply for a refund of 17 cents per gallon if it could show it purchased undyed fuel (which had been subject to the full 20.1-cents-per-gallon tax) rather than dyed fuel.

However, similar to the present law for certain gasoline vendors, only registered ultimate vendors (in lieu of the farmer or State or local government) will be permitted to apply for excise tax refunds or credits for any sales of undyed (tax-paid) diesel fuel for use on a farm for a farming purposes or by a State or local government.

[128] The tax imposed by this bill (sec. 8163) on diesel fuel that is used by noncommercial motorboats will be collected at the terminal rack. Diesel fuel that is used by commercial motorboats (which will be an exempt use) will not be taxed as the fuel is removed from the terminal if the dyeing requirements are met. If a tax is imposed on the removal of diesel fuel that is subsequently used as supplies for vessels (within the meaning of sec. 4221(d)(3)), the wholesale distributor of the fuel may apply for the refund (see sec. 6416(b)(2)).

Vendors will be able to file an expedited claim for refund of these taxes for any period for which the claim is $200 or more and the period is not less than one week. If the Treasury Department does not pay a proper claim for refund filed under these procedures within 20 days, the Treasury Department will pay interest on the refund.

Administrative provisions

As under present law, the Treasury Department is permitted to require appropriate registration of persons necessary to implement the diesel fuel tax, including diesel fuel refiners and dye manufacturers. The Treasury Department also is authorized to require position holders, terminal operators, and other appropriate persons to keep records and to report the quantity of dyed and undyed fuel that is removed from a terminal or refinery.

As under the present law gasoline tax rules, the Treasury Department is permitted to prescribe rules and administrative procedures for determining the liability for payment of tax. These regulations are expected to provide that a terminal operator will be jointly and severally liable for any unpaid tax if a position holder is not registered with the Treasury Department. In addition, the terminal operator may be held jointly and severally liable for any unpaid tax if the terminal operator failed to keep any required records or to make any required reports on the removal of dyed and undyed diesel fuel.

In addition, a new penalty is to be imposed on any person who sold dyed fuel to a person whom it knew or had reason to know would use the fuel for a taxable use, or any person who knew or had reason to know that it used dyed fuel for a taxable use. This new penalty is the greater of $1,000 or twice the otherwise applicable tax on the diesel fuel so used. The Treasury Department also is authorized to require the conspicuous labeling of retail diesel fuel pumps (and other delivery facilities) to assure that persons are aware of which fuel is available for nontaxable uses.

Effective Date

The provision applies to diesel fuel removed from terminals after December 31, 1993. A floor stocks tax is imposed on diesel fuel held for sale or in bulk quantities for taxable use on January 1, 1994; the tax applies only to diesel fuel held beyond the terminal rack on January 1, 1994, and the amount of tax is reduced by any tax previously imposed on the fuel under section 4041 or 4091. The Treasury Department further is authorized to require dyeing of bulk quantities of diesel fuel held beyond the terminal rack for nontaxable uses on that date.

3. Extend the current 2.5-cents-per-gallon motor fuels excise tax rate; Transfer revenues to the Highway Trust Fund (sec. 8244 of the bill and secs. 4041, 4081, and 4091 of the Code)

Present Law

The Federal motor fuels excise taxes generally are imposed on motor fuels (gasoline, special motor fuels, and diesel fuel) used for

highway transportation, gasoline and special motor fuels used in motorboats, and diesel fuel used in trains. Off-highway business uses generally are exempt from motor fuels taxes, as are sales for export, for the exclusive use of State and local governments and nonprofit educational organizations, and for farming uses.

The rate of tax on motor fuels is 14.1 cents per gallon on gasoline and special motor fuels and 20.1 cents per gallon on diesel fuel; this rate includes a "deficit reduction rate" (General Fund rate) of 2.5 cents per gallon. and a Leaking Underground Storage Tank (LUST) Trust Fund rate of 0.1 cent per gallon. Diesel used in trains is subject only to the 2.5-cents deficit reduction rate and to the 0.1-cent LUST rate (not to the full 20.1 cents per gallon rate). The deficit reduction rate does not apply after September 30, 1995. Revenues from the deficit reduction rate are retained in the General Fund, while the balance of the highway motor fuels tax revenues are transferred to the Highway Trust Fund through September 30, 1999. Revenues from the 0.1-cent-per-gallon LUST tax rate are transferred to the LUST Trust Fund through December 31, 1995.

Reasons for Change

The committee believes that extending the 2.5-cents-per-gallon motor fuels tax rate, and dedicating the highway-related motor fuels tax receipts to the Highway Trust Fund, will provide additional resources to meet the country's infrastructure needs. Retaining non-highway fuels tax revenues from the 2.5-cents-per-gallon motor fuels tax in the General Fund will contribute to deficit reduction.

Explanation of Provision

The bill extends the current 2.5-cents-per-gallon motor fuels tax rate from October 1, 1995, through September 30, 1999. The revenues from this rate generally are to be transferred into the Highway Trust Fund, with revenues equivalent to 2 cents per gallon credited to the Highway Account and 0.5 cent per gallon to the Mass Transit Account. However, revenues from the 2.5-cents-per-gallon tax on diesel used in trains are to be retained in the General Fund as are revenues from 2.5 cents per gallon of the tax on motorboat, small-engine, and nonhighway recreational fuels. The provision retains present-law motor fuels tax exemptions.

Effective Date

The extension of the 2.5-cents-per-gallon rate applies after September 30, 1995.

E. Compliance Provisions

1. Reporting rule for service payments to corporations (sec. 8251 of the bill and secs. 6041 and 6041A of the Code)

Present Law

A person engaged in a trade or business who makes payments during the calendar year of $600 or more to a person for services performed must file an information return with the Internal Revenue Service ("IRS") reporting the amount of such payments, as well as the name, address and taxpayer identification number of the person to whom such payments were made. A similar statement must also be furnished to the person to whom such payments were made. Treasury regulations generally provide, however, that payments to corporations (including payments for services) need not be reported (Treas. Reg. sec. 1.6041-3(c); Prop. Treas. Reg. sec. 1.6041A-1(d)(2)).[129]

Reasons for Change

IRS studies show that the level of voluntary tax compliance among smaller corporate service providers has been decreasing in recent years because of non-filing and underreporting of income and is lower than that of most other smaller corporate businesses. In addition, payors cannot easily determine whether a business is actually conducted in corporate form (i.e., not subject to information reporting) because payees can simply claim to be incorporated, and payors are not required to verify such claims. The committee also understands that when taxpayers know that the IRS has received information reports on payments made to them, they are more likely to file tax returns and to report their income accurately. The committee therefore believes that the IRS's ability to identify nonfilers and to require backup withholding will be substantially improved by repealing the regulatory exception for corporate service providers.

Explanation of Provision

The bill provides that payments for services purchased in the course of the payor's trade or business will not be exempt from the information reporting requirements merely because the payments are made to a corporation. The committee understands, however, that the IRS may continue to exempt from information reporting certain types of payments and certain types of corporate payees where the risk of noncompliance is minimal. The committee believes that IRS should implement this provision so as to minimize the burdens on businesses that are fully complying with the law, while at the same time increasing compliance by businesses that are not fully complying. IRS should, for example, rapidly implement measures to reduce the noncompliance that is occurring under present law which is attributable to businesses that claim to be incorporated but in fact are not.

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[129] In general, information returns are required regarding payments to a corporation engaged in providing medical and health care services or engaged in billing and collecting payments with respect to medical and health care services.

Effective Date

The provision applies to payments for services made by a payor after December 31, 1993.

2. Raise standard for accuracy-related and preparer penalties (sec. 8252(a) of the bill and secs. 6662 and 6694 of the Code)

Present Law

A 20-percent penalty is imposed on any portion of an underpayment of tax that is attributable either to a substantial understatement of income tax on a return, or to negligence or disregard of rules or regulations (sec. 6662).

For this purpose, an understatement[130] is considered substantial if it exceeds the greater of 10 percent of the tax required to be shown on the year's return or $5,000 ($10,000 for corporations other than S corporations and personal holding companies). In determining whether an understatement is substantial, the amount of the understatement is reduced by any portion attributable to an item if (1) the treatment of the item on the return is or was supported by substantial authority, or (2) facts relevant to the tax treatment of the item were adequately disclosed on the tax return (or a statement attached to the return), provided that the treatment of the disclosed item was not "frivolous" (Treas. Reg. sec. 1.6662-4). Special rules apply to tax shelters.

The term "negligence" includes any failure to make a reasonable attempt to comply with the internal revenue laws, a failure to exercise ordinary and reasonable care in the preparation of a tax return, and a failure to keep adequate books and records or to substantiate items properly (Treas. Reg. sec. 1.6662-3(b)(1)). The term "disregard" includes any careless, reckless, or intentional disregard of rules or regulations (sec. 6662(c)). The penalty for negligence or disregard of rules or regulations does not apply where the position taken is adequately disclosed, the position is not "frivolous", and the taxpayer has adequate books and records and has substantiated items properly (Treas. Reg. sec. 1.6662-3(c)).[131]

A $250 penalty with respect to a return or claim for refund of income tax may be imposed on the preparer if any understatement of tax liability on the return or claim for refund resulted from a position that did not have a realistic possibility of being sustained on its merits and the preparer knew or reasonably should have known of the position (sec. 6694(a)). The penalty is $1,000 per return or claim for refund if the understatement is due to any reckless or intentional disregard of rules or regulations (sec. 6694(b)). These penalties may be avoided where the position taken on the return or claim for refund is adequately disclosed and is not "frivolous" (Treas. Reg. secs. 1.6694-2(c), 1.6694-3(c)(2)).[132]

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[130] An "understatement" of income tax is the excess of the tax required to be shown on the return over the tax imposed which is shown on the return (reduced by any rebates of tax).

[131] In the case of a position contrary to a regulation, the position taken must also represent a good faith challenge to the validity of the regulation.

[132] In the case of a position contrary to a regulation, the position taken must also represent a good faith challenge to the validity of the regulation.

A "frivolous" position with respect to an item for purposes of all of these penalty provisions is one that is "patently improper" (Treas. Reg. sec. 1.6662-3(b)(3), 1.6662-4(e)(2)(i), 1.6694-2(c)(2), 1.6694-3(c)(2)).

Reasons for Change

The committee believes that the "frivolous" standard does not sufficiently discourage taxpayers and preparers from taking unreasonable return positions. Accordingly, to encourage compliance, the committee believes that a tougher standard should be imposed.

Explanation of Provision

Under the bill, the "reasonable basis" standard replaces the "not frivolous" standard for purposes of the accuracy-related and income tax return preparer penalties. The committee intends that "reasonable basis" be a relatively high standard of tax reporting, that is, significantly higher than "not patently improper." This standard is not satisfied by a return position that is merely arguable or that is merely a colorable claim.

