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EXPLANATION OF PROVISIONS APPROVED BY THE COMMITTEE ON MARCH 21, 1984

COMMITTEE ON FINANCE
UNITED STATES SENATE

Volume I

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VOLUME II:

VIII. Statutory Language of Finance Committee Budget Deficit Reduction Provisions ... 1

I. LEGISLATIVE BACKGROUND OF FINANCE COMMITTEE DEFICIT REDUCTION PROVISIONS

1983 Committee Action

Provisions Included in S. 2062

The Senate Committee on Finance approved its fiscal year 1984 budget reconciliation recommendations on October 31, 1983, and transmitted bill and report language on that date to the Senate Committee on the Budget. The Budget Committee included the Finance Committee's revenue and spending reduction recommendations as title I (Deficit Reduction Act of 1983) of S. 2062 (Omnibus Reconciliation Act of 1983) as reported by the Budget Committee on November 4, 1983 (S. Rep. No. 98-300).

The Finance Committee budget reconciliation provisions in S. 2062 as reported included revenue increases of $13.4 billion over fiscal years 1984-1986 ($21.2 billion over fiscal years 1984-1987) and spending (outlay) reductions of $2.6 billion over fiscal years 1984-1986 ($4.1 billion over fiscal years 1984-1987).

S. 2062 was placed on the Senate Calendar and briefly considered on November 16, 1983, and was returned to the Calendar on November 18, 1983.

Additional 1983 Committee Consideration

Subsequent to the reporting of S. 2062, the Finance Committee met on November 16 and 18, 1983, to consider possible additional deficit reduction proposals. On November 18, 1983, the Committee approved a resolution to instruct the staffs of the Finance Committee and Joint Committee on Taxation, in consultation with the Treasury Department, to draft a deficit reduction package to reduce the projected budget deficit for fiscal years 1984-1987. The draft of the deficit reduction package was to be ready for Committee consideration by February 15, 1984.

The Finance Committee held public hearings on December 12-14, 1983, to receive further testimony on ways to reduce the Federal deficit.

1984 Committee Action

The Finance Committee began markup again on deficit reduction proposals on February 23, 1984, following public hearings on February 2 and 7, 1984, to receive testimony from the Aministration on their fiscal year 1985 budget proposal (submitted to the Congress on February 1, 1984). Also, a public hearing was held on February 8, 1984, to receive testimony concerning deficit reduction proposals made by the President's Private Sector Survey on Cost Control ("Grace Commission"). Finance Committee markup continued on February 28-29, and March 1, 7-8, 13-15, and 20-21, 1984, with the

Committee approval (by a recorded vote of 20-0 on March 21), of a deficit reduction proposal.

Following is a committee explanation of that proposal (revenue and spending reduction provisions), including estimated budget effects of the revenue and spending reduction provisions. Titles I-VIII are the revenue provisions, and title IX contains the spending reduction provisions.

II. SUMMARY OF PROVISIONS

Title I.—Tax Reforms Generally

A. Deferral of Certain Tax Reductions

1. Investment credit for used property

Under present law, the maximum amount of used property eligible for the investment credit is scheduled to increase from $125,000 to $150,000 in 1985. The bill freezes the amount eligible for the credit at $125,000 through 1987, after which this limit increases to $150,000.

2. Finance leasing

Under present law, liberalized leasing rules for agreements relating to limited use property or containing fixed price purchase options become effective on January 1, 1984. The bill postpones that effective date for four years. Present liberalized leasing rules are continued for up to $150,000 of farm equipment and for certain automotive manufacturing property. In addition, general transition rules are provided.

3. Expensing of business personal property

Under present law, the amount of personal property which businesses may elect to expense each year is scheduled to increase from $5,000 in 1983 to $7,500 in 1984 and 1985 and to $10,000 thereafter. The bill freezes the maximum amount that can be expensed at $5,000 through 1987, increasing it to $7,500 in 1988 and 1989 and $10,000 thereafter.

4. Telephone excise tax

Under present law, the 3-percent telephone excise tax is scheduled to expire after 1985. Under the bill, the 3-percent tax remains in effect through 1987.

5. Net interest exclusion

Under present law, starting in 1985, individuals will be able to exclude 15 percent of interest income to the extent such income exceeds certain interest deductions, up to a maximum exclusion of $450 for single persons and $900 for married couples. The bill postpones this net interest exclusion until 1988.

6. Foreign earned income

Under present law, the maximum amount of income earned abroad excluded from taxable income is $80,000 for 1983, and is scheduled to increase in $5,000 annual increments to a permanent level of $95,000 in 1986. The bill freezes the amount of the exclusion at $80,000 until 1988 and increases it in $5,000 increments to $95,000 in 1990.

B. Tax-Exempt Entity Leasing

Present law

The Federal income tax benefits of ownership of property generally include accelerated depreciation deductions and investment tax credits. Essentially, the law is that the economic substance of a transaction, not its form, determines who is entitled to the tax benefits associated with ownership. Thus, in a lease or similar arrangement, the person claiming ownership for Federal income tax purposes must show that he has sufficient economic indicia of ownership.

The tax benefits of ownership are generally allowed only for property used for a business or income-producing purpose. They are not available for property that is owned by governmental units and tax-exempt organizations. Property that is used (though not owned) by a tax-exempt organization or a domestic governmental unit qualifies for accelerated cost recovery (ACRS) or other depreciation deductions but generally does not qualify for investment credits. A statutory exception to the investment credit limitation provides that qualified rehabilitation expenditures for a building leased to a tax-exempt organization or a governmental unit can qualify for the rehabilitation tax credit. Also, one court has held, and the Internal Revenue Service (IRS) has ruled, that investment credits can be claimed where a governmental unit essentially contracts not for the use of property itself, but rather for a service to be provided by the owner of the property.

Property used by a foreign government or person is not subject to the nontaxable use restriction. However, if the property is used predominantly outside the United States, generally ACRS deductions are slowed down and no investment credit is allowed.

Only 50 percent of the investment credit otherwise allowable is allowable with respect to property owned by a thrift institution, but no such limitation specifically applies with respect to property leased to it. Furthermore, certain property owned by or leased to a public utility is subject to special depreciation and investment credit rules. However, those rules are not specifically applicable to property used to provide services to the public utility.

The bill

In general, the bill reduces the tax benefits available for certain property that is leased to or otherwise used by tax-exempt entities. Under the bill, tax-exempt entities include the United States, any State or local governmental unit, possessions of the United States, and most agencies and instrumentalities of any of the foregoing. The term also includes (1) organizations (other than farmers' cooperatives described in section 521) exempt from United States income tax and certain formerly exempt organizations and (2) certain foreign persons or entities.

The bill generally requires that ACRS or other depreciation deductions for property used by tax-exempt entities be computed using the straight-line method over a recovery period equal to the greater of the present class life of the property under the Asset Depreciation Range (ADR) system (40 years in the case of 15-year or 20-year real property) or, in the case of property subject to a lease, 125 percent of the term of the lease. In the case of 15-year or 20-year real property, this provision applies to the extent of use of a type or types specified in the bill, but only if more than 50 percent (35 percent in the case of use of a type or types specified in the bill by one tax-exempt entity and related tax-exempt entities) of the property is so used. The depreciation rules of the bill do not apply to certain short-lived property. Depreciation deductions for property used by foreign persons or entities will be computed using the 175-percent declining balance method over a specified number of years for property placed in service in 1984 and the 150-percent declining balance method over a specified number of years for property placed in service after 1984.

The bill also provides criteria for determining whether a transaction that is structured as a service contract or other arrangement should be treated as a lease for all Federal income tax purposes. The rehabilitation credit will be denied for tax-exempt use real property. Finally, lessors will not be entitled to investment credits with respect to property leased to thrift institutions in excess of the credits that would have been allowed to the lessee had the lessee owned the property. Property used by foreign persons or entities and currently eligible for the investment credit is restricted to one-half of the credit if placed in service in 1984. If placed in service after 1984, such property generally is ineligible for the credit.

The bill does not apply to property leased to a tax-exempt entity for a short term. For depreciation purposes, a short-term lease is a lease with a term not in excess of 1 year or 30 percent of the property ADR mid-point life (but not more than 3 years), whichever is greater. For investment credit purposes, a short-term lease is generally a lease of less than 6 months, although for certain property, the depreciation short-term lease rule applies.

The bill generally applies to property placed in service by the taxpayer after May 23, 1983, and to property used under an agreement entered into after that date. However, transitional rules are provided.

C. Treatment of Bonds and Other Debt Instruments

1. Debt obligations acquired at a discount

a. Market discount

Under present law, upon the disposition of a market-discount bond issued by a corporation or a governmental unit and held for more than one year, capital gain treatment is accorded to the appreciation in value attributable to market discount. When a taxpayer borrows the funds used to purchase a market-discount bond, interest on the acquisition indebtedness generally can be deducted currently against ordinary income. Thus, a taxpayer who leverages the purchase of a market-discount bond effectively converts ordinary income to capital gain.

The bill generally requires that gain on disposition of a market discount bond be recognized as interest income, to the extent of accrued market discount. This provision is effective for bonds issued after the date of enactment.