Under the bill, a taxpayer can avoid a substantial understatement penalty by adequately disclosing a return position only if the position has at least a reasonable basis. Similarly, a taxpayer can avoid the penalty that applies to disregarding rules or regulations by adequately disclosing a return position only if the position has at least a reasonable basis. The disclosure exception is no longer relevant with respect to the penalty for negligence, because a taxpayer generally is not considered to have been negligent with respect to a return position, regardless of whether it was disclosed, if the position has a reasonable basis. Also, a preparer can avoid a penalty by adequately disclosing a return position only if the position has at least a reasonable basis.

The bill also eliminates the reasonable cause and good faith exception for fraud, because fraud is inconsistent with reasonable cause and good faith.

Effective Date

The provision applies to tax returns due (without regard to extensions) after December 31, 1993.

3. Modify tax shelter rules for purposes of the substantial understatement penalty (sec. 8252(b) of the bill and sec. 6662(d) of the Code)

Present Law

Under present law, a 20-percent penalty applies to any portion of an underpayment of income tax required to be shown on a return that is attributable to a substantial understatement of income tax (sec. 6662). For this purpose, an understatement is considered substantial if it exceeds the greater of (1) 10 percent of the tax required to be shown on the return, or (2) $5,000 ($10,000 in the case of a corporation other than an S corporation or a personal holding company). The amount of an understatement of income tax is the excess of the tax required to be shown on the return, over the tax

imposed which is shown on the return (reduced by any rebates of tax).

In determining whether an understatement is substantial, the understatement generally is reduced by the portion of the understatement that is attributable to an item for which there was substantial authority or adequate disclosure (sec. 6662(d)(2)). However, in the case of tax shelter items, the understatement is reduced only by the portion of the understatement that is attributable to an item both for which there was substantial authority and with respect to which the taxpayer reasonably believed that the claimed treatment of the item was more likely than not the proper treatment (sec. 6662(d)(2)(C)(i)). Disclosure made with respect to a tax shelter item does not affect the amount of an understatement.

A "tax shelter" is any partnership or other entity, any investment plan or arrangement, or any other plan or arrangement if the principal purpose of such partnership, entity, plan or arrangement is to avoid or to evade Federal income tax (sec. 6662(d)(2)(C)(ii)). An item of income, gain, loss, deduction or credit is a "tax shelter item" if the item is directly or indirectly attributable to the principal purpose of the tax shelter (Treas. Reg. sec. 1.6662-4(g)(3)).

Reasons for Change

The committee understands that the substantial understatement penalty may not effectively deter certain abusive tax shelter transactions that are structured with little anticipated profit apart from the expected tax benefits. Taxpayers can assert that these types of tax shelter transactions have "economic substance" because of the existence of some profit potential and some economic risk. As a result, they may be able to avoid the substantial understatement penalty by arguing that they reasonably believed the tax treatment of the tax shelter items was more likely than not the proper treatment. Accordingly, the committee believes that the requirements under section 6662 for reducing the amount of an understatement in the case of tax shelter items should be tightened.

Explanation of Provision

Under the bill, an understatement is reduced by the portion of the understatement attributable to a tax shelter item only if, in addition to satisfying existing requirements, the taxpayer can demonstrate that the reasonably anticipated after-tax benefits from the taxpayer's investment in the shelter do not significantly exceed the reasonably anticipated net pre-tax economic profit from such investment. Thus, an understatement is reduced by the portion of the understatement attributable to a tax shelter item only if (1) there was substantial authority for the treatment of the item claimed on the return, (2) the taxpayer reasonably believed that the claimed treatment was more likely than not the proper treatment, and (3) the reasonably anticipated after-tax benefits from the taxpayer's investment in the shelter do not significantly exceed the reasonably anticipated net pre-tax economic profit from such investment. The bill does not alter the definition of "tax shelter" for purposes of the substantial understatement penalty and, therefore, applies only to

investments in arrangements that are considered tax shelters without regard to this bill.

In general, the comparison of the reasonably anticipated net pre-tax economic profit to the reasonably anticipated after-tax benefits shall be made by comparing the net present values of the respective items. This comparison shall be made based upon a reasonable financial projection, prepared generally at or about the time of a taxpayer's investment in the shelter,[133] that takes into account all items (e.g., items relating to partnership transactions, investor transactions, corporate formations and distributions, dispositions of residuals) reasonably expected to be attributable to the taxpayer's investment in the shelter.[134] In order to be "reasonable", a financial projection must be based on reasonable economic and business assumptions, reflect circumstances that are reasonably likely to occur, and be made in good faith.

Under the net present value approach, the reasonably anticipated net pre-tax economic profit from a taxpayer's investment in a shelter generally is the taxpayer's share of the discounted cash inflows and outflows attributable to the shelter that are reasonably anticipated over the expected life of the taxpayer's investment in the shelter, exclusive of federal income tax effects. Cash inflows and outflows generally include income, operating expenses, debt service, disposition of residuals, satisfaction of loans, and equity investments.

The reasonably anticipated after-tax benefits from a taxpayer's investment in a shelter are computed by adding the discounted tax inflows and outflows reasonably anticipated from the investment to the taxpayer's share of the discounted cash inflows and outflows attributable to the shelter. For purposes of determining tax inflows and outflows, the taxpayer shall use the Federal income tax rate reasonably anticipated to be applicable to him or her for the applicable year(s).

The present values of the reasonably anticipated after-tax benefits and the reasonably anticipated net pre-tax economic profit are computed by using a reasonable discount rate. A reasonable discount rate is the taxpayer's expected rate of return on investments with comparable risk.

The determination of whether the reasonably anticipated after-tax benefits significantly exceed the reasonably anticipated net pre-tax economic profit shall take into account the amount of the taxpayer's investment in the shelter.

Effective Date

This provision applies to tax returns due (without regard to extensions) after December 31, 1993.

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[133] Ordinarily, a subsequent comparison based upon revised financial projections will be required where there is a material change in the taxpayer's investment or in the tax shelter (e.g., a material change in the investment structure or strategy of the tax shelter) that was not reflected in the original financial projections.

[134] If a statement is made in connection with the offering that a tax benefit will be available from the shelter, that benefit must be treated as "reasonably anticipated", regardless of whether that benefit would be taken into account in a reasonable financial projection.

4. Information returns relating to the discharge of indebtedness by certain financial entities (sec. 8253 of the bill and sec. 6050P of the Code)

Present Law

Under section 61(a)(12), a taxpayer's gross income includes income from the discharge of indebtedness. The Code, however, does not currently require lenders to file information returns with respect to discharged debt.[135]

The determination of when a discharge of indebtedness occurs under section 61(a)(12) is a question of fact. In general, a debtor has discharge of indebtedness income where a debt is repurchased or otherwise deemed satisfied for less than its outstanding balance. For example, discharge of indebtedness income may be triggered by a debt modification under section 1001 or where a court adjudicates favorably a defense for the borrower. Discharge of indebtedness income is generally not deemed to result merely because the lender (1) has not actively pursued its claim against the debtor, provided a legal claim still exists, (2) claims a deduction for financial or regulatory reporting purposes, or (3) claims a partial or full bad debt deduction for tax purposes; however, where several of these factors are present, a discharge of indebtedness may be deemed to have occurred. See, e.g., *Carl T. Miller Trust v. Commissioner*, 76 T.C. 191 (1981).

Pursuant to a 1984 Office of Management and Budget memorandum, Treasury Department guidelines currently require Federal agencies to report forgiven debt amounts exceeding $600 to the Internal Revenue Service (IRS) on a Form 1099-G, except where prohibited by law. The Federal Deposit Insurance Corporation (FDIC) and Resolution Trust Corporation (RTC) do not issue such reports because of concerns that information reporting may violate the Right to Financial Privacy Act of 1978 (RFPA). The RFPA permits such information reporting if the Code specifically requires it.

Reasons for Change

The committee believes that it is inappropriate to exempt the FDIC and the RTC from information reporting with respect to discharged indebtedness when other Federal agencies are required to report such information. Moreover, to encourage taxpayer compliance with respect to discharged indebtedness, the committee believes that private financial institutions and credit unions also should be required to report discharged indebtedness. The committee understands that information reporting will enhance the ability of the IRS to enforce the discharge of indebtedness rules.

Explanation of Provision

The bill requires "applicable financial entities" to file information returns with the IRS regarding any discharge of indebtedness

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[135] Lenders are generally required to report any foreclosure or other acquisition of property in satisfaction of a debt secured by that property (sec. 6050J). Such events may effect a discharge of indebtedness. The committee intends that the Treasury Department issue guidance to coordinate reporting under this section with reporting on foreclosures and abandonments under section 6050J.

(within the meaning of sec. 61(a)(12))[136] of $600 or more. Such information returns are required regardless of whether the debtor is subject to tax on the discharged debt. For example, Congress does not expect reporting financial institutions and agencies to determine whether the debtor qualifies for an exclusion under section 108.

The information return must set forth the name, address and taxpayer identification number of the person whose debt was discharged, the amount of debt discharged, and the date on which the debt was discharged.[137] The information return must be filed in the manner and at the time specified by the IRS. The same information also must be provided to the person whose debt is discharged by January 31 of the year following the discharge.

For purposes of the bill, "applicable financial entities" include: (1) the FDIC, the RTC, the National Credit Union Administration, and any successor or subunit of any of them;[138] (2) any financial institution (described in secs. 581 or 591(a)); (3) any credit union; and (4) any subsidiary of an entity described in (2) or (3) which, by virtue of being affiliated with such entity, is subject to supervision and examination by a Federal or State agency regulating such entities. Other Federal agencies required to report under the current Treasury Department guidelines are also subject to this provision, so that all Federal agencies are subject to uniform rules.

Under the bill, the penalties for failure to file correct information reports with the IRS, and to furnish statements to taxpayers, are similar to those imposed with respect to a failure to provide other information returns. For example, the penalty for failure to furnish statements to taxpayers is generally $50 per failure, subject to a maximum of $100,000 for any calendar year.[139] These penalties are not applicable if the failure is due to reasonable cause and not to willful neglect.

Effective Date

The provision applies to discharges of indebtedness after the date of enactment.

[136] This provision is not intended to alter the present law determination of when a discharge of indebtedness occurs under section 61(a)(12).

[137] The date of discharge is required to facilitate the use of such information returns with respect to fiscal year taxpayers.

[138] With respect to these entities, any return required by the bill shall be made by the officer or employee appropriately designated to make these returns.

[139] In the case of intentional disregard of the filing requirements, the penalty is not less than $100 per failure and the $100,000 annual limitation does not apply.

F. Treatment of Intangibles

1. Amortization of goodwill and certain other intangibles (sec. 8261 of the bill and new sec. 197 of the Code)

Present Law

In determining taxable income for Federal income tax purposes, a taxpayer is allowed depreciation or amortization deductions for the cost or other basis of intangible property that is used in a trade or business or held for the production of income if the property has a limited useful life that may be determined with reasonable accuracy. Treas. Reg. sec. 1.167(a)-(3). These Treasury Regulations also state that no depreciation deductions are allowed with respect to goodwill.

The U.S. Supreme Court recently held that a taxpayer able to prove that a particular asset can be valued, and that the asset has a limited useful life which can be ascertained with reasonable accuracy, may depreciate the value over the useful life regardless of how much the asset appears to reflect the expectancy of continued patronage. However, the Supreme Court also characterized the taxpayer's burden of proof as "substantial" and stated that it "often will prove too great to bear." *Newark Morning Ledger Co. v. United States*, —— U.S.——, 61 U.S.L.W. 4313 at 4320, 4319 (April 20, 1993).