The bill also limits a taxpayer's ability to take current interest deductions on indebtedness incurred to purchase or carry a market discount bond. This change is effective for bonds acquired after the date of enactment. For bonds issued before date of enactment but acquired after date of enactment, gain will be recharacterized as ordinary income to the extent of deferred interest deductions.

The bill provides an election to include accrued market discount in income currently. Neither the rule requiring ordinary income treatment on disposition nor the rule limiting interest deductions will apply to bonds with respect to which the election is made.

b. Original issue discount on tax-exempt bonds

Under the Code, original issue discount (OID) on certain obligations issued by a State or local government is exempt from tax. Under Internal Revenue Service rulings, tax-exempt OID is apportioned on a straight-line basis among the original holder and subsequent purchasers of a bond. The application of this rule may permit the holder of a deep discount municipal bond to generate an artificial loss by disposing of the bond prior to maturity.

The bill requires the holders of tax-exempt obligations to accrue tax-exempt OID by using the constant interest method provided by present law for the holders of obligations issued by corporations and other entities. Under the bill, the basis of an obligation is increased by the amount of accrued tax-exempt OID. Thus, the holder of a zero coupon municipal bond will be able to claim economic losses realized on disposition of the bond. These changes apply to bonds issued after September 3, 1982, and acquired after March 1, 1984.

c. Discount on short-term obligations

For governmental obligations (Treasury bills) issued at a discount and payable without interest at a fixed maturity not exceeding one year, the acquisition discount is not considered under present law to accrue until the obligation is paid at maturity or otherwise disposed of. A similar rule applies with respect to original issue discount on other obligations with a maturity of one year or less (e.g., bank certificates of deposit). Taxpayers who make leveraged purchases of obligations eligible for the special rules are able to defer tax liability on unrelated income.

The bill limits the ability to use leveraged purchases of short-term obligations within the special rules to defer tax on ordinary income by deferring the deductions for interest on indebtedness used to purchase or carry short-term discount obligations. An election is provided under which taxpayers can avoid application of the interest deferral rule by electing to include acquisition and original issue discount in income as it accrues.

This provision will be effective for obligations acquired after the date of enactment.

D. Tax Treatment of Corporations and Their Shareholders

1. Dividends received by corporations

a. Debt-financed portfolio stock

Under present law, when a corporation borrows funds used to purchase dividend-paying stock, interest on the acquisition indebtedness is generally deductible against ordinary income. Dividends received by a corporation are eligible for an 85-percent dividends received deduction. Thus, a corporation that borrows to finance purchases of portfolio stock effectively converts some ordinary income to dividend income, which is taxed at a maximum rate of 6.9 percent.

Under the bill, the dividends received deduction is reduced by an amount determined by reference to interest paid or accrued on debt that is directly attributable to the investment in the underlying stock. The provision applies to stock the holding period for which begins after the date of enactment.

b. Dividends from regulated investment companies

Under present law, a mutual fund, or regulated investment company (RIC), is not subject to Federal income tax if it distributes its income to its shareholders. If at least 75 percent of a RIC's gross income consists of dividends from domestic corporations, then the entire amount of the RIC's dividends to its shareholders is eligible for the 85-percent intercorporate dividends received deduction and the $100 dividend exclusion for individuals. Taxpayers have organized RICs to take advantage of this tax provision that permits the conversion of interest income into dividend income.

Under the bill, the 75-percent rule of present law is raised to 95 percent. The provision applies with respect to taxable years of a RIC beginning after the date of enactment.

c. Extraordinary dividends

Under present law, dividends received by a corporation generally have no effect on its basis in the stock of the distributing corporation. As a result, a corporation can buy stock for $100, receive a $15 extraordinary dividend on it, and then in short order sell the stock for $85. While some portion (generally 15 percent) of the $15 dividend will be taxed as ordinary income to the recipient corporation, the transaction, which may have no significant economic consequences, will also generate $15 of short-term capital loss on the sale of the stock. This is an attractive transaction for corporations that have capital gains which can be sheltered by the loss on the sale of stock.

Under the bill, if a corporate shareholder does not hold stock for more than one year, the fair market value of any extraordinary dividend (to the extent not subject to tax) reduces its basis in the stock. Extraordinary dividends include dividends received within any 85-day period with a fair market value equal to or greater than 10 percent (5 percent in the case of preferred stock) of the taxpayer's basis in the stock. This change applies to distributions after the date of enactment.

In general, the holding period is limited to exclude, among other periods, any period during which the taxpayer is the grantor of a deep-in-the-money option with respect to the stock, or any period that the taxpayer's risk of loss is diminished because of holding substantially similar positions. A similar rule is adopted for purposes of all the holding period rules applicable to the dividends received deduction. Broker-dealers who hold stocks for sale to customers or as hedges will be exempt from the "risk of loss" rule. This holding period provision applies to stock acquired after the date of enactment.

A corporate shareholder's holding period for property received as a dividend with respect to stock is limited so that it cannot exceed its holding period for such stock. This change applies with respect to stock acquired after the date of enactment.

2. Ordinary nonliquidating dividends of appreciated property

Generally, under present law, a distribution of appreciated property (such as interests in an oil and gas royalty trust) by a corporation with respect to its stock is not a taxable event to the distributing corporation.

Under the bill, in general, an ordinary nonliquidating distribution of appreciated property is taxable to the distributing corporation. Certain exceptions are provided. The provision applies with respect to distributions declared after March 15, 1984, with transition rules.

3. Transactions in mutual fund shares

Under present law, mutual fund distributions from net capital gain income are taxed as long-term capital gain to shareholders even when made to a shareholder who holds the share for one year or less. If a shareholder who has held a share of a mutual fund for less than 31 days sells such share at a loss after a capital gain dividend has been received, the loss is treated as long-term rather than short-term to the extent of the capital gain dividend. Similar rules apply to real estate investment trusts.

Under the bill, losses on mutual fund stock held 6 months or less are treated as long-term losses to the extent of any capital gain dividends paid on the stock. There is an exception for periodic redemption plans. A similar rule is provided for real estate investment trusts. The provision applies to losses with respect to shares of stock with respect to which the taxpayer's holding period begins after the date of enactment.

4. Expenses incurred in connection with short sales

A short sale is a transaction in which the investor borrows stock, sells the stock, and later buys stock to repay the loan. Under present law, amounts paid by the taxpayer to the lender in lieu of dividends are deductible against ordinary income. A taxpayer can create short-term capital gain and ordinary loss by selling short before a dividend payment date and closing the short sale after the ex-dividend date in a transaction with essentially no economic consequences.

Under the bill, in the case of a short sale of stock, payments in lieu of dividends are not deductible unless the short sale is held open for at least 16 days. No deduction is allowed for payments in lieu of extraordinary dividends unless the short sale is held open for at least one year. Amounts disallowed are treated as part of the basis of the short seller in the stock acquired to close the short sale. Amounts not disallowed as a deduction are treated as interest for certain Code purposes. The provision applies with respect to short sales after the date of enactment.

5. Transactions in stock warrants

Present law is unclear as to the tax consequences of a corporation's dealing in its own warrants. Under present law, taxpayers with a gain may take the position that no gain is recognized and taxpayers with a loss may report the loss.

Under the bill, no gain or loss is recognized by a corporation on any transaction with respect to a warrant to buy or sell its own stock. The provision applies with respect to warrants acquired or lapsing after the date of enactment.

6. Companies that accumulate earnings

Under present law, a corporation may deduct 85 percent of the dividends it receives on portfolio stock investments. Furthermore, gain on the sale of stock held by an individual for more than one year is generally taxed as long-term capital gains at rates not in excess of 20 percent. As a result, if a widely-held investment company invests in dividend-paying stocks and pays no dividends, its shareholders could hold the stock for at least a year and then sell it at a price that reflects dividends received and retained by the company. Their gains would generally be long-term capital gain, so individual shareholders would essentially be recognizing dividend income at a tax rate substantially below 50 percent. The company may take the position that it is not subject to the accumulated earnings tax because it is widely held.

Under the bill, generally, widely held companies are not automatically excluded from the accumulated earnings tax. Also, the net capital loss deduction (including by carryover) is denied for mere investment or holding companies and amended, along with other provisions, for other companies. These provisions apply with respect to taxable years beginning after the date of enactment.

7. Distribution of debt by a corporation

Under present law, earnings and profits of a corporation are reduced by the principal amount of its obligations distributed to shareholders. Generally, for noncorporate shareholders, the amount of a distribution taken into account is the fair market value of the property distributed. A long-term obligation bearing little or no stated interest will have a fair market value well below its stated redemption price. The result may be to eliminate corporate earnings and profits at the cost of a relatively small dividend to shareholders.

The bill amends the earnings and profit rules to limit the reduction in earnings and profits resulting from the distribution of the corporation's own debt obligations. Also, under the bill, these obligations are subject to the original issue discount rules. These provisions apply with respect to distributions declared after March 15, 1984.

8. Phaseout of graduated rates for large corporations

Under present law, the first $100,000 of corporate taxable income is taxed at graduated rates. The taxable income in excess of $100,000 is taxed at the 46-percent rate. The graduated tax rates provide a tax reduction of $20,250 to corporations with taxable income in excess of $100,000 relative to a flat 46-percent tax.

The bill provides that the benefits of the graduated rates will effectively be phased out for any corporation with taxable income in excess of $1 million. An additional 5-percent tax, not to exceed $20,000 in amount, will be imposed on a corporation's taxable income in excess of $1 million. This provision will be effective for taxable years beginning after December 31, 1983.

9. Corporate tax preferences

The bill increases the present law corporate tax preference cutback from 15 percent to 20 percent, beginning in 1985.

10. Golden parachutes

Corporations fearing a hostile takeover attempt frequently enter into contracts with key personnel pursuant to which substantial payments will be made to such personnel in the event of a successful takeover. Under the bill, certain payments under such "golden parachute" contracts substantially in excess of historic compensation will be presumed not to be ordinary and necessary business expenses and not deductible. Furthermore a nondeductible 20-percent excise tax will be imposed on the recipient. The presumption will be rebuttable.

The provisions are effective with respect to payments under golden parachute contracts entered into after March 15, 1984.

11. Earnings and profits

Distributions from a corporation are generally treated as dividends only if they are paid out of current or accumulated earnings and profits. Under present law, a corporation's earnings and profits may be substantially less than its "true," or economic, income. This is because many of the tax rules applicable in determining taxable income are applicable to a greater or lesser extent in determining earnings and profits.

The bill makes a number of changes in the definition of earnings and profits in order to make it conform more closely to true or economic income. The bill also makes provision for the effect on earnings and profits of redemptions. With several exceptions, the provisions are effective for taxable years beginning after the date of enactment.

12. Net operating losses

Provisions from the Tax Reform Act of 1976 relating to special limitations on the carryover of net operating losses and other tax attributes are scheduled to become effective at varying times during 1984.

The bill delays the effective date of those provisions. As a result, the rules in effect prior to 1984 remain in effect.

13. "C" reorganizations

Present law contains no requirement that the transferor corporation distribute all its assets to shareholders in order for a transaction to qualify as a "C" reorganization. As a result, the transferor corporation can remain in existence, having transferred its tax attributes (particularly earnings and profits) to the acquiring corporation. Furthermore, the absence of a distribution requirement permits acquired corporations to avoid, to some extent, the rules of section 355.

The bill requires the transferor corporation to distribute all its assets to shareholders in order to qualify a transaction as a "C" reorganization. The Treasury is authorized to prescribe regulations providing relief from the rules in appropriate cases. The bill also requires an appropriate allocation of earnings and profits in certain "C" reorganizations. The provisions are effective for transactions pursuant to a plan adopted after the date of enactment.

14. "D" reorganizations

Under present law, the transfer of assets of a corporation to another corporation qualifies as a non-divisive "D" reorganization if, among other things, shareholders of the acquired corporation are in control of the acquiring corporation immediately after the transaction. Control is defined as ownership of at least 80 percent of the total combined voting power of all classes of stock entitled to vote and at least 80 percent of the total number of all other classes of stock.

The bill changes the control requirement to at least 50 percent. In addition, the bill provides that attribution rules are applicable in determining ownership. The provisions apply to transactions pursuant to a plan adopted after the date of enactment.

15. Collapsible corporations

In general, under present law, a collapsible corporation is one which is formed or availed of with a view (on the part of those in control of the corporation) to realize the value of the corporation's collapsible assets before the corporation has realized a "substantial part" of the taxable income to be derived from such property. Under the bill, the substantial part requirement would be defined to be "two-thirds" of the taxable income to be derived from the property.

The "70/30" rule of present law would be amended to authorize Treasury regulations specifying the extent to which all inventory assets be aggregated and treated as a single asset in determining whether the gain attributable to such assets should be treated as attributable to collapsible assets for purposes of the "70/30" rule.

The provisions are generally applicable to sales, exchanges, or distributions after December 31, 1984.

E. Partnerships and other Pass-through Entities

1. Allocations of partnership income or loss

a. Contributed property

Under present law, a partnership may elect to allocate gain or loss and depreciation or depletion with respect to contributed property to reflect variations between the basis of the property and its fair market value when contributed. In the absence of the election, it is possible that the gain or loss with respect to contributed property may be effectively shifted among members of the partnership.

Under the committee bill, the special allocation of gain or loss, depreciation, and depletion with respect to contributed property will be made mandatory. The provision applies to contributions made after March 31, 1984.

b. Partnership losses

Under present law, retroactive allocation of partnership deductions to partners entering late in the year is prohibited. Nonetheless, it may be possible to accomplish such an allocation through the use of tiered partnerships or, in the case of cash method partnerships, by delaying actual payment for accrued expenses.

With respect to the tiered partnership technique, the bill generally requires items of income, gain, loss, deduction and credit passing from a subsidiary partnership to a parent partnership to be allocated equally among the days in the parent's taxable year for which it has an interest in the subsidiary. Further, for cash basis partnerships, certain items such as taxes, interest, and rents are to be allocated proportionately over the periods to which they relate, so that a partner generally can be allocated only those items actually accrued while he is a partner. The bill also provides for a convention under which partners entering in any month may be treated as entering at the beginning of the month. The provision applies to items paid or accrued after March 31, 1984.

2. Conversion or deferral of income

a. Disguised payments

Under present law, amounts expended to organize or promote a partnership generally must be capitalized. Other payments for property or services may also be required to be capitalized. It has been suggested that these capitalization requirements may, in effect, be avoided when the payee is also a partner by allocating a greater share of income to that partner.

The bill provides that when a partner performs services for, or transfers property to, a partnership and receives a related allocation and distribution of partnership income or gain, the allocation and distribution, if properly so characterized, will be treated as a transaction occurring between the partnership and a person who is not a partner. The provision applies to services performed or property transferred after February 29, 1984.

b. Disguised sales

Under present law, a partner may be able to avoid recognition of gain on the sale of property to a partnership or another partner by characterizing the transaction as a contribution of the property followed by a distribution of cash or other property to the contributing partner.

The bill provides that, when properly so characterized, a transfer of property by a partner to a partnership and a related transfer to that or another partner will be treated as a sale between partners or between the partnership and one who is not a partner. The provision generally applies to transfers after March 31, 1984.

c. Gain or loss on contributed property

Present law provides that if certain ordinary income property of a partnership is distributed to a partner, its character as ordinary income property is preserved in the hands of the distributee for at least five years. No comparable rule applies to property contributed to a partnership. Thus, it may be possible to change the character of property from ordinary income to capital gain or from capital loss to ordinary loss through a contribution to a partnership.

Under the bill, the ordinary income or loss character of unrealized receivables contributed to a partnership will be preserved in the hands of the partnership. Further, the ordinary income or loss character of inventory items will be preserved in the hands of the partnership for five years. Built-in losses on capital assets contributed to a partnership are treated as capital losses if recognized by the partnership within 5 years. The provision applies with respect to property contributed after March 31, 1984.

d. Ordinary income property in tiered partnerships

Under present law, amounts received by a transferor partner in exchange for all or part of his partnership interest that are attributable to his interest in ordinary income assets of the partnership are treated as ordinary income. It has been argued that this rule can be avoided if ordinary income assets are held in a second partnership in which the distributing partnership holds an interest.

The bill treats a partnership that owns an interest in another partnership as owning its proportionate share of the ordinary income assets of such partnership directly. A similar rule applies to interests in trusts. The provision applies to distributions, sales or exchanges after March 31, 1984.

3. Transfers of partnership and trust interests by corporations

Under present law, when a partnership interest is sold, any gain is ordinary income to the extent attributable to certain ordinary income items of the partnership. When a corporation distributes property, or sells property in the course of certain complete liquidations, recapture income is taxed to the corporation while non-recapture gain attributable to appreciation in the transferred property goes unrecognized. It has been argued that the corporate recapture provisions do not apply to the distribution or liquidating sale of an interest in a partnership that holds recapture property.

Under the bill, a corporate distribution or a liquidating sale of a partnership interest is treated as a transfer of the distributing corporation's proportionate share of certain recapture items (and other corporate recognition property) held by the partnership. The provision also clarifies that a distribution is treated as a sale or exchange for purposes of the basis adjustment rules. The provision applies to distributions after March 31, 1984.

4. Like-kind exchanges of partnership interests; deferred like-kind exchanges

Under present law, like-kind exchanges of property held for productive use or investment are permitted to be made tax-free. These rules do not apply to inventory, stock, certificates of trust or beneficial interests, or other securities or evidences of indebtedness. In some cases. the courts have permitted tax-free like-kind exchanges of partnership interests. The Treasury has not acquiesced in these holdings. The bill provides that tax-free like-kind exchange treatment is not available for exchanges of interests in different partnerships. The provision applies with respect to transfers after the date of enactment.

Under present law, an intended like-kind exchange transaction may be held open for as long as five years under the case law. The bill provides that property which is received in an exchange and is either not designated at the time the taxpayer transfers his property or is received more than 180 days after the taxpayer transfers the relinquished property (or, if earlier, after the due date of the taxpayer's return), will not be treated as like-kind property. This provision will apply to transfers of property made after the date of enactment.