Reasons for Change

The Federal income tax treatment of the costs of acquiring intangible assets is a source of considerable controversy between taxpayers and the Internal Revenue Service. Disputes arise concerning (1) whether an amortizable intangible asset exists; (2) in the case of an acquisition of a trade or business, the portion of the purchase price that is allocable to an amortizable intangible asset; and (3) the proper method and period for recovering the cost of an amortizable intangible asset. These types of disputes can be expected to continue to arise, even after the decision of the U.S. Supreme Court in *Newark Morning Ledger Co. v. United States, supra.*

It is believed that much of the controversy that arises under present law with respect to acquired intangible assets could be eliminated by specifying a single method and period for recovering the cost of most acquired intangible assets and by specifying a fixed percentage of such cost that is nonamortizable. It is also believed that there is no need at this time to change the Federal income tax treatment of self-created intangible assets, such as goodwill that is created through advertising and other similar expenditures.

Accordingly, the bill provides a specified allocation and amortization method for the cost of most acquired intangible assets, including goodwill and going concern value. A portion of the costs of such assets (75 percent) is required to be amortized ratably over a 14-year period. The remaining 25 percent of such costs is not amortizable.

It is recognized that the useful lives of certain acquired intangible assets which are amortizable under present law may be shorter than 14 years, while the useful lives of other such acquired intangi-

ble assets may be longer than 14 years. It is also recognized that the percentage of intangible asset basis that would be allocable to nonamortizable assets under present law would vary.

Explanation of Provision

In general

The bill allows an amortization deduction with respect to a portion of the capitalized costs of certain intangible property (defined as a "section 197 intangible") that is acquired by a taxpayer and that is held by the taxpayer in connection with the conduct of a trade or business or an activity engaged in for the production of income. The amount of the deduction is determined by amortizing 75 percent of the adjusted basis (for purposes of determining gain) of the intangible ratably over a 14-year period that begins with the month that the intangible is acquired.[140] The remaining 25 percent of basis is not amortizable. No other depreciation or amortization deduction is allowed with respect to a section 197 intangible that is acquired by a taxpayer.

In general, the bill applies to a section 197 intangible acquired by a taxpayer regardless of whether it is acquired as part of a trade or business. In addition, the bill generally applies to a section 197 intangible that is treated as acquired under section 338 of the Code. The bill generally does not apply to a section 197 intangible that is created by the taxpayer if the intangible is not created in connection with a transaction (or series of related transactions) that involves the acquisition of a trade or business or a substantial portion thereof.

Except in the case of amounts paid or incurred under certain covenants not to compete (or under certain other arrangements that have substantially the same effect as covenants not to compete) and certain amounts paid or incurred on account of the transfer of a franchise, trademark, or trade name, the bill generally does not apply to any amount that is otherwise currently deductible (i.e., not capitalized) under present law.

No inference is intended as to whether a depreciation or amortization deduction is allowed under present law with respect to any intangible property that is either included in, or excluded from, the definition of a section 197 intangible. In addition, no inference is intended as to whether an asset is to be considered tangible or intangible property for any other purpose of the Internal Revenue Code.

Definition of section 197 intangible

In general

The term "section 197 intangible" is defined as any property that is included in any one or more of the following categories: (1) goodwill and going concern value; (2) certain specified types of intangible property that generally relate to workforce, information base, know-how, customers, suppliers, or other similar items; (3) any license, permit, or other right granted by a governmental unit or an

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[140] In the case of a short taxable year, the amortization deduction is to be based on the number of months in such taxable year.

agency or instrumentality thereof; (4) any covenant not to compete (or other arrangement to the extent that the arrangement has substantially the same effect as a covenant not to compete) entered into in connection with the direct or indirect acquisition of an interest in a trade or business (or a substantial portion thereof); and (5) any franchise, trademark, or trade name.

Certain types of property, however, are specifically excluded from the definition of the term "section 197 intangible." The term "section 197 intangible" does not include: (1) any interest in a corporation, partnership, trust, or estate; (2) any interest under an existing futures contract, foreign currency contract, notional principal contract, interest rate swap, or other similar financial contract; (3) any interest in land; (4) certain computer software; (5) certain interests in films, sound recordings, video tapes, books, or other similar property; (6) certain rights to receive tangible property or services; (7) certain interests in patents or copyrights; (8) any interest under an existing lease of tangible property; (9) any interest under an existing indebtedness (except for the deposit base and similar items of a financial institution); (10) a franchise to engage in any professional sport, and any item acquired in connection with such a franchise; (11) certain transaction costs; and (12) certain purchased mortgage servicing rights.

Special allocation and amortization rules apply for certain acquired computer software businesses that had made certain computer software expenditures.

In addition, the Treasury Department is authorized to issue regulations that exclude certain rights of fixed duration or amount from the definition of a section 197 intangible.

Goodwill and going concern value

For purposes of the bill, goodwill is the value of a trade or business that is attributable to the expectancy of continued customer patronage, whether due to the name of a trade or business, the reputation of a trade or business, or any other factor.

In addition, for purposes of the bill, going concern value is the additional element of value of a trade or business that attaches to property by reason of its existence as an integral part of a going concern. Going concern value includes the value that is attributable to the ability of a trade or business to continue to function and generate income without interruption notwithstanding a change in ownership. Going concern value also includes the value that is attributable to the use or availability of an acquired trade or business (for example, the net earnings that otherwise would not be received during any period were the acquired trade or business not available or operational).

Under the bill, as is the case for the cost of other acquired amortizable section 197 intangibles, 75 percent of the purchase price that is allocable to goodwill or going concern value is amortized over a 14-year period, and the remaining 25 percent of the purchase price allocable to such assets is not amortizable.

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Workforce, information base, know-how, customer-based intangibles, supplier-based intangibles and other similar items

Workforce.—The term "section 197 intangible" includes workforce in place (which is sometimes referred to as agency force or assembled workforce), the composition of a workforce (for example, the experience, education, or training of a workforce), the terms and conditions of employment whether contractual or otherwise, and any other value placed on employees or any of their attributes. Thus, for example, 75 percent of the portion (if any) of the purchase price of an acquired trade or business that is attributable to the existence of a highly-skilled workforce is to be amortized over the 14-year period specified in the bill. As a further example, 75 percent of the cost of acquiring an existing employment contract (or contracts) or a relationship with employees or consultants (including but not limited to any "key employee" contract or relationship) as part of the acquisition of a trade or business is to be amortized over the 14-year period specified in the bill.

Information base.—The term "section 197 intangible" includes business books and records, operating systems, and any other information base including lists or other information with respect to current or prospective customers (regardless of the method of recording such information). Thus, for example, 75 percent of the portion (if any) of the purchase price of an acquired trade or business that is attributable to the intangible value of technical manuals, training manuals or programs, data files, and accounting or inventory control systems is to be amortized over the 14-year period specified in the bill. As a further example, 75 percent of the cost of acquiring customer lists, subscription lists, insurance expirations,[141] patient or client files, or lists of newspaper, magazine, radio or television advertisers is to be amortized over the 14-year period specified in the bill.

Know-how.—The term "section 197 intangible" includes any patent, copyright, formula, process, design, pattern, know-how, format, or other similar item. For this purpose, the term "section 197 intangible" is to include package designs, computer software, and any interest in a film, sound recording, video tape, book, or other similar property, except as specifically provided otherwise in the bill.[142]

Customer-based intangibles.—The term "section 197 intangible" includes any customer-based intangible, which is defined as the composition of market, market share, and any other value resulting from the future provision of goods or services pursuant to relationships with customers (contractual or otherwise) in the ordinary course of business. Thus, for example, 75 percent of the portion (if any) of the purchase price of an acquired trade or business that is attributable to the existence of customer base, circulation base, undeveloped market or market growth, insurance in force, mortgage servicing contracts[143], investment management contracts, or other

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[141] Insurance expirations are records that are maintained by insurance agents with respect to insurance customers. These records generally include information relating to the type of insurance, the amount of insurance, and the expiration date of the insurance.

[142] See below for a description of the exceptions for certain patents, certain computer software, and certain interests in films, sound recordings, video tapes, books, or other similar property.

[143] Certain purchased mortgage servicing rights are excluded from the definition of a section 197 intangible under special rules described below.

relationships with customers that involve the future provision of goods or services, is to be amortized over the 14-year period specified in the bill. On the other hand, the portion (if any) of the purchase price of an acquired trade or business that is attributable to accounts receivable or other similar rights to income for those goods or services that have been provided to customers prior to the acquisition of a trade or business is not to be taken into account under the bill.[144]

In addition, the bill specifically provides that the term "customer-based intangible" includes the deposit base and any similar asset of a financial institution. Thus, for example, 75 percent of the portion (if any) of the purchase price of an acquired financial institution that is attributable to the checking accounts, savings accounts, escrow accounts and other similar items of the financial institution is to be amortized over the 14-year period specified in the bill.

Supplier-based intangibles.—The term "section 197 intangible" includes any supplier-based intangible, which is defined as the value resulting from the future acquisition of goods or services pursuant to relationships (contractual or otherwise) in the ordinary course of business with suppliers of goods or services to be used or sold by the taxpayer. Thus, for example, 75 percent of the portion (if any) of the purchase price of an acquired trade or business that is attributable to the existence of a favorable relationship with persons that provide distribution services (for example, favorable shelf or display space at a retail outlet), the existence of a favorable credit rating, or the existence of favorable supply contracts, is to be amortized over the 14-year period specified in the bill.[145]

Other similar items.—The term "section 197 intangible" also includes any other intangible property that is similar to workforce, information base, know-how, customer-based intangibles, or supplier-based intangibles.

Licenses, permits, and other rights granted by governmental units

The term "section 197 intangible" also includes any license, permit, or other right granted by a governmental unit or any agency or instrumentality thereof (even if the right is granted for an indefinite period or the right is reasonably expected to be renewed for an indefinite period).[146] Thus, for example, 75 percent of the capitalized cost of acquiring from any person a liquor license, a taxi-cab medallion (or license), an airport landing or takeoff right (which is sometimes referred to as a slot), a regulated airline route, or a television or radio broadcasting license is to be amortized over the 14-year period specified in the bill. For purposes of the bill, the issuance or renewal of a license, permit, or other right granted by

[144] As under present law, the portion of the purchase price of an acquired trade or business that is attributable to accounts receivable is to be allocated among such receivables and is to be taken into account as payment is received under each receivable or at the time that a receivable becomes worthless.

[145] See below, however, for a description of the exception for certain rights to receive tangible property or services from another person.

[146] A right granted by a governmental unit or an agency or instrumentality thereof that constitutes an interest in land or an interest under a lease of tangible property is excluded from the definition of a section 197 intangible. See below for a description of the exceptions for interests in land and for interests under leases of tangible property.

a governmental unit or an agency or instrumentality thereof is to be considered an acquisition of such license, permit, or other right.