F. Trust Provisions

1. Trust distributions

Under present law, beneficiaries are taxed on the value of property distributed from a trust (or estate) to the extent of the trust's (or estate's) distributable net income. The trust (or estate) is allowed a deduction for amounts taxed to its beneficiaries. The basis of the property in the hands of the beneficiary is stepped up to its fair market value even though no tax is imposed on the unrealized appreciation.

Under the bill, distributions of property result in gain or loss to the trust or estate. Alternatively, the trustee or executor may elect to treat distributions of property as carrying out distributable net income only to the extent of the property's basis. The beneficiary's basis would be the same as the trust's (or estate's) and the appreciation would no longer be exempted from tax.

This provision applies to distributions from a trust (or estate) after March 1, 1984.

2. Multiple trusts

Treasury regulations prevent grantors of trusts from reducing present taxation by establishing multiple trusts for the same beneficiaries which take advantage of the separate graduated rates applicable to each trust. A recent court decision held these regulations to be invalid. The bill provides that trusts established by substantially the same grantors for substantially the same beneficiaries with a principal purpose of tax avoidance will be consolidated for tax purposes. This provision is generally effective for taxable years beginning after March 1, 1984.

G. Time Value of Money and Other Accounting Provisions

1. Deferred payment transactions

a. Time for inclusion or deduction of deferred interest

Present law provides that, in general, in a discount lending transaction, the borrower is treated as having paid, and the lender as having received, the annual unpaid interest, which is then relent to the borrower. These original issue discount (OID) rules match the interest inclusion by the lender with the interest deduction by the borrower. The OID rules of present law do not apply to obligations issued in exchange for property where neither the obligation nor the property is publicly traded; to obligations issued by individuals; or, as to holders of discount obligations, to obligations not held as capital assets.

The bill extends the OID rules to obligations issued for nontraded property, issued by individuals, and not held as capital assets. The interest element in obligations issued for nontraded property is to be compared to a test rate. The test (safe harbor) rate is 110 percent of an average yield on Federal obligations of similar maturity (the "applicable Federal rate"). This yield is to be redetermined semi-annually for 3 categories of maturities (short-, medium-, and long-term). If interest is not paid annually at least at this rate (or, if interest is stated at a higher rate, is not paid at least at that higher rate), interest is to be imputed at a rate equal to 120 percent of the applicable Federal rate (or at the higher stated rate) and annually included in the income of the lender and deducted by the borrower. Exceptions to these rules are provided for sales of principal residences, certain sales of farms, sales involving total payments of $250,000 or less, and issuers of obligations issued in a sale of assets not used by the purchaser in a trade or business or held by the purchaser for investment.

The bill also provides exceptions to the OID rules for loans of $10,000 or less between family members and for borrowers in negative amortization loan transactions where the loan proceeds are used to purchase non-business or non-investment property. These provisions generally apply to transactions entered into after December 31, 1984, except for sales or exchanges with respect to which there was a binding commitment on March 15, 1984.

b. Measurement of interest in deferred payment transactions

Under present law, if the parties to a deferred payment sale fail to state interest at a safe-harbor rate fixed by regulation, interest is imputed at a higher rate fixed by regulation. The safe-harbor rate is a simple interest rate; the imputed rate is a compound rate. Imputed interest is allocated among deferred payments in proportion to the amount of the payment, without regard to the period of time that has elapsed since the sale.

The bill provides that the adequacy of the interest element in a deferred payment sale is to be tested against a self-adjusting compound rate of interest which approximates a market rate. This test (safe-harbor) rate is the same rate applied under the proposed amendments to the OID rules: 110 percent of the applicable Federal rate. If insufficient interest is stated, interest is to be imputed at a rate equal to 120 percent of the applicable Federal rate. Interest income will be recognized by the lender and interest expense will be deducted by the borrower on an economic accrual basis when paid (in the case of a cash method taxpayer) or when due (in the case of an accrual method taxpayer). An exception is provided for purchasers of assets that do not constitute trade or business or investment assets in the hands of the purchaser.

The bill generally applies to sales or exchanges after December 31, 1984, except for sales or exchanges with respect to which there was a binding commitment on March 15, 1984. However, as to any transactions entered into after March 15, 1984, and before January 1, 1985, the bill provides that a deduction will not be allowed for interest in excess of the amount properly allocable to the period.

2. Deferred payments for use of property and services

Under present law, a lessor of property reporting income on the cash method includes rents from the property in income in the year in which the rent is actually or constructively received; an accrual method lessor reports rental income in the year in which all events fixing the lessee's liability for the rent have occurred and the amount thereof can be determined with reasonable accuracy (the "all-events test"). A cash method lessee otherwise entitled to deduct rent generally claims a deduction in the year the rent is paid; an accrual method lessee generally deducts rent in the year the all-events test is satisfied. An accrual basis lessor or lessee which is a party to a lease under which rents are not payable currently normally accrues a ratable portion of the rent income or expense in each year of the lease.

The bill requires that rental and interest income attributable to a deferred rental payment agreement be reported as income by the lessor and deducted by the lessee as if both were on the accrual method, irrespective of their actual methods of accounting. The provision will generally apply both in the case where payment of rent is deferred beyond the end of the taxable year subsequent to the year to which the rent relates and where rents are "stepped" (that is, increase or decrease over the term of the lease) more than is commercially reasonable. A stricter standard of commercial reasonableness applies to sale-leaseback transactions.

If a transaction is subject to these provisions, the amount of rent to be accrued by the parties for a taxable year will be based upon a rental rate that is constant or level for each period of the lease. In addition, the lessor will annually accrue interest income, and the lessee will deduct interest expense, at a rate equal to 120 percent of a self-adjusting statutory rate, on any unpaid accrued rent and interest.

Deferred payments under service contracts are treated in a manner similar to deferred rents, except that the annual inclusion and deduction rules apply only to the imputed interest element of the transaction.

Exceptions are provided for deferred payment transactions involving total payments of $250,000 or less and certain other situations.

The provisions are effective for agreements entered into after March 15, 1984, for taxable years ending after such date.

3. Premature accruals

Under the accrual method of accounting, an expense is deductible when all events have occurred which establish the fact of liability and the amount of the liability can be determined with reasonable accuracy. The proper time for deducting expenses for which economic performance has not yet occurred is the subject of controversy under present law.

The bill generally requires that economic performance must occur before all events establishing the fact of liability will be considered to have occurred. Exceptions are made for items for which specific timing rules are already provided under the Code, such as bad debts and vacation pay.

The bill permits utility companies owning nuclear power plants to take deductions for contributions to a segregated reserve fund dedicated to plant decommissioning, subject to certain limits. This reserve fund will be taxed as a separate entity, with respect to fund earnings, at the maximum corporate tax rate (46 percent).

The bill requires that all customer charges for decommissioning are to be included in the income of the company that is providing the services.

The bill also provides an elective method for deducting site reclamation and closing costs of surface and deep mines and solid, liquid, and hazardous waste disposal sites (not including superfund sites), associated with meeting the requirements of Federal or State law.

The bill also provides a 10-year carryback for losses arising from certain deferred liabilities and a longer period for certain losses associated with the decommissioning of nuclear generating plants.

The bill applies to expenses accruing after the date of enactment, subject to certain transition rules.

4. Prepayment of expenses

Except with respect to interest and prepayments by farm syndicates, present law is unclear as to the proper timing of a deduction for prepaid items by cash method taxpayers. In the case of interest, deductions are allowed only for the year to which the interest relates. A similar rule applies to prepaid expenses of farm syndicates.

The bill provides that farmers, other than farm syndicates, will not be allowed to deduct any amount paid for feed, seed, fertilizer or other supplies prior tc the time such supplies are used or consumed if more than 50 percent of the expenses incurred in the trade or business of farming are prepaid. For other taxpayers (including farm syndicates), prepaid expenses will be treated as under present law. This rule will apply to prepayments made after the date of enactment.

5. Construction period interest and taxes for residential property

Under present law, taxpayers are generally required to capitalize construction period interest and taxes on real property other than low income housing. This rule does not apply to residential real property acquired, constructed or carried by a corporation (other than an S corporation).

The bill will require corporations to capitalize construction period interest and taxes for residential real property other than low income residential real property. This change will apply to interest and taxes paid or incurred in taxable years beginning after December 31, 1984, for construction of residential real property begun after March 15, 1984.

6. Pre-opening expenditures

Under present law, taxpayers may elect to amortize pre-opening or start-up expenditures over the first five years after the business is opened. If the election to amortize is not made, the IRS views these expenditures as nondeductible capital items. Certain taxpayers, nevertheless, claim those items as currently deductible if the five-year amortization election is not made.

The bill provides that pre-opening or start-up expenditures must be amortized over a five-year period. The provision is effective for taxable years beginning after June 30, 1984.

H. Straddles and Other Securities Transactions

Under present law, several special rules apply to limit tax benefits from straddle transactions. Under the loss deferral rule, losses on straddles are deferred to the extent of gains on offsetting positions. However, there is an exception from this rule for straddles involving stock and stock options. Also, a mark-to-market system applies to regulated futures contracts under which taxes are paid on unrecognized gains and losses at the end of each year. Under the mark-to-market rules, gains and losses are treated as 60-percent long-term and 40-percent short-term, providing a maximum tax rate of 32 percent. The tax treatment of options on futures contracts and cash settlement options is unclear under present law.

The bill repeals the exception from the loss deferral rule for stock options and stock offset by an option, and substitutes a limited exception applying to covered calls which are not deep-in-the-money. The exception from the straddle rules for stock would not apply where the corporation is formed or availed of to enter into positions to offset the shareholder's own positions. When a taxpayer has written an in-the-money covered call, any long-term gain on the sale of the stock will be recharacterized as short-term to the extent of any short-term losses on the option.

The bill also extends the mark-to-market system to options on futures contracts (other than stock index futures contracts), to options where the underlying property is not equity based, and to options held by options market makers.

The bill modifies the hedging exception to the anti-straddle rules to reduce the possibility that it may be used to generate losses that shelter unrelated income from tax.

The Treasury Department's authority to issue regulations with regard to the straddles rules is extended so that it can deal with the problems presented under present law by mixed straddles. Its authority to prescribe effective identification requirements for the hedging exception and broker-dealer investment accounts is also broadened.

The wash-sale rule is extended to apply to short sales, including short sales "against the box."

The bill clarifies the treatment of cash settlement options.

The repeal of the exception for stock options from the anti-straddle rules is effective for positions entered into after October 31, 1983. The extension of mark-to-market rules is effective for positions entered into after the date of enactment. Transition rules are provided similar to those which were provided when the mark-to-market system for regulated futures contracts was implemented in 1981.

I. Pensions, Welfare Benefit Plans, ESOPs

1. General Pension Provisions

a. Deduction limits for qualified pension plans

Under present law, deduction limits are imposed on the amount of employer contributions to a qualified pension, profit-sharing, or stock bonus plan ("qualified pension plan"). If an employer maintains a pension plan and an annuity, profit-sharing, or stock bonus plan, the deduction for a year is limited to the greater of (1) 25 percent of aggregate compensation of all beneficiaries under the plan or (2) the amount necessary to satisfy the minimum funding requirement under the pension plan. In addition, present law provides overall limits on the contributions and benefits that may be provided to participants under qualified pension plans.

In the case of an employee participating both in a defined contribution plan and a defined benefit plan maintained by the same employer, the sum of the fractions of the separate limits for each plan is subject to an overall limit, which TEFRA generally reduced from 1.4 to 1.25. In addition, TEFRA suspended all cost-of-living adjustments to the dollar limits on contributions and benefits under qualified pension plans until 1986.

The bill applies the 25-percent limitation rule of present law to situations in which the employer maintains both a defined benefit pension plan and a money purchase pension plan for the same employees. In such a case, the deduction is limited to the greater of (1) 25 percent of compensation or (2) the minimum funding requirement under the defined benefit pension plan. Under the bill, in no event can an employer's deduction for contributions to all qualified pension plans of the employer exceed 100 percent of the aggregate compensation of all beneficiaries.

Under the bill, in the case of an employee participating in both a defined contribution plan and a defined benefit plan maintained by the same employer, the combined limit on the sum of the fractions of the separate limits is raised to 1.4, if no plan of the employer is top heavy or integrated with social security after June 30, 1982.

Finally, the bill postpones the cost-of-living increases to the dollar limits on contributions and benefits under qualified pension plans until 1988. Beginning in 1988, the limits will be adjusted for post-1986 cost-of-living increases under the formula then in effect to provide cost-of-living increases in social security benefits.

The provisions are effective for years beginning after December 31, 1984.

b. Provisions relating to top-heavy plans

Under present law, if a qualified pension plan is top heavy, certain minimum requirements must be met. These requirements include rules relating to the provision of minimum benefits or contributions to non-key employees. If a plan is top heavy, the combined limit on contributions and benefits for a key employee participating in both a defined contribution plan and a defined benefit plan is reduced to 1.0, unless additional minimum benefits or contributions are provided to non-key employee. In the case of a super top-heavy plan, the 1.0 combined limit cannot be avoided by providing additional minimum benefits or contributions.

Under the bill, the special limit for super top-heavy plans is repealed. The definition of a key employee is amended to exclude officers who earn less than twice the dollar limit on annual additions under a defined contribution plan. The accrued benefit of any individual is disregarded after the individual has been separated from service for 5 years. Under the bill, employer contributions made pursuant to a salary reduction arrangement are counted for purposes of the top-heavy plan rules. The bill exempts governmental plans from the top-heavy plan rules. In addition, a simplified amendment provision applies if the Secretary fails to issue final regulations with respect to the top-heavy requirements by January 1, 1985.

The provisions generally are effective for plan years beginning after December 31, 1983. The rules relating to separated employees and salary reduction arrangements are effective for plan years beginning after December 31, 1984.

c. Distribution rules for qualified pension plans

Present law requires that distributions to an individual under a qualified pension plan prior to age 59½ are subject to an additional 10-percent income tax to the extent that the amounts are attributable to years in which the individual was a key employee in a top-heavy plan. In addition, present law requires that distributions to a key employee in a top-heavy plan commence no later than age 70½ without regard to whether the key employee has retired.

Under present law, in the case of a qualified pension plan or an IRA, after the death of the participant and the participant's surviving spouse, any distributions to beneficiaries must be made within 5 years after the death of the participant or surviving spouse.

Under present law, if the balance to the credit of an employee is paid as a qualifying rollover distribution, all or any portion of the distribution may be rolled over, within 60 days of the date of the distribution, to another qualified pension or annuity plan or an IRA. No rollover is permitted for a plan distribution that is not a total distribution.

Under the bill, the additional 10-percent income tax applies to amounts attributable to years in which the individual was a 5-percent owner of the employer without regard to whether the plan was top heavy. Rollovers to IRAs of certain partial distributions under a qualified pension plan are permitted. In addition, the bill applies the rules that distributions must commence at age 70½ to all 5-percent owners of the employer.

The bill changes the after-death distribution rules to provide that the 5-year rule is satisfied under a qualified pension plan or an IRA if (1) an immediate annuity contract is distributed to the beneficiary or (2) an annuity is paid from or under a defined benefit pension plan.

The provisions generally are effective for plan years beginning after December 31, 1984.

d. *Treatment of distributions of benefits substantially all of which are derived from employee contributions*

Under present law, an employee-contribution only plan may be a qualified pension plan. In addition, nondeductible employee contributions to a qualified pension plan may be withdrawn at any time without penalty. The first withdrawals of nondeductible contributions are treated as a return of nondeductible contributions, which are not includible in gross income.

Under the bill, in the case of a plan in which substantially all of the accrued benefits are derived from employee contributions, the first amounts withdrawn from the plan are treated as coming out of earnings in the employee's account. In addition, if an employee receives a loan (directly or indirectly) under the plan, the bill treats the amount of the loan as a distribution under the plan.

The provision is effective for any withdrawals occurring, or loans made, more than 90 days after the date of enactment

e. *Repeal of estate tax exclusion for qualified pension plan benefits*

TEFRA reduced the estate tax exclusion for certain benefits under qualified pension plans and IRAs to $100,000, for decedents dying after December 31, 1982.

Under the bill, the separate estate tax exclusion for retirement benefits is repealed, effective for decedents dying after December 31, 1984. A grandfather rule is provided for this provision and for the TEFRA change with respect to certain participants whose benefits were in pay status as of the effective date of either provision.

f. *Affiliated service groups, employee leasing arrangements, and collective bargaining agreements*

Under present law, certain aggregation rules apply to treat employees of related employers as if employed by a single employer. In addition, under certain circumstances, a leased employee is treated as the employee of the lessee. Present law provides that many of the nondiscrimination rules do not apply to a plan maintained pursuant to a collective bargaining agreement.

Under the bill, modifications are made to the rules for affiliated service groups, employee leasing arrangements, and collectively bargained plans maintained primarily for management employees.

The modification to the rules for affiliated service groups is effective for plan years beginning after December 31, 1984. The employee leasing provision is effective for plan years beginning after December 31, 1983. The collective bargaining agreement provision is effective on April 1, 1984.