Covenants not to compete and other similar arrangements

The term "section 197 intangible" also includes any covenant not to compete (or other arrangement to the extent that the arrangement has substantially the same effect as a covenant not to compete; hereafter "other similar arrangement") entered into in connection with the direct or indirect acquisition of an interest in a trade or business (or a substantial portion thereof). For this purpose, an interest in a trade or business includes not only the assets of a trade or business, but also stock in a corporation that is engaged in a trade or business or an interest in a partnership that is engaged in a trade or business.

Any amount that is paid or incurred under a covenant not to compete (or other similar arrangement) entered into in connection with the direct or indirect acquisition of an interest in a trade or business (or a substantial portion thereof) is chargeable to capital account and 75 percent of such amount is to be amortized ratably over the 14-year period specified in the bill. As in the case of other section 197 intangibles, the remaining 25 percent is not amortizable. In addition, 75 percent of any amount that is paid or incurred under a covenant not to compete (or other similar arrangement) after the taxable year in which the covenant (or other similar arrangement) was entered into is to be amortized ratably over the remaining months in the 14-year amortization period that applies to the covenant (or other similar arrangement) as of the beginning of the month that the amount is paid or incurred; the remaining 25 percent is not amortizable.

For purposes of this provision, an arrangement that requires the former owner of an interest in a trade or business to continue to perform services (or to provide property or the use of property) that benefit the trade or business is considered to have substantially the same effect as a covenant not to compete to the extent that the amount paid to the former owner under the arrangement exceeds the amount that represents reasonable compensation for the services actually rendered (or for the property or use of property actually provided) by the former owner. As under present law, to the extent that the amount paid or incurred under a covenant not to compete (or other similar arrangement) represents additional consideration for the acquisition of stock in a corporation, such amount is not to be taken into account under this provision but, instead, is to be included as part of the acquirer's basis in the stock.

Franchises, trademarks, and trade names

The term "section 197 intangible" also includes any franchise, trademark, or trade name. For this purpose, the term "franchise" is defined, as under present law, to include any agreement that provides one of the parties to the agreement the right to distribute, sell, or provide goods, services, or facilities, within a specified area.[147] In addition, as provided under present law, the renewal of

[147] Section 1253(b)(1) of the Code.

a franchise, trademark, or trade name is to be treated as an acquisition of such franchise, trademark, or trade name.[148]

The bill continues the present-law treatment of certain contingent amounts that are paid or incurred on account of the transfer of a franchise, trademark, or trade name. Under these rules, a deduction is allowed for amounts that are contingent on the productivity, use, or disposition of a franchise, trademark, or trade name only if (1) the contingent amounts are paid as part of a series of payments that are payable at least annually throughout the term of the transfer agreement, and (2) the payments are substantially equal in amount or payable under a fixed formula.[149] Any other amount, whether fixed or contingent, that is paid or incurred on account of the transfer of a franchise, trademark, or trade name is chargeable to capital account and 75 percent is to be amortized ratably over the 14-year period specified in the bill.

Exceptions to the definition of a section 197 intangible

In general.—The bill contains several exceptions to the definition of the term "section 197 intangible." Several of the exceptions contained in the bill apply only if the intangible property is not acquired in a transaction (or series of related transactions) that involves the acquisition of assets which constitute a trade or business or a substantial portion of a trade or business. It is anticipated that the Treasury Department will exercise its regulatory authority to require any intangible property that would otherwise be excluded from the definition of the term "section 197 intangible" to be taken into account under the bill under circumstances where the acquisition of the intangible property is, in and of itself, the acquisition of an asset which constitutes a trade or business or a substantial portion of a trade or business.

The determination of whether acquired assets constitute a substantial portion of a trade or business is to be based on all of the facts and circumstances, including the nature and the amount of the assets acquired as well as the nature and amount of the assets retained by the transferor. It is not intended, however, that the value of the assets acquired relative to the value of the assets retained by the transferor is determinative of whether the acquired assets constitute a substantial portion of a trade or business.

For purposes of the bill, a group of assets is to constitute a trade or business if the use of such assets would constitute a trade or business for purposes of section 1060 of the Code (i.e., if the assets are of such a character that goodwill or going concern value could under any circumstances attach to the assets). In addition, the acquisition of a franchise, trademark or trade name is to constitute the acquisition of a trade or business or a substantial portion of a trade or business.

In determining whether a taxpayer has acquired an intangible asset in a transaction (or series of related transactions) that in-

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[148] Only the 75 percent of costs incurred in connection with the renewal, however, is to be amortized over the 14-year period that begins with the month that the franchise, trademark, or trade name is renewed. The amortizable portion of any costs incurred in connection with the issuance (or an earlier renewal) of a franchise, trademark, or trade name is to continue to be taken into account over the remaining portion of the amortization period that began at the time of such issuance (or earlier renewal).

[149] Section 1253(d)(1) of the Code.

volves the acquisition of assets that constitute a trade or business or a substantial portion of a trade or business, only those assets acquired in a transaction (or a series of related transactions) by a taxpayer (and persons related to the taxpayer) from the same person (and any related person) are to be taken into account. In addition, any employee relationships that continue (or covenants not to compete that are entered into) as part of the transfer of assets are to be taken into account in determining whether the transferred assets constitute a trade or business or a substantial portion of a trade or business.

Interests in a corporation, partnership, trust, or estate.—The term "section 197 intangible" does not include any interest in a corporation, partnership, trust, or estate. Thus, for example, the bill does not apply to the cost of acquiring stock, partnership interests, or interests in a trust or estate, whether or not such interests are regularly traded on an established market.[150]

Interests under certain financial contracts.—The term "section 197 intangible" does not include any interest under an existing futures contract, foreign currency contract, notional principal contract, interest rate swap, or other similar financial contract, whether or not such interest is regularly traded on an established market. Any interest under a mortgage servicing contract,[151] credit card servicing contract or other contract to service indebtedness issued by another person, and any interest under an assumption reinsurance contract[152] is not excluded from the definition of the term "section 197 intangible" by reason of the exception for interests under certain financial contracts.

Interests in land.—The term "section 197 intangible" does not include any interest in land. Thus, the cost of acquiring an interest in land is to be taken into account under present law rather than under the bill. For this purpose, an interest in land includes a fee interest, life estate, remainder, easement, mineral rights, timber rights, grazing rights, riparian rights, air rights, zoning variances, and any other similar rights with respect to land. An interest in land is not to include an airport landing or takeoff right, a regulated airline route, or a franchise to provide cable television services.

The costs of acquiring licenses, permits, and other rights relating to improvements to land, such as building construction or use permits, are to be taken into account in the same manner as the underlying improvement in accordance with present law.

Certain computer software.—The term "section 197 intangible" does not include computer software (whether acquired as part of a trade or business or otherwise) that (1) is readily available for purchase by the general public; (2) is subject to a non-exclusive license; and (3) has not been substantially modified. In addition, the term "section 197 intangible" does not include computer software which is not acquired in a transaction (or a series of related transactions)

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[150] A temporal interest in property, outright or in trust, may not be used to convert a section 197 intangible into property that is amortizable more rapidly than would be permitted under the 75-percent, 14-year rule specified in the bill.

[151] Certain purchased mortgage servicing rights are excluded from the definition of a section 197 intangible under special rules described below.

[152] See below for a description of the treatment of assumption reinsurance contracts.

that involves the acquisition of assets which constitute a trade or business or a substantial portion of a trade or business.

For purposes of the bill, the term "computer software" is defined as any program (i.e., any sequence of machine-readable code) that is designed to cause a computer to perform a desired function. The term "computer software" includes any incidental and ancillary rights with respect to computer software that (1) are necessary to effect the legal acquisition of the title to, and the ownership of, the computer software, and (2) are used only in connection with the computer software. The term "computer software" does not include any data base or similar item (other than a data base or item that is in the public domain and that is incidental to the software)[153] regardless of the form in which it is maintained or stored.

If a depreciation deduction is allowed with respect to any computer software that is not a section 197 intangible, the amount of the deduction is to be determined by amortizing the adjusted basis of the computer software ratably over a 36-month period that begins with the month that the computer software is placed in service. For this purpose, the cost of any computer software that is taken into account as part of the cost of computer hardware or other tangible property under present law is to continue to be taken into account in such manner under the bill. In addition, the cost of any computer software that is currently deductible (*i.e.*, not capitalized) under present law is to continue to be taken into account in such manner under the bill.

Certain interests in films, sound recordings, video tapes, books, or other similar property.—The term "section 197 intangible" does not include any interest (including an interest as a licensee) in a film, sound recording, video tape, book, or other similar property (including the right to broadcast or transmit a live event) if the interest is not acquired in a transaction (or a series of related transactions) that involves the acquisition of assets which constitute a trade or business or a substantial portion of a trade or business.

Certain rights to receive tangible property or services.—The term "section 197 intangible" does not include any right to receive tangible property or services under a contract (or any right to receive tangible property or services granted by a governmental unit or an agency or instrumentality thereof) if the right is not acquired in a transaction (or a series of related transactions) that involves the acquisition of assets which constitute a trade or business or a substantial portion of a trade or business.

If a depreciation deduction is allowed with respect to a right to receive tangible property or services that is not a section 197 intangible, the amount of the deduction is to be determined in accordance with regulations to be promulgated by the Treasury Department. It is anticipated that the regulations may provide that in the case of an amortizable right to receive tangible property or services in substantially equal amounts over a fixed period that is not renewable, the cost of acquiring the right will be taken into account ratably over such fixed period. It is also anticipated that the regulations may provide that in the case of a right to receive a fixed

[153] For example, a data base would not include a dictionary feature used to spell-check a word processing program.

amount of tangible property or services over an unspecified period, the cost of acquiring such right will be taken into account under a method that allows a deduction based on the amount of tangible property or services received during a taxable year compared to the total amount of tangible property or services to be received.

For example, assume that a taxpayer acquires from another person a favorable contract right of such person to receive a specified amount of raw materials each month for the next three years (which is the remaining life of the contract) and that the right to receive such raw materials is not acquired as part of the acquisition of assets that constitute a trade or business or a substantial portion thereof (i.e., such contract right is not a section 197 intangible). It is anticipated that the taxpayer may be required to amortize the cost of acquiring the contract right ratably over the three-year remaining life of the contract. Alternatively, if the favorable contract right is to receive a specified amount of raw materials during an unspecified period, it is anticipated that the taxpayer may be required to amortize the cost of acquiring the contract right by multiplying such cost by a fraction, the numerator of which is the amount of raw materials received under the contract during any taxable year and the denominator of which is the total amount of raw materials to be received under the contract.

It is also anticipated that the regulations may require a taxpayer under appropriate circumstances to amortize the cost of acquiring a renewable right to receive tangible property or services over a period that includes all renewal options exercisable by the taxpayer at less than fair market value.

Certain interests in patents or copyrights.—The term "section 197 intangible" does not include any interest in a patent or copyright which is not acquired in a transaction (or a series of related transactions) that involves the acquisition of assets which constitute a trade or business or a substantial portion of a trade or business.