2. Welfare Benefit Plans

a. Additional requirements for tax-exempt status of certain organizations

Under the bill, an organization generally will not qualify as a tax-exempt voluntary employees' beneficiary association (VEBA), a supplemental unemployment compensation benefit trust (SUB), or a group legal service organization for a year unless the plan of which it is a part meets requirements relating to the proportion of benefits provided to certain key employees. In addition, an organization will not be tax-exempt as a VEBA, SUB, or group legal service organization unless the plan of which it is a part meets new, more effective, standards prohibiting discrimination in favor of employees who are highly compensated. These additional requirements apply for taxable years beginning after 1984.

b. Excise taxes involving funded welfare benefit funds

Under the bill, if the use of certain facilities is provided under a funded welfare benefit plan, a nondeductible excise tax is imposed on the use of the facilities by certain key employees under specified circumstances. The bill also imposes nondeductible excise taxes on employers with respect to certain facilities and with respect to excess reserve amounts under a funded, top-heavy welfare benefit plan. The provision applies to years beginning after 1984.

c. Tax with respect to other benefits of key employees

Under the bill, if certain key employees are provided more than 25 percent of the use of certain facilities or if a welfare benefit fund is top heavy for a year, then benefits with respect to certain key employees for the year are subject to a 50 percent excise tax. The provision applies for taxable years beginning after 1984.

d. Treatment of certain medical, etc., benefits under section 415

Present law limits contributions and benefits under qualified pension, profit-sharing, and stock bonus plans. Medical benefits provided under a qualified pension plan are not taken into account in applying the limits. Under the bill, in the case of a top-heavy qualified pension plan, medical benefits are to be taken into account with respect to any participant who has an individual medical benefit account. A plan would be required to maintain such an account for each key employee beginning with the first year in which it is top heavy. The provision applies to years beginning after March 31, 1984.

e. Employee and welfare benefit fund treated as related persons

Under present law, the gain from the sale of depreciable property between certain related taxpayers is treated as ordinary income but an employer and a welfare benefit fund to which the employer contributes generally are not treated as related parties. The bill treats an employer and a welfare benefit fund as related parties if the employer controls the fund directly or indirectly. The provision applies to sales and exchanges after the date of enactment, in taxable years ending after that date.

3. Retirement Savings Incentives

Individual retirement accounts for one-earner couples

Under present law, an individual generally is entitled to deduct IRA contributions up to the lesser of $2,000 or 100 percent of compensation. The $2,000 deduction limit is increased to $2,250 for any year in which (1) at least $250 is contributed to an IRA for the spouse of the individual and (2) the spouse has no compensation for the year. Under certain circumstances, alimony may be considered compensation for purposes of the IRA deduction limits.

Under the bill, the dollar amount of the IRA deduction limit for a married couple is increased to $4,000 as follows: (1) for taxable years beginning in 1985 and 1986, $2,750, (2) for taxable years beginning in 1987 and 1988, $3,250, (3) for taxable years beginning in 1989 and 1990, $3,750, and (4) for taxable years beginning in 1991 and thereafter, $4,000. In addition, the bill repeals the special rules for alimony and treats all alimony received as compensation for purposes of the IRA deduction limit.

The provisions are effective for taxable years beginning after December 31, 1984.

4. Employee Stock Ownership Provisions

Under present law, the limit on the tax credit for employer contributions to an employee stock ownership plan (ESOP) is scheduled to increase from one-half of one percent of payroll in 1983 and 1984 to three-fourths of one percent in 1985. The bill freezes the limit at the current rate through 1985.

The bill provides a number of incentives for employee stock ownership. First, it permits a tax-free rollover of the proceeds from the sale of a business to an ESOP or to certain worker-owned cooperatives, provided the proceeds are reinvested in the securities of another business. Second, a corporate deduction is allowed for dividends paid on ESOP stock, provided the dividends are paid out currently to employees or used to repay an ESOP loan. Third, a bank, insurance company, or other commercial lender is permitted an exclusion from income for 50 percent of the interest received on loans to ESOP companies, provided the loan proceeds are used to finance an ESOP's acquisition of company stock. Fourth, the capital gain exclusion is increased from 60 to 80 percent for investments in certain companies with employee ownership.

The bill also provides that the liability for estate taxes may be assumed by an ESOP in return for a transfer from the estate of stock of an equal value, provided the company sponsoring the ESOP guarantees payment of the taxes. In addition, an exclusion from the gross estate is allowed for 50 percent of the proceeds realized on the sale of employer securities to an ESOP or to certain worker-owned cooperatives. Also, for income, gift and estate tax purposes, an ESOP is treated as a charitable organization, provided donated stock is not allocated to the donor, family members of the donor or 25-percent or more shareholders.

The provisions are effective for years beginning after December 31, 1984.

5. Miscellaneous Pension Provisions

a. Elimination of retroactive application of amendments made by Multiemployer Pension Plan Amendments Act of 1980

The Multiemployer Pension Plan Amendments Act of 1980 (MPPAA) was enacted on September 26, 1980. That Act generally imposes liability on an employer who withdraws from a multiemployer defined benefit pension plan on or after April 28, 1980.

Under the bill, an employer does not have withdrawal liability under the MPPAA as a result of a withdrawal from a multiemployer plan before September 26, 1980. In addition, withdrawal liability does not apply to a withdrawal completed before December 31, 1980, pursuant to a binding agreement in effect on September 26, 1980. Employers are entitled to a refund of amounts collected. The provision is effective on the date of enactment.

b. Treatment of certain distributions from a qualified terminated plan

Under present law, a distribution under a qualified pension plan is not a lump sum distribution eligible for rollover to an IRA unless it consists of the balance to the credit of the employee and is made within one taxable year of the recipient.

Under the bill, special relief is provided for certain pension plan distributions received by a taxpayer during 1976 and 1977 so that the amounts received are treated as a lump sum distribution eligible for rollover. In addition, the usual statute of limitations period is extended. The provision is effective upon date of enactment.

c. Special rule for Trans-Alaskan pipeline employees

Under present law, in the case of the partial termination of a qualified pension plan, the rights of all affected employees to benefits accrued to the date of the partial termination generally become nonforfeitable upon the partial termination to the extent those benefits have been funded.

Under the bill, in the case of certain multiemployer pension plans located in the state of Alaska, no partial termination is deemed to have occurred merely because there was a reduction in workforce upon completion of the Trans-Alaskan pipeline. The provision is effective on the date of enactment.

d. Distribution requirements for accounts and annuities of an insurer in rehabilitation proceedings

Under present law, distributions to the owner of an IRA must be made by the end of the taxable year in which the owner attains 70½. In addition, after the death of the owner, distributions must be made to beneficiaries within 5 years of death of the owner. In the event that distributions are not made as required under present law, an excise tax of 50 percent applies to the amounts that are required to be distributed.

Under the bill, an amount is not required to be distributed under the usual rules for IRAs to the extent that the amounts are held by an insurance company that, on March 15, 1984, is engaged in rehabilitation proceedings under applicable State law. The provision is effective on March 15, 1984.

e. *Extension of time for repayment of qualified refunding loans*

TEFRA imposed limits on the extent to which an individual can borrow amounts from a qualified pension plan without the loan being treated as a distribution under the plan. A transition rule was provided for certain "qualified refunding loans" made on or after August 13, 1982, and repaid before August 14, 1983.

Under the bill, the period for making and repaying qualified refunding loans is extended to January 1, 1985, for qualified refunding loans of non-key employees. The provision is effective as if enacted in TEFRA.

f. *Pension portability involving telecommunications divestiture*

Under present law, generally all years of service with the employer maintaining a qualified pension plan must be taken into account for purposes of the minimum participation and vesting requirements. In any case in which an employer maintains a plan of a predecessor employer, service for the predecessor is treated as service for the employer.

Under the provision, the period of service of a qualified employee (an employee of AT&T or any of its subsidiaries immediately before divestiture) with any of the companies after divestiture includes service with any of the other companies whether or not that service was performed before divestiture, under the rules in effect for 1984. Accordingly, the rules provided by the court order for 1985, under which post-divestiture service with another divested company would not be taken into account, will not be effective.

J. Foreign Provisions

1. Factoring trade receivables

Under present law, a seller who sells goods for the buyer's receivable (a transferable debt) may sell that receivable to a third party—a factor—at a discount. If a U.S.-owned factor is in a tax haven, it may earn income free of U.S. tax. That income may be eligible for deferral, and it may be foreign-source income that is sheltered by excess foreign tax credits. Further, when a foreign subsidiary of a U.S. corporation invests in U.S. property, that investment is taxable as a dividend to the U.S. parent. Some taxpayers allege that this rule does not apply to a foreign factoring subsidiary that buys receivables from its U.S. parent.

Under the bill, when a foreign factoring subsidiary of a U.S. owner gets cash for a receivable that (1) it bought from a related person, and (2) the related person had taken in exchange for inventory, the U.S. owner is taxed on that factoring income. The bill treats income from a related U.S. person's receivables as U.S.-source income except for income from export receivables which is treated as 50 percent U.S. source and 50 percent foreign source. The bill also treats payments of cash from a foreign subsidiary to a related U.S. person for receivables (except for export receivables) arising from the U.S. person's sales of inventory, as investments in U.S. property. Thus, payments of cash for receivables will be taxable as dividends to the U.S. parent. Export receivables will not include receivables attributable to sales involving a DISC or FSC. This provision will apply to accounts receivable and evidences of indebtedness transferred after March 1, 1984 in taxable years ending after that date.

2. Certain transfers of appreciated property to foreign corporations

Under present law, certain transfers of appreciated assets to foreign corporations in reorganizations and liquidations, which would be tax-free, are taxable if the Internal Revenue Service rules that one of the principal purposes of the transfers was the avoidance of Federal income tax. Under Internal Revenue Service guidelines, generally, transfers of property used in the active conduct of a foreign trade or business are not taxed. However, also under those guidelines, transfers of assets containing built-in gain (such as inventory and accounts receivable) are generally taxed.

Judicial interpretation of the principal purpose test has reduced the ability of the Internal Revenue Service to administer these rules. In addition, the Internal Revenue Service's current ruling policy permits the tax-free transfer of intangible property abroad, where the development of the property generated significant U.S. tax benefits but the income derived from the property may escape U.S. taxation. Finally, the courts have rejected the Internal Revenue Service's requirement that certain losses be recaptured upon the incorporation of a foreign branch by a U.S. person.

Under tne bill, the rules governing transfers of appreciated property abroad are amended to provide for gain recognition without regard to purpose, unless the property is transferred for use in an active trade or business abroad. Certain transfers of assets containing built-in gain are automatically subject to tax. Transfers of stock are subject to the active trade or business test. In addition, transfers of intangibles that would otherwise be tax-free are subject to tax. The intangibles rule does not apply to good will or going concern value developed by a foreign branch. Finally, the current Internal Revenue Service policy on incorporations of foreign branches is codified. The provision generally applies to transfers after January 1, 1985.

3. Decontrol of foreign corporations

Under present law, when a U.S. taxpayer who is a 10-percent shareholder of a controlled foreign corporation sells or exchanges stock in a taxable transaction, the gain is treated as ordinary (dividend) income to the extent of the shareholder's pro rata share of the corporation's post-1962 accumulated earnings and profits. A U.S. corporation that disposes of stock by distributing it as a dividend-in-kind or in the course of liquidation, in a transaction otherwise eligible for nonrecognition treatment to the U.S. corporation, is also required to include in income its share of post-1962 accumulated earnings and profits. Taxpayers have taken the position that this rule does not apply if a controlled foreign corporation that is wholly owned by a U.S. corporation issues new shares for shares of the U.S. corporation. If this position were sustained, such a transaction could lead to permanent exemption from U.S. corporate tax of the earnings of the controlled foreign corporation accumulated prior to the exchange.

Under the bill, certain exchanges by a controlled foreign corporation of its newly issued stock for shares of its U.S. parent corporation are treated as sales or exchanges by the U.S. parent of stock in the controlled foreign corporation. The provision applies as of the date of enactment.

4. Foreign investors—original issue discount and coupon stripping

Foreign investors acquiring pure original issue discount corporate bonds—those with no payment of interest until maturity—defer U.S. taxation until they surrender the bonds at maturity. The rules governing timing of income inclusion for foreign investors holding corporate OID debt differ in some respects from those governing income inclusion for U.S. investors. As for foreign holders of debt originally issued at a discount by obligors other than corporations and governmental entities, existing law is unclear.

The bill conforms the timing of income inclusions for foreign investors to the timing for comparable U.S. investors, except that there is no inclusion for foreign investors until actual receipt of payment. The bill also conforms the treatment of noncorporate debt to the treatment of corporate debt. These provisions generally apply to payments made on or after the 60th day after the date of enactment.

The Internal Revenue Code does not contain specific rules governing foreign investors who sell or surrender stripped bonds or who sell stripped coupons. The bill generally conforms the rules governing foreign investors to those governing U.S. investors, except that there is no inclusion for foreign investors until actual receipt of payment. Thus, foreign investors will treat stripped coupons and stripped bonds as being OID instruments. These provisions will apply generally to payments made on or after the 60th day after enactment.

5. Recharacterization of U.S. income as foreign income

Under present law, the United States taxes the U.S. income of U.S. taxpayers. U.S. taxpayers' foreign income can be free of U.S. tax under the foreign tax credit. U.S. taxpayers can place the "foreign" label on some U.S. income (such as interest and insurance premiums) by routing it through a foreign corporation. This foreign corporation distributes foreign dividends to its U.S. owners. This newly foreign income may escape U.S. (and foreign) tax.

The bill prevents re-labelling of U.S. income as foreign income. Under the bill, if a corporation, 10 percent (or more) of whose gross income is U.S. income (including U.S. business income), pays interest or dividends to a U.S. taxpayer, a pro rata portion of the payment is U.S. income. The bill applies only to 50-percent U.S-owned corporations. Generally, it applies with respect to income earned by paying corporations after the date of enactment. Transitional rules are provided.

6. Recharacterization of interest income as dividend income

Under present law, a U.S. taxpayer's foreign interest income cannot escape both U.S. and foreign tax (under the United States' separate foreign tax credit limitation that prevents foreign taxes on non-interest income from offsetting U.S. tax on foreign interest income). U.S. taxpayers can circumvent this rule by creating foreign subsidiaries to earn foreign interest income (for example, by depositing money in foreign banks). When the U.S. taxpayer is taxable on the earnings of its foreign subsidiary, its income is dividend income, not interest income. Thus, newly recharacterized "non-interest" income may totally escape both U.S. and foreign tax.

The bill treats foreign dividends as interest to the extent that the paying corporation's earnings and profits arise from interest. This rule applies only if 10 percent or more of the paying corporation's earnings and profits for a base period (generally the three taxable years preceding the taxable year in which the dividend is paid) arise from interest. The provision generally applies to income earned by paying corporations in taxable years beginning after the date of enactment. Transitional rules are provided.

7. Source of transportation income

Under present law, in general, the United States taxes all U.S. income, but not all foreign income, of United States persons. In general, the United States does not tax the foreign income of foreign persons (such as foreign corporations). Under present law, transportation income can be almost all foreign even if the transportation is between two U.S. points, if the route of transport lies primarily outside the United States' three mile territorial limit.

Under the bill, income earned from transportation that begins and ends in the United States (or U.S. possessions) is treated as U.S. income. Income earned from transportation includes services income and leasing income from ships, airplanes, and containers used in connection with ships and airplanes. The effective date is the date of enactment.

8. Foreign collapsible corporations

Under present law, sales of inventory yield ordinary income, not capital gain. "Collapsible" corporations' assets generally include inventory. Generally, a shareholder's gain on the sale or liquidation of a collapsible corporation is ordinary income rather than capital gain. However, if a collapsible corporation consents under section 341(f) to recognize ordinary income on disposition of its inventory and the like, the shareholder gets capital gain treatment on the sale or liquidation of the corporation. In the case of a consenting foreign corporation, enforcement of the consent may be impractical.

Under the bill, in general, a section 341(f) consent given by a foreign corporation is not given effect to the extent provided in regulations. This provision is effective for sales or exchanges after the date of enactment.

9. Insurance of related parties by a controlled foreign corporation

Under present law, income that a controlled foreign corporation earns from insuring U.S. risks is currently taxable to its U.S. shareholders; income earned from insuring non-U.S. risks of a related party may not be currently taxable. The bill provides that, for purposes of determining foreign base company services income (which is also currently taxable to U.S. shareholders of a controlled foreign corporation), any services performed with respect to any policy of insurance or reinsurance covering risks of a related party will be treated as having been performed in the country in which the insured risk is located. This provision will apply to taxable years of foreign corporations beginning after the date of enactment.

10. Excise tax on insurance premiums paid to foreign insurers and reinsurers

Generally, present law imposes an excise tax on premium payments for the direct insurance or reinsurance of U.S. risks with foreign insurers or reinsurers. The bill conforms the tax rate on reinsurance to that imposed on direct insurance depending on the character of the U.S. risk covered, but imposes an excise tax only once—on retained premiums received by foreign insurers or reinsurers—when the U.S. risk is insured or reinsured outside the U.S. The excise tax on the insurance or reinsurance of U.S. casualty risks by a foreign insurer will be four percent of premiums paid; for U.S. life, accident or health, or annuity risks, the excise tax will be one percent of the premiums paid. In addition, the bill adopts a withholding provision for the excise tax. This provision will apply generally to premium payments made after the date of enactment.

11. Withholding on dispositions by foreigners of United States real property interests

Under the Foreign Investment in Real Property Tax Act of 1980, foreign persons who dispose of U.S. real property interests generally are required to pay tax on any gain realized on the disposition. The Act provides for enforcement of the tax on foreign persons through a system of information reporting designed to identify foreign owners of U.S. real property interests.

The bill generally allows replacement of the information reporting system with a withholding system. Generally, the bill requires withholding of a certain portion of the sales price by a transferee of U.S. real estate, any agent of a transferee, or any settlement officer or transferor's agent (hereinafter collectively referred to as the withholding agent) where U.S. real estate is acquired from a foreign person. Withholding generally is required only if the withholding agent knows (or has received notice from the transferor or his agent) that the transferor is a foreign person. The bill provides for exemptions from withholding in certain cases including that in which the transferee is to use the real property as his principal residence and the purchase price is $200,000 or less. This provision will be effective for payments with respect to dispositions made more than 30 days after the date of enactment.

12. Provisions relating to foreign personal holding companies

The bill clarifies the family and partner attribution rules for determining when a foreign corporation is a foreign personal holding company. It also prevents avoidance of U.S. tax by interposition of a foreign trust or another foreign entity between a foreign personal holding company and a U.S. taxpayer. In addition, the bill coordinates the foreign personal holding company rules with the controlled foreign corporation rules. It provides that shareholders of a controlled foreign corporation (that is also a foreign personal holding company) are subject to the controlled foreign corporation rules to the extent that income taxable under those rules exceeds income taxable under the foreign personal holding company rules. These provisions generally apply to taxable years beginning after the date of enactment.