If a depreciation deduction is allowed with respect to an interest in a patent or copyright and the interest is not a section 197 intangible, then the amount of the deduction is to be determined in accordance with regulations to be promulgated by the Treasury Department. It is expected that the regulations may provide that if the purchase price of a patent is payable on an annual basis as a fixed percentage of the revenue derived from the use of the patent, then the amount of the depreciation deduction allowed for any taxable year with respect to the patent equals the amount of the royalty paid or incurred during such year.[154]

Interests under leases of tangible property.—The term "section 197 intangible" does not include any interest as a lessor or lessee under an existing lease of tangible property (whether real or personal).[155] The cost of acquiring an interest as a lessor under a lease of tangible property where the interest as lessor is acquired in connection with the acquisition of the tangible property is to be taken into account as part of the cost of the tangible property. For example, if a taxpayer acquires a shopping center that is leased to ten-

[154] See *Associated Patentees, Inc.*, 4 T.C. 979 (1945); and Rev. Rul. 67-136, 1967-1 C.B. 58.

[155] The bill provides that a sublease is to be treated in the same manner as a lease of the underlying property. Thus, the term "section 197 intangible" does not include any interest as a sublessor or sublessee of tangible property.

ants operating retail stores, the portion (if any) of the purchase price of the shopping center that is attributable to the favorable attributes of the leases is to be taken into account as a part of the basis of the shopping center and is to be taken into account in determining the depreciation deduction allowed with respect to the shopping center.

The cost of acquiring an interest as a lessee under an existing lease of tangible property is to be taken into account under present law (see section 178 of the Code and Treas. Reg. sec. 1.162-11(a)) rather than under the provisions of the bill.[156] In the case of any interest as a lessee under a lease of tangible property that is acquired with any other intangible property (either in the same transaction or series of related transactions), however, the portion of the total purchase price that is allocable to the interest as a lessee is not to exceed the excess of (1) the present value of the fair market value rent for the use of the tangible property for the term of the lease,[157] over (2) the present value of the rent reasonably expected to be paid for the use of the tangible property for the term of the lease.

Interests under indebtedness.—The term "section 197 intangible" does not include any interest (whether as a creditor or debtor) under any indebtedness that was in existence on the date that the interest was acquired.[158] Thus, for example, the value of assuming an existing indebtedness with a below-market interest rate is to be taken into account under present law rather than under the bill. In addition, the premium paid for acquiring the right to receive an above-market rate of interest under a debt instrument may be taken into account under section 171 of the Code, which generally allows the amount of the premium to be amortized on a yield-to-maturity basis over the remaining term of the debt instrument. This exception for interests under existing indebtedness does not apply to the deposit base and other similar items of a financial institution.

Professional sports franchises.—The term "section 197 intangible" does not include a franchise to engage in professional baseball, basketball, football, or other professional sport, and any item acquired in connection with such a franchise. Consequently, the cost of acquiring a professional sports franchise and related assets (including any goodwill, going concern value, or other section 197 intangibles) is to be allocated among the assets acquired as provided under present law (see, for example, section 1056 of the Code) and is to be taken into account under the provisions of present law.

Certain transaction costs.—The term section 197 intangible does not include the amount of any fees for professional services, and any transaction costs, incurred by parties to a transaction with re-

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[156] The lease of a gate at an airport for the purpose of loading and unloading passengers and cargo is a lease of tangible property for this purpose. It is anticipated that such treatment will serve as guidance to the Internal Revenue Service and taxpayers in resolving existing disputes.

[157] In no event is the present value of the fair market value rent for the use of the tangible property for the term of the lease to exceed the fair market value of the tangible property as of the date of acquisition. The present value of such rent is presumed to be less than the value of the tangible property if the duration of the lease is less than the economic useful life of the property.

[158] For purposes of this exception, the term "interest under any existing indebtedness" is to include mortgage servicing rights to the extent that the rights are stripped coupons under section 1286 of the Code. See Rev. Rul. 91-46, 1991-2 C.B. 358.

spect to which any portion of the gain or loss is not recognized under part III of subchapter C. This provision addresses a concern that some taxpayers might attempt to contend that the 14-year amortization provided by the provision applies to a portion of any such amounts that may be required to be capitalized under present law but that do not relate to any asset with a readily identifiable useful life.[159] The exception is provided solely to clarify that section 197 is not to be construed to provide 14-year amortization for a portion of any such amounts. No inference is intended that such amounts would (but for this provision) be properly characterized as amounts eligible for such 14-year amortization, nor is any inference intended that any amounts not specified in this provision should be so characterized. In addition, no inference is intended regarding the proper treatment of professional fees or transaction costs in other circumstances under present law.

Purchased mortgage servicing rights.— The term "section 197 intangible" does not include any right to service indebtedness that is secured by residential real property (a "purchased mortgage servicing right"), unless such right is acquired in a transaction (or series of related transactions) involving the acquisition of assets (other than such right or other such purchased mortgage servicing rights) constituting a trade or business or a substantial portion of a trade or business.

Any such rights that are excluded from the definition of a section 197 intangible shall be amortized on a straight line basis over a period of 9 years (108 months).

Regulatory authority regarding rights of fixed term or duration.— The bill authorizes the Treasury Department to issue regulations that exclude a right received under a contract, or granted by a governmental unit or an agency or instrumentality thereof, from the definition of a section 197 intangible if (1) the right is not acquired in a transaction (or a series of related transactions) that involves the acquisition of assets which constitute a trade or business (or a substantial portion thereof) and (2) the right either (A) has a fixed duration of less than 14 years or (B) is fixed as to amount[160] and the cost is properly recoverable (without regard to this provision) under a method similar to the unit of production method.

Generally, it is anticipated that the mere fact that a taxpayer will have the opportunity to renew a contract or other right on the same terms as are available to others, in a competitive auction or similar process that is designed to reflect fair market value and in which the taxpayer is not contractually advantaged, will not be taken into account in determining the duration of such right or whether it is for a fixed amount. However, the fact that competitive bidding occurs at the time of renewal and that there are or may be modifications in price (or in terms or requirements relating to the right that increase the cost to the bidder) shall not be within the scope of the preceding sentence unless the bidding also actually

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[159] See, e.g., *INDOPCO, Inc. v. Commissioner*, 112 S. Ct. 1039 (1992).

[160] For example, an emission allowance granted a public utility under Title IV of the Clean Air Act Amendments of 1990 is a right that is limited in amount within the meaning of this provision, because each allowance grants a right to a fixed amount of emissions. It is expected that the Treasury Department will provide guidance regarding the interaction of section 461 with these provisions. No inference is intended that would require the Treasury Department to disturb the result in Rev. Proc. 92-91, 1992-46 I.R.B. 32.

produces a fair market value price comparable to the price that would obtain if the rights were purchased immediately after renewal from a person (other than the person granting the renewal) in an arm's length transaction. Furthermore, it is expected that, as under present law, the Treasury Department will take into account all the facts and circumstances, including any facts indicating an actual practice of renewals or expectancy of renewals.

For example, assume Company A enters into a license with Company B to use certain know-how developed by B. In addition, assume that the license is for five years, that the license cannot be renewed by A except on terms that are fully available to A's competitors and that the price paid by A will reflect the arm's length price that a third party would pay A for the license immediately after renewal. Finally, assume that the license does not constitute a substantial portion of a trade or business and is not entered into as part of a transaction (or series of related transactions) that constitute the acquisition of a trade or business or substantial portion thereof. It is anticipated that in these circumstances the regulations will provide that the license is not a section 197 intangible because it is of fixed duration.

The regulations may also prescribe rules governing the extent to which renewal options and similar items will be taken into account for the purpose of determining whether rights are fixed in duration or amount. It is also anticipated that such regulations may prescribe the appropriate method of amortizing the capitalized costs of rights which are excluded by such regulations from the definition of a section 197 intangible.

Special rules for acquisitions of certain computer software businesses

The bill provides a special rule for certain acquisitions of computer software businesses that had made certain computer software expenditures. For these acquisitions, 50 percent of the amortizable basis of all section 197 intangibles (i.e., 50 percent of the amortizable 75 percent of basis) is amortized over 60 months on a straight line basis. The other 50 percent is amortized over 14 years pursuant to the general treatment under the bill. An acquisition qualifies for this treatment if the principal business activity of the acquired business is computer software development; computer software sales, licensing, or leasing; the provision of computer software services; or a combination of these; and a five-year test is met. Under this test, for the five years ending with the acquisition date for the acquisition transaction (or series of related transactions), the total of (a) computer software development costs of the acquired business that qualify as research and experimentation expenditures under section 174, plus (b) the amortization deductions of the trade or business with respect to computer software that was not acquired in a transaction (or series of related transactions) involving the acquisition of a trade or business or substantial portion thereof, must equal at least 17 percent of the greater of (i) total gross receipts, or (ii) total expenditures of the acquired business (including for this purpose capitalized amounts).

The Treasury Department shall exercise its general authority under the provision to prevent manipulation of receipts, expendi-

tures, or any other factor, in a manner to avoid the purpose of this rule, and to prevent the use of any qualifying business as a conduit for the transfer of assets that are not principally computer software. As one example, it is expected that the benefits of 60-month amortization shall not apply to any asset of the acquired business that was acquired by the business with a basis determined in whole or in part by reference to the basis in the hands of the person from whom acquired, if a principal purpose of the transfer of such asset was to secure the benefits of the special 60-month amortization.

Exception for certain self-created intangibles

The bill generally does not apply to any section 197 intangible that is created by the taxpayer if the section 197 intangible is not created in connection with a transaction (or a series of related transactions) that involves the acquisition of assets which constitute a trade or business or a substantial portion thereof.

For purposes of this exception, a section 197 intangible that is owned by a taxpayer is to be considered created by the taxpayer if the intangible is produced for the taxpayer by another person under a contract with the taxpayer that is entered into prior to the production of the intangible. For example, a technological process or other know-how that is developed specifically for a taxpayer under an arrangement with another person pursuant to which the taxpayer retains all rights to the process or know-how is to be considered created by the taxpayer.

The exception for "self-created" intangibles does not apply to the entering into (or renewal of) a contract for the use of a section 197 intangible. Thus, for example, the exception does not apply to the capitalized costs incurred by a licensee in connection with the entering into (or renewal of) a contract for the use of know-how or other section 197 intangible. Seventy-five percent of these capitalized costs are to be amortized over the 14-year period specified in the bill.

In addition, the exception for "self-created" intangibles does not apply to: (1) any license, permit, or other right that is granted by a governmental unit or an agency or instrumentality thereof; (2) any covenant not to compete (or other similar arrangement) entered into in connection with the direct or indirect acquisition of an interest in a trade or business (or a substantial portion thereof); and (3) any franchise, trademark, or trade name. Thus, for example, 75 percent of the capitalized costs incurred in connection with the development or registration of a trademark or trade name are to be amortized over the 14-year period specified in the bill.

Special rules

Determination of adjusted basis

The adjusted basis of a section 197 intangible that is acquired from another person generally is to be determined under the principles of present law that apply to tangible property that is acquired from another person. Thus, for example, if a portion of the cost of acquiring an amortizable section 197 intangible is contingent, the adjusted basis of the section 197 intangible is to be in-

creased as of the beginning of the month that the contingent amount is paid or incurred. Seventy-five percent of this additional amount is to be amortized ratably over the remaining months in the 14-year amortization period that applies to the intangible as of the beginning of the month that the contingent amount is paid or incurred.

Treatment of certain dispositions of amortizable section 197 intangibles

Special rules apply if a taxpayer disposes of a section 197 intangible that was acquired in a transaction or series of related transactions and, after the disposition,[161] the taxpayer retains other section 197 intangibles that were acquired in such transaction or series or related transactions.[162] First, no loss is to be recognized by reason of such a disposition. Second, the adjusted bases of the retained section 197 intangibles that were acquired in connection with such transaction or series of related transactions are to be increased by the amount of any loss that is not recognized. The adjusted basis of any such retained section 197 intangible is increased by the product of (1) the amount of the loss that is not recognized solely by reason of this provision, and (2) a fraction, the numerator of which is the adjusted basis of the intangible as of the date of the disposition and the denominator of which is the total adjusted bases of all such retained section 197 intangibles as of the date of the disposition.

For purposes of these rules, all persons treated as a single taxpayer under section 41(f)(1) of the Code are treated as a single taxpayer. Thus, for example, a loss is not to be recognized by a corporation upon the disposition of a section 197 intangible if after the disposition a member of the same controlled group as the corporation retains other section 197 intangibles that were acquired in the same transaction (or a series of related transactions) as the section 197 intangible that was disposed of. It is anticipated that the Treasury Department will provide rules for taking into account the amount of any loss that is not recognized due to this rule (for example, by allowing the corporation that disposed of the section 197 intangible to amortize an appropriate portion of the loss over the remaining portion of the 14-year amortization period and to allocate an appropriate portion of the loss to nonamortizable basis).

Treatment of certain nonrecognition transactions

If any section 197 intangible is acquired in a transaction to which section 332, 351, 361, 721, 731, 1031, or 1033 of the Code applies (or any transaction between members of the same affiliated

[161] For this purpose, the abandonment of a section 197 intangible or any other event that renders a section 197 intangible worthless is to be considered a disposition of a section 197 intangible.

[162] These special rules do not apply to a section 197 intangible that is separately acquired (i.e., a section 197 intangible that is acquired other than in a transaction or a series of related transactions that involve the acquisition of other section 197 intangibles). Consequently, a loss may be recognized upon the disposition of a separately acquired section 197 intangible. In no event, however, is the termination or worthlessness of a portion of a section 197 intangible to be considered the disposition of a separately acquired section 197 intangible. For example, the termination of one or more customers from an acquired customer list or the worthlessness of some information from an acquired data base is not to be considered the disposition of a separately acquired section 197 intangible.

group during any taxable year for which a consolidated return is filed),[163] the transferee is to be treated as the transferor for purposes of applying this provision with respect to the amount of the adjusted basis of the transferee that does not exceed the adjusted basis of the transferor.

For example, assume that an individual owns an amortizable section 197 intangible that has been amortized under section 197 for 4 full years and has a remaining unamortized but amortizable basis of $300,000. In addition, assume that the individual exchanges the asset and $100,000 for a like-kind amortizable section 197 intangible in a transaction to which section 1031 applies. Under the bill, $300,000 of the basis of the acquired amortizable section 197 intangible is to be amortized over the 10 years remaining in the original 14-year amortization period for the transferred asset and 75 percent of the other $100,000 of basis is to be amortized over the 14-year period specified in the bill.[164]

Treatment of certain partnership transactions

Generally, consistent with the rules described above for certain nonrecognition transactions, a transaction in which a taxpayer acquires an interest in an intangible held through a partnership (either before or after the transaction) will be treated as an acquisition to which the bill applies only if, and to the extent that, the acquiring taxpayer obtains, as a result of the transaction, an increased basis for such intangible.[165]

For example, assume that A, B and C each contribute $700 for equal shares in partnership P, which on January 1, 1994, acquires as its sole asset an amortizable section 197 intangible for $2,100. Under the bill, 75 percent of this amount ($1,575) is amortizable over 14 years; the remaining 25 percent ($525) is not amortizable. Assume that on January 1, 1998, (1) the sole asset of P is the intangible acquired in 1994, (2) the intangible has an unamortized basis of $1,650 (of which $1,125 is amortizable) and A, B, and C each have a basis of $550 in their partnership interests, and (3) D (who is not related to A, B, or C) acquires A's interest in P for $800. Under the bill, if there is no section 754 election in effect for 1998, there will be no change in the basis or amortization of the intangible and D will merely step into the shoes of A with respect to the intangible. D's share of the basis in the intangible will be $550, $375 of which is amortizable and will be amortized over the 10 years remaining in the amortization period for the intangible.

On the other hand, if a section 754 election is in effect for 1998, then D will be treated as having an $800 basis for its share of P's intangible. Under section 197, D's share of income and loss will be determined as if P owns two intangible assets. D will be treated as having a basis of $550 in one asset, $375 of which is amortizable and will continue to be amortized over the 10 remaining years of

[163] The termination of a partnership under section 708(b)(1)(B) of the Code is a transaction to which this rule applies. In such a case, the bill applies only to the extent that the adjusted basis of the section 197 intangibles before the termination exceeds the adjusted basis of the section 197 intangibles after the termination. (See the example below in the discussion of "Treatment of certain partnership transactions.")

[164] No inference is intended whether any asset treated as a section 197 intangible under the bill is eligible for like kind exchange treatment.

[165] This discussion is subject to the application of the anti-churning rules which are discussed below.

the original 14-year life. With respect to the other asset, D will be treated as having a basis of $250 (the amount of step-up obtained by D under section 743 as a result of the section 754 election) 75 percent of which ($187.50) will be amortized over a 14-year period starting with January of 1998. B and C will each continue to share equally in a $1,100 basis in the intangible and amortize $750 of that amount ($375 each) over the remaining 10-year life.

As an additional example, assume the same facts as described above, except that D acquires both A's and B's interests in P for $1,600. Under section 708, the transaction is treated as if P is liquidated immediately after the transfer, with C and D each receiving their pro rata share of P's assets which they then immediately contribute to a new partnership. The distributions in liquidation are governed by section 731. Under the bill, C's interest in the intangible will be treated as having a $550 basis, of which $375 is amortizable with a remaining amortization period of 10 years. D will be treated as having an interest in two assets: one with a basis of $1,100 of which $750 is amortizable with a remaining amortization period of 10 years, and the other with a basis of $500, of which 75 percent ($375) will be amortizable and will have a new amortization period of 14 years.

As discussed more fully below, the bill also changes the treatment of payments made in liquidation of the interest of a deceased or retired partner in exchange for goodwill. Except in the case of payments made on the retirement or death of a general partner of a partnership for which capital is not a material income-producing factor, such payments will not be treated as a distribution of partnership income. Under the bill, however, if the partnership makes an election under section 754, section 734 will generally provide the partnership the benefit of a stepped-up basis for the retiring or deceased partner's share of partnership goodwill and an amortization deduction for the increase in basis under section 197.

For example, using the facts from the preceding examples, assume that on January 1, 1998, A retires from the partnership in exchange for a payment from the partnership of $800, all of which is in exchange for A's interest in the intangible asset owned by P. Under the bill, if there is a section 754 election in effect for 1998, P will be treated as having two amortizable section 197 intangibles: one with a basis of $1,650, of which $1,125 is amortizable with a remaining life of 10 years, and the other with a basis of $250, of which 75 percent ($187.50) is amortizable over a new life of 14 years.

Treatment of certain reinsurance transactions

The bill applies to any insurance contract that is acquired from another person through an assumption reinsurance transaction (but not through an indemnity reinsurance transaction).[166] The amount taken into account as the adjusted basis of such a section 197 intangible, however, is to equal the excess of (1) the amount

[166] An assumption reinsurance transaction is an arrangement whereby one insurance company (the reinsurer) becomes solely liable to policyholders on contracts transferred by another insurance company (the ceding company). In addition, for purposes of the bill, an assumption reinsurance transaction is to include any acquisition of an insurance contract that is treated as occurring by reason of an election under section 338 of the Code.

paid or incurred by the acquirer/reinsurer under the assumption reinsurance transaction,[167] over (2) the amount of the specified policy acquisition expenses (as determined under section 848 of the Code) that is attributable to premiums received under the assumption reinsurance transaction. The amount of the specified policy acquisition expenses of an insurance company that is attributable to premiums received under an assumption reinsurance transaction is to be amortized over the period specified in section 848 of the Code.

Treatment of amortizable section 197 intangible as depreciable property

For purposes of chapter 1 of the Internal Revenue Code, an amortizable section 197 intangible is to be treated as property of a character which is subject to the allowance for depreciation provided in section 167. Thus, for example, an amortizable section 197 intangible is not a capital asset for purposes of section 1221 of the Code, but an amortizable section 197 intangible held for more than one year generally qualifies as property used in a trade or business for purposes of section 1231 of the Code. As further examples, an amortizable section 197 intangible is to constitute section 1245 property, and section 1239 of the Code is to apply to any gain recognized upon the sale or exchange of an amortizable section 197 intangible, directly or indirectly, between related persons.

Treatment of certain amounts that are properly taken intoaccount in determining the cost of property that is not a section 197 intangible

The bill does not apply to any amount that is properly taken into account under present law in determining the cost of property that is not a section 197 intangible. Thus, for example, no portion of the cost of acquiring real property that is held for the production of rental income (for example, an office building, apartment building or shopping center) is to be taken into account under the bill (i.e., no goodwill, going concern value or any other section 197 intangible is to arise in connection with the acquisition of such real property). Instead, the entire cost of acquiring such real property is to be included in the basis of the real property and is to be recovered under the principles of present law applicable to such property.

Modification of purchase price allocation and reporting rules for certain asset acquisitions

Sections 338(b)(5) and 1060 of the Code authorize the Treasury Department to promulgate regulations that provide for the allocation of purchase price among assets in the case of certain asset acquisitions. Under regulations that have been promulgated pursuant to this authority, the purchase price of an acquired trade or business must be allocated among the assets of the trade or business using the "residual method."

Under the residual method specified in the Treasury regulations, all assets of an acquired trade or business are divided into the following four classes: (1) Class I assets, which generally include cash

[167] The amount paid or incurred by the acquirer/reinsurer under an assumption reinsurance transaction is to be determined under the principles of present law. (See Treas. Reg. sec. 1.817-4(d)(2).)

and cash equivalents; (2) Class II assets, which generally include certificates of deposit, U.S. government securities, readily marketable stock or securities, and foreign currency; (3) Class III assets, which generally include all assets other than those included in Class I, II, or IV (generally all furniture, fixtures, land, buildings, equipment, other tangible property, accounts receivable, covenants not to compete, and other amortizable intangible assets); and (4) Class IV assets, which include intangible assets in the nature of goodwill or going concern value. The purchase price of an acquired trade or business (as first reduced by the amount of the assets included in Class I) is allocated to the assets included in Class II and Class III based on the value of the assets included in each class. To the extent that the purchase price (as reduced by the amount of the assets in Class I) exceeds the value of the assets included in Class II and Class III, the excess is allocable to assets included in Class IV.

It is expected that the present Treasury regulations which provide for the allocation of purchase price in the case of certain asset acquisitions will be amended to reflect the fact that the bill allows an amortization deduction with respect to intangible assets in the nature of goodwill and going concern value. It is anticipated that the residual method specified in the regulations will be modified to treat all amortizable section 197 intangibles as Class IV assets and that this modification will apply to any acquisition of property to which the bill applies.

Section 1060 also authorizes the Treasury Department to require the transferor and transferee in certain asset acquisitions to furnish information to the Treasury Department concerning the amount of any purchase price that is allocable to goodwill or going concern value. The bill provides that the information furnished to the Treasury Department with respect to certain asset acquisitions is to specify the amount of purchase price that is allocable to amortizable section 197 intangibles rather than the amount of purchase price that is allocable to goodwill or going concern value. In addition, it is anticipated that the Treasury Department will exercise its existing regulatory authority to require taxpayers to furnish such additional information as may be necessary or appropriate to carry out the provisions of the bill, including the amount of purchase price that is allocable to intangible assets that are not amortizable section 197 intangibles.[168]

General regulatory authority

The Treasury Department is authorized to prescribe such regulations as may be appropriate to carry out the purposes of the bill including such regulations as may be appropriate to prevent avoidance of the purposes of the bill through related persons or otherwise. It is anticipated that the Treasury Department will exercise its regulatory authority where appropriate to clarify the types of intangible property that constitute section 197 intangibles.

The purpose of the provision is to simplify the law regarding the amortization of intangibles. The severe backlog of cases in audit

[168] There is no intention to codify any aspect of the existing regulations under section 1060 or other provisions. Furthermore, it is expected that the Treasury Department will review the operation of the regulations under sections 1060 and 338 in light of new section 197.

and litigation is a matter of great concern, and any principles established in such cases will no longer have precedential value due to the provision. Therefore, the Internal Revenue Service is urged in the strongest possible terms to expedite the settlement of cases under present law. In considering settlements and establishing procedures for handling existing controversies in an expedient and balanced manner, the Internal Revenue Service is strongly encouraged to take into account the principles of the bill so as to produce consistent results for similarly situated taxpayers. However, no inference is intended that any deduction should be allowed in these cases for assets that are not amortizable under present law.

Effective Date

In general

The provision generally applies to property acquired after the date of enactment of the bill. As more fully described below, however, a taxpayer may elect to apply the bill to all property acquired after July 25, 1991. In addition, a taxpayer that does not make this election may elect to apply present law (rather than the provisions of the bill) to property that is acquired after the date of enactment of the bill pursuant to a binding written contract in effect on the date of enactment of the bill and at all times thereafter until the property is acquired. Finally, special "anti-churning" rules may apply to prevent taxpayers from converting existing goodwill, going concern value, or any other section 197 intangible for which a depreciation or amortization deduction would not have been allowable under present law into amortizable property to which the bill applies.

Election to apply bill to property acquired after July 25, 1991

A taxpayer may elect to apply the bill to all property acquired by the taxpayer after July 25, 1991. If a taxpayer makes this election, the bill also applies to all property acquired after July 25, 1991, by any taxpayer that is under common control with the electing taxpayer (within the meaning of subparagraphs (A) and (B) of section 41(f)(1)) of the Code) at any time during the period that began on November 22, 1991, and that ends on the date that the election is made.[169]

The election is to be made at such time and in such manner as may be specified by the Treasury Department,[170] and the election may be revoked only with the consent of the Treasury Department.

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[169] However, with certain exceptions, an amortization deduction is not to be allowed under the bill for goodwill, going concern value, or any other section 197 intangible for which a depreciation or amortization deduction would not be allowable but for the provisions of the bill if: (1) the section 197 intangible is acquired after July 25, 1991; and (2) either (a) the taxpayer or a related person held or used the intangible on July 25, 1991; (b) the taxpayer acquired the intangible from a person that held such intangible on July 25, 1991, and, as part of the transaction, the user of the intangible does not change; or (c) the taxpayer grants the right to use the intangible to a person (or a person related to such person) that held or used the intangible on July 25, 1991. See below for a more detailed description of these "anti-churning" rules.

[170] It is anticipated that the Treasury Department will require the election to be made on the timely filed Federal income tax return of the taxpayer for the taxable year that includes the date of enactment of the bill.

Elective binding contract exception

A taxpayer may also elect to apply present law (rather than the provisions of the bill) to property that is acquired after the date of enactment of the bill if the property is acquired pursuant to a binding written contract that was in effect on the date of enactment of the bill and at all times thereafter until the property is acquired. This election may not be made by any taxpayer that is subject to either of the elections described above that apply the provisions of the bill to property acquired before the date of enactment of the bill.

The election is to be made at such time and in such manner as may be specified by the Treasury Department,[171] and the election may be revoked only with the consent of the Treasury Department.

Anti-churning rules

Special rules are provided by the bill to prevent taxpayers from converting existing goodwill, going concern value, or any other section 197 intangible for which a depreciation or amortization deduction would not have been allowable under present law into amortizable property to which the bill applies.

Under these "anti-churning" rules, goodwill, going concern value, or any other section 197 intangible for which a depreciation or amortization deduction would not be allowable but for the provisions of the bill [172] may not be amortized as an amortizable section 197 intangible if: (1) the section 197 intangible is acquired by a taxpayer after the date of enactment of the bill; and (2) either (a) the taxpayer or a related person held or used the intangible at any time during the period that begins on July 25, 1991, and that ends on the date of enactment of the bill; (b) the taxpayer acquired the intangible from a person that held such intangible at any time during the period that begins on July 25, 1991, and that ends on the date of enactment of the bill and, as part of the transaction, the user of the intangible does not change; or (c) the taxpayer grants the right to use the intangible to a person (or a person related to such person) that held or used the intangible at any time during the period that begins on July 25, 1991, and that ends on the date of enactment of the bill. The anti-churning rules, however, do not apply to the acquisition of any intangible by a taxpayer if the basis of the intangible in the hands of the taxpayer is determined under section 1014(a) (relating to property acquired from a decedent).

For purposes of the anti-churning rules, a person is related to another person if: (1) the person bears a relationship to that person which would be specified in section 267(b)(1) or 707(b)(1) of the Code if those sections were amended by substituting 20 percent for 50 percent; or (2) the persons are engaged in trades or businesses under common control (within the meaning of subparagraphs (A) and (B) of section 41(f)(1) of the Code). A person is treated as relat-

[171] It is anticipated that the Treasury Department will require the election to be made on the timely filed Federal income tax return of the taxpayer for the taxable year that includes the date of enactment of the bill.

[172] Amounts that are properly deductible pursuant to section 1253 under present law are to be treated for purposes of the anti-churning provision as amounts for which depreciation or amortization is allowable under present law.

ed to another person if such relationship exists immediately before or immediately after the acquisition of the intangible involved.

In addition, in determining whether the anti-churning rules apply with respect to any increase in the basis of partnership property under section 732, 734, or 743 of the Code, the determinations are to be made at the partner level and each partner is to be treated as having owned or used the partner's proportionate share of the partnership property. Thus, for example, the anti-churning rules do not apply to any increase in the basis of partnership property that occurs upon the acquisition of an interest in a partnership that has made a section 754 election if the person acquiring the partnership interest is not related to the person selling the partnership interest.[173]

These "anti-churning" rules are not to apply to any section 197 intangible that is acquired from a person with less than a 50-percent relationship to the acquirer to the extent that: (1) the seller recognizes gain on the transaction with respect to such intangible; and (2) the seller agrees, notwithstanding any other provision of the Code, to pay a tax on such gain which, when added to any other Federal income tax imposed on such gain, equals the product of such gain and the highest rate of tax imposed by section 1 or 11 of the Code, whichever is applicable. The seller is treated as satisfying the second requirement if the excess of (1) the total tax liability for the year of the transaction over (2) what its tax liability for such year would have been had the sale of the intangible (but not the remainder of the transaction) been excluded from the computation equals or exceeds the product of the gain on that asset times the relevant maximum rate.

The bill also contains a general anti-abuse rule that applies to any section 197 intangible that is acquired by a taxpayer from another person. Under this rule, a section 197 intangible may not be amortized under the provisions of the bill if the taxpayer acquired the intangible in a transaction one of the principal purposes of which is to (1) avoid the requirement that the intangible be acquired after the date of enactment of the bill or (2) avoid any of the anti-churning rules described above that are applicable to goodwill, going concern value, or any other section 197 intangible for which a depreciation or amortization deduction would not be allowable but for the provisions of the bill.

Finally, the special rules described above that apply in the case of a transactions described in section 332, 351, 361, 721, 731, 1031, or 1033 of the Code also apply for purposes of the effective date. Consequently, if the transferor of any section 197 property is not allowed an amortization deduction with respect to such property under this provision, then the transferee is not allowed an amorti-

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[173] In addition to these rules, it is anticipated that rules similar to the anti-churning rules under section 168 of the Code will apply in determining whether persons are related. (See Prop. Treas. Reg. 1.168-4 (February 16, 1984).) For example, it is anticipated that a corporation, partnership, or trust that owned or used property at any time during the period that begins on July 25, 1991, and that ends on the date of enactment of the bill and that is no longer in existence will be considered to be in existence for purposes of determining whether the taxpayer that acquired the property is related to such corporation, partnership, or trust.

As a further example, it is anticipated that in the case of a transaction to which section 338 of the Code applies, the corporation that is treated as selling its assets will not to be considered related to the corporation that is treated as purchasing the assets if at least 80 percent of the stock of the corporation that is treated as selling its assets is acquired by purchase after July 25, 1991.

zation deduction under this provision to the extent of the adjusted basis of the transferee that does not exceed the adjusted basis of the transferor. In addition, this provision is to apply to any subsequent transfers of any such property in a transaction described in section 332, 351, 361, 721, 731, 1031, or 1033.

2. Modify special treatment of certain liquidation payments (sec. 8262 of the bill and sec. 736 of the Code)

Present Law

Payments for purchase of goodwill and accounts receivable

A current deduction generally is not allowed for a capital expenditure (i.e., an expenditure that yields benefits beyond the current taxable year). The cost of goodwill acquired in connection with the assets of a going concern normally is a capital expenditure, as is the cost of acquiring accounts receivable. The cost of acquiring goodwill is recovered only when the goodwill is disposed of, while the cost of acquiring accounts receivable is taken into account only when the receivable is disposed of or becomes worthless.

Payments made in liquidation of partnership interest

The tax treatment of a payment made in liquidation of the interest of a retiring or deceased partner depends upon whether the payment is made in exchange for the partner's interest in partnership property. A liquidating payment made in exchange for such property is treated as a distribution by the partnership (sec. 736(b)). Such distribution generally results in gain to the retiring partner only to the extent that the cash distributed exceeds such partner's adjusted basis in the partnership interest.

A liquidating payment not made in exchange for the partner's interest in partnership property receives either of two possible treatments. If the amount of the payment is determined without reference to partnership income, it is treated as a guaranteed payment and is generally deductible (sec. 736(a)(2)). If the amount of payment is determined by reference to partnership income, the payment is treated as a distributive share of partnership income, thereby reducing the distributive shares of other partners (which is equivalent to a deduction) (sec. 736(a)(2)).

A special rule treats amounts paid for goodwill of the partnership (except to the extent provided in the partnership agreement) and unrealized receivables as not made in exchange for an interest in partnership property (sec. 736(b)(2)(B)). Thus, such amounts may be deductible. Unrealized receivables include unbilled amounts, accounts receivable, depreciation recapture, market discount, and certain other items (sec. 751(c)).

Sale or exchange of a partnership interest

The sale or exchange of a partnership interest results in capital gain or loss to the transferor partner, except to the extent that ordinary income or loss is recognized with respect to the partner's share of the partnership's unrealized receivables and substantially appreciated inventory items (sec. 741). It is often unclear whether a payment by a partnership to a retiring partner is made in sale or exchange of, or in liquidation of, a partnership interest.

Reasons for Change

In general

By treating a payment for unstated goodwill and unrealized receivables as a guaranteed payment or distributive share, present law in effect permits a deduction for an amount that would otherwise constitute a capital expenditure. This treatment does not measure partnership income properly. It also threatens to erode the rule requiring capitalization of such payments generally. Under present law, a prospective buyer of a business may structure the transaction so as to currently deduct such an amount by first entering into a partnership with the seller and then liquidating the seller's partnership interest.

Section 736 was intended to simplify the taxation of payments in liquidation. Instead, it has created confusion as to whether a particular payment is a payment in liquidation or is made pursuant to a sale of the partnership interest to the continuing partners. The proposal reduces this confusion by eliminating a primary difference between sales and liquidations.

The special treatment of goodwill was apparently predicated on the assumption that the adverse positions of the taxpayers will result in a stated price equal to the true value of the goodwill. That assumption is false. If the value of the preferential rate (if any) and the income deflection are not equal, the stated goodwill and total retirement payments will likely be set so as to maximize the combined tax savings for both retiring and continuing partners.

It is recognized, however, that general partners in service partnerships do not ordinarily value goodwill in liquidating partners. Accordingly, such partners may continue to receive the special rule of present law.

Unrealized receivables

When originally enacted, the term "unrealized receivables" was limited to unbilled amounts and accounts receivable. The tax deferral resulting from immediate deduction of amounts paid for these items is relatively short because payment is usually received in the near future. Such deferral is considerably longer, however, with respect to the deduction of other items now included in the expanded definition of unrealized receivables, such as depreciation recapture on business assets, which are slow to give rise to ordinary income.

Explanation of Provision

In general

The bill generally repeals the special treatment of liquidation payments made for goodwill and unrealized receivables. Thus, such payments would be treated as made in exchange for the partner's interest in partnership property, and not as a distributive share or guaranteed payment that could give rise to a deduction or its equivalent. The bill does not change present law with respect to payments made to a general partner in a partnership in which capital is not a material income-producing factor. The determination of whether capital is a material income-producing factor would be

made under principles of present and prior law. [174] For purposes of this provision, capital is not a material income-producing factor where substantially all the gross income of the business consists of fees, commissions, or other compensation for personal services performed by an individual. The practice of his or her profession by a doctor, dentist, lawyer, architect, or accountant will not, as such, be treated as a trade or business in which capital is a material income-producing factor even though the practitioner may have a substantial capital investment in professional equipment or in the physical plant constituting the office from which such individual conducts his or her practice so long as such capital investment is merely incidental to such professional practice. In addition, the bill does not affect the deductibility of compensation paid to a retiring partner for past services.

Unrealized receivables

The bill also repeals the special treatment of payments made for unrealized receivables (other than unbilled amounts and accounts receivable) for all partners. Such amounts would be treated as made in exchange for the partner's interest in partnership property. Thus, for example, a payment for depreciation recapture would be treated as made in exchange for an interest in partnership property, and not as a distributive share or guaranteed payment that could give rise to a deduction or its equivalent.

Effective Date

The provision generally applies to partners retiring or dying on or after January 5, 1993. The provision does not apply to any partner who retires on or after January 5, 1993, if a written contract to purchase the partner's interest in the partnership was binding on January 4, 1993 and at all times thereafter until such purchase. For this purpose, a written contract is to be considered binding only if the contract specifies the amount to be paid for the partnership interest and the timing of any such payments.

[174] E.g., sections 401(c)(2) and 911(d) of the Code and old section 1348(b)(1)(A) of the Code.

G. Miscellaneous Revenue-Raising Provisions

1. Deny deductions relating to travel expenses paid or incurred in connection with travel of taxpayer's spouse or dependents (sec. 8271 of the bill and sec. 274(m) of the Code)

Present Law

In general, a taxpayer is permitted a deduction for all ordinary and necessary expenses paid or incurred during the taxable year (1) in carrying on any trade or business and (2) in the case of an individual, for the production of income. Such deductible expenses may include reasonable travel expenses paid or incurred while away from home, such as transportation costs and the cost of meals and lodging.

In the case of ordinary and necessary business expenses, if a taxpayer travels to a destination and while at that destination engages in both business and personal activities, travel expenses to and from such destination are deductible only if the trip is related primarily to the taxpayer's trade or business. If the trip is primarily personal in nature, expenses while at the destination that are properly allocable to the taxpayer's trade or business are deductible even though the traveling expenses to and from the destination are not deductible (Treas. Reg. sec. 1.162-2(b)(1)).

Under Treasury regulations, if the taxpayer's spouse accompanies the taxpayer on a business trip, expenses attributable to the spouse's travel are not deductible unless it is adequately shown that the spouse's presence on the trip has a bona fide business purpose (Treas. reg. sec. 1.162-2(c)). The performance of some incidental service by the spouse does not cause the expenses to qualify as deductible business expenses. Under the Treasury regulations, the same rules apply to any other members of the taxpayer's family who accompany the taxpayer on such a trip.

Reasons for Change

The committee believes that no deduction should be allowed for travel expenses paid or incurred with respect to a spouse, dependent, or other individual accompanying a person on business travel unless such expenses are legitimate business expenses of the taxpayer claiming the deduction. The committee believes that merely accompanying or being related to the person traveling on business does not convert otherwise nondeductible personal expenses to deductible business expenses.

Explanation of Provision

The bill denies a deduction for travel expenses paid or incurred with respect to a spouse, dependent, or other individual accompanying a person on business travel, unless (1) the spouse, dependent, or other individual accompanying the person is a bona fide employee of the person paying or reimbursing the expenses, (2) the travel of the spouse, dependent, or other individual is for a bona fide business purpose, and (3) the expenses of the spouse, dependent, or other individual would otherwise be deductible. No infer-

ence is intended as to the deductibility of these expenses under present law. The denial of the deduction does not apply to expenses that would otherwise qualify as deductible moving expenses.

Effective Date

The provision is effective for amounts paid or incurred after December 31, 1993.

2. Increase withholding rate on supplemental wage payments (sec. 8272 of the bill and sec. 3402(g) of the Code)

Present Law

Under Treasury regulations, withholding on supplemental wage payments (such as bonuses, commissions, and overtime pay) that are not paid concurrently with wages (or that are paid concurrently with wages, but are separately stated) for a payroll period may be done at a rate of 20 percent (at the employer's election) (Treas. Reg. sec. 31.3402(g)-1).[175]

Reasons for Change

The committee believes that it is appropriate to raise the withholding rate on supplemental wage payments so that withholding more closely approximates the ultimate tax liability with respect to these payments.

Explanation of Provision

The bill increases the applicable withholding rate on supplemental wage payments to 28 percent.

Effective Date

The provision is effective for payments made after December 31, 1993.

3. Permanent extension of vaccine excise tax (sec. 8273 of the bill and secs. 4131 and 9510 of the Code)

Present Law

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

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[175] If the employer chooses not to use the 20-percent method, withholding may be computed by aggregating the supplemental payments with regular wages paid within the same calendar year for the last preceding payroll period or the current payroll period. The employer would then use withholding tables to determine the total tax on this aggregate amount. The amount to be withheld for the supplemental wages is the total tax less any amount already withheld for regular wages included in the aggregate amount.

Under the Program, all persons who were immunized with a covered vaccine after the effective date of the Program, October 1, 1988, are prohibited from commencing a civil action in State court for vaccine-related damages unless they first file a petition with the United States Claims Court, where such petitions are assigned to a special master and governed by streamlined procedural rules designed to expedite the proceedings.[176] In these cases, the Federal Government is the respondent party in the proceedings, and the claimant generally must show only that certain medical conditions (or death) followed the administration of a covered vaccine and that the first onset of symptoms occurred within a prescribed time period.[177] Compensation under the Program generally is limited to actual and projected unreimbursed medical, rehabilitative, and custodial expenses, lost earnings, pain and suffering (or, in the event of death, a recovery for the estate) up to $250,000, and reasonable attorney's fees.[178] Only if the final settlement under the Program is rejected may the claimant proceed with a civil tort action in the appropriate State court, where recovery generally will be governed by State tort law principles[179], subject to certain limitations and specifications imposed by the National Childhood Vaccine Injury Act of 1986.[180]

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

The vaccine excise tax expired after December 31, 1992. Amounts in the Vaccine Trust Fund are available for the payment of compensation under the Program with respect to vaccines administered after September 30, 1988, and before October 1, 1992.

Reasons for Change

To enhance compliance with the nation's childhood immunization efforts, the committee believes it is appropriate to extend permanently the vaccine excise taxes and the authority for compensation

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

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

[178] 42 U.S.C. sec. 300aa-15.

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

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

[180] Title III, P.L. 99-660. This Act preempts State tort law to a limited extent by imposing limits on recovery from vaccine manufacturers. Among the limitations are a prohibition on compensation if the injury or death resulted from side effects that were unavoidable; a presumption that manufacturers are not negligent in manufacturing or marketing vaccines if they complied, in all material respects, with Federal Food and Drug Administration requirements; and limits on punitive damage awards.

to be paid from the Vaccine Trust Fund for certain damages resulting from the administration of vaccines.

Explanation of Provision

The bill permanently extends the excise taxes imposed on certain vaccines (at the rates in effect when such taxes expired after December 31, 1992). Authorization for compensation to be paid from the Vaccine Trust Fund under the National Vaccine Injury Compensation Program for certain damages resulting from vaccines administered after September 30, 1988, also is permanently extended.[181]

Effective Date

The extension of coverage under the National Vaccine Injury Compensation Program is effective for vaccines administered on or after October 1, 1992. The extension of the vaccine excise taxes is effective on the date of enactment, with a floor stocks tax imposed on vaccines purchased after December 31, 1992, that are being held for sale or use on the date of enactment.

[181] The committee intends that the Secretary of the Treasury expeditiously (within 60 days of enactment) adopt rules for purposes of Code section 4221 for determining the conditions under which exported vaccines to be administered to individuals not eligible for compensation under the program are not subject to tax.