13. Foreign investment companies

Under present law, taxpayers contend that a foreign corporation that is widely held by U.S. persons may establish a subsidiary to invest in U.S. commodities markets without any of the parties incurring U.S. tax. They also contend that when the U.S. shareholders eventually dispose of their shares in the foreign corporation they will be subject to tax at only the capital gains rate.

The bill will, in certain cases, apply the accumulated earnings tax to earnings from U.S. investments, even after those earnings pass through corporate solution as dividends or interest. This provision applies generally to distributions received on or after May 23, 1983. It will also generally treat gains of U.S. shareholders from those investments as ordinary income. This provision applies generally to sales or exchanges on or after October 31, 1983.

14. Repeal of 30-percent withholding tax on certain interest paid to foreign persons

Under present law, a U.S. tax of 30 percent is generally imposed on the gross amount of U.S. source annuities, interest, dividends, rents, royalties, and similar payments to foreign persons if the payments are not effectively connected with a U.S. trade or business conducted by the foreign person. Exemptions from the tax are provided in certain situations. The tax is generally withheld by the payor. In addition, U.S. tax treaties generally reduce or eliminate the tax on interest paid to treaty country residents.

The bill provides for a phase-out of the 30-percent tax on interest paid on portfolio indebtedness by U.S. borrowers to nonresident alien individuals and foreign corporations. The rate of tax will be reduced to five percent for interest received after the date of enactment. The rate of tax will be reduced to four percent in 1985, three percent in 1986, two percent in 1987, and one percent for the period January 1 to June 30, 1988. Effective July 1, 1988, the withholding tax on interest received by nonresident alien individuals and foreign corporations on portfolio indebtedness will be repealed. However, the 30 percent tax on such interest will be retained in certain cases where the foreign person is related to the U.S. obligor, where the foreign person is controlled by U.S. persons, or where the foreign person is a bank.

15. Extension of moratorium on application of research and experimental expense allocation regulation

In determining foreign-source taxable income for purposes of computing the foreign tax credit limitation, taxpayers must allocate or apportion expenses between foreign-source income and U.S.-source income (Code secs. 861-863). Rules for allocating and apportioning research and other expenses are set forth in Treasury Regulation sec. 1.861-8.

In the Economic Recovery Tax Act of 1981 (ERTA), Congress directed the Treasury Department to study the impact of its section 861 regulations on research activities conducted in the United States and on the availability of the foreign tax credit. Congress also provided that for a taxpayer's first two taxable years beginning after the date of enactment of ERTA (August 13, 1981), all research expenditures in those years for research activities conducted in the United States are to be allocated or apportioned to sources within the United States. This two-year moratorium on the application of the research and experimental expense allocation rules of Treas. Reg. sec. 1.861-8 does not apply to subsequent taxable years.

The bill generally extends for two more years the moratorium on the application of the Treasury research expense allocation rules. The extension is effective on the date of enactment.

K. Taxpayer Compliance and Tax Administration Provisions

1. Syndicate promoters

Present law does not provide the Treasury with the means of detecting and tracing tax shelter promotions through the activities of the promoters.

The bill provides for registration of tax shelter promotions with the IRS so that the IRS can more effectively manage its activities with respect to tax shelters. Also, the bill requires promoters to keep a list of their investors for inspection by the IRS.

2. Cash and mortgage interest reporting

Present law provides for reporting of cash transactions by certain financial institutions, but does not require nonfinancial institutions to report receipts of cash from individuals. Similarly, present law does not require reporting by recipients of amounts that may be deducted by the payor.

The bill requires persons who, in connection with their trade or business, receive cash payments from another person in excess of $10,000, or mortgage interest payments in excess of $2,300 annually, to report those payments to the IRS.

3. Foreclosure reporting

Under present law, foreclosures in satisfaction of a debt or forgiveness of a debt may give rise to income to the debtor. The bill requires persons lending in the course of a trade or business to report to the IRS when the security for a loan is acquired by foreclosure or otherwise in satisfaction of all or part of the debt. Reporting is also required when the borrower abandons the security or the lender claims a bad debt deduction.

4. Promoter penalty

The Tax Equity and Fiscal Responsibility Act of 1982 provides for a penalty on promoters and salespersons of abusive tax shelters equal to the greater of $1,000 or 10 percent of gross income to be derived from the activity. The bill increases the penalty to the greater of $2,000 or 20 percent of gross income. The bill also makes actions incidental to the activities of a tax shelter subject to penalty and injunction.

5. Interest for tax shelter cases

The bill provides a special, higher interest rate in pre-1983 tax shelter cases for interest accruing after 1983.

6. Reporting of State income tax refunds

Present law requires States to report refunds of State or local income tax to the IRS and to provide the individual taxpayer with a copy of the report during January of the year following the year of refund. The bill alternatively permits the State to furnish the statement to the taxpayer at the same time that payment of a refund is made.

7. Regulation of appraisers

Present law allows the Treasury to regulate the practice of attorneys and accountants who appear before the Treasury. No comparable authority exists with respect to appraisers. The bill provides authority for the Treasury to bar disreputable appraisers from practice before the Treasury.

8. IRA reporting

Present law generally allows an individual to deduct the amount of qualified individual retirement account (IRA) contributions made for a year, either during the year or before the due date (with extensions) of the income tax return for the year. In the absence of reporting specifically by the trustee or issuer, the Internal Revenue Service has difficulty verifying whether contributions were made and the proper year to which they relate. The bill clarifies the authority of the Treasury Department to require reporting on contributions to IRAs by the trustee or issuer. Reports are to include the amount and the year to which a contribution relates. The bill also provides that an IRA contribution is not deductible for any year unless made on or before the unextended due date of the return for that year.

9. Short-sale compliance

A broker who holds securities for a customer in a street name may lend those securities to another for use in a short-sale. If dividends or interest are paid on the securities before the stock is returned to the broker, the short-seller will make substitute payments to the broker. These payments are not eligible for the dividends received deduction or any otherwise applicable interest exclusion. The bill requires brokers to notify their customers when payments they receive are amounts in lieu of dividends or tax-exempt interest occurring by reason of a short-sale. Regulatory authority will permit the Treasury to extend these rules to other transactions when appropriate. This provision applies to payments in lieu of dividends or tax-exempt interest made after December 31, 1984.

10. Charitable contribution and other valuation rules

The bill imposes a number of substantiation rules and sanctions (relating to appraisals and information reporting) in the case of charitable contributions of property other than publicly traded securities, effective for post-1984 contributions.

Also, the bill provides certain disallowance sanctions for overvaluations claimed for certain charitable contributions. If the value claimed on the return is between 150 and 175 percent of the correct value (i.e., as determined by a court or settlement agreement), the donor's deduction cannot exceed basis plus one-half of the appreciation otherwise deductible; if between 175 and 200 percent, the deduction cannot exceed the donor's basis; if 200 percent or more, the donor cannot deduct either basis or appreciation. The bill also modifies the present-law penalty with respect to incorrect valuations generally, including deletion of the exception for property held for more than five years, and extension of the penalty to incorrect estate and gift tax valuations. The overvaluation disallowance and penalty rules apply with respect to returns filed after 1984.

11. Disclosure of tax return information

The bill modifies the present law disclosure rules to permit exchanges of tax return information between the IRS and cities with a population of over 2 million individuals that have income or wage taxes.

12. Changes in accounting methods

The bill precludes a taxpayer from asserting that the IRS has not consented to a change in accounting method as a defense to any penalty unless the taxpayer has requested permission to change methods.

13. Interest on penalties

The bill provides that interest shall be charged on the penalties for failure to file, valuation overstatement, and substantial understatement of tax as if the penalties were assessed on the due date of the return (with extensions).

14. Tax deposits

The bill requires taxpayers required to deposit more than once a month to make any deposit of $20,000 or more on or before the due date of the deposit. They may no longer treat deposits mailed two days in advance of the due date as timely made.

15. Tax litigation

The bill increases the present law $5,000 limit on small tax case proceedings to $10,000. The present law penalty (expanded in 1982) for maintaining dilatory Tax Court actions is made applicable to all cases pending 120 days after enactment. Title 18 is amended to provide for appropriate, even single, venue of multi-party criminal tax litigation.

16. False withholding certificates

Language in the criminal penalty with respect to false withholding information which provides that no other penalty may apply is eliminated.

17. Backup withholding

The bill provides that, with respect to backup withholding, the Secretary's authority to require that a payee certify under penalties of perjury that his taxpayer identification number is correct is limited to interest, dividends, patronage dividends, and amounts subject to broker reporting.

18. Tax shelter study

The bill provides for a study by the Treasury Department of certain aspects of tax shelters to be submitted to the Congress by December 1, 1984.

L. Depreciation

1. Real estate depreciation

Under present law, real estate can generally be depreciated, on an accelerated basis, over 15 years. The bill provides that new and used real property, other than low-income housing, is to be depreciated over not less than 20 years.

Subject to a transitional rule, the provision is applicable with respect to property placed in service by a taxpayer after March 15, 1984.

2. Depreciation recapture and installment sales

Under present law, the installment sale rules override the depreciation recapture rules applicable to real estate. Generally, no real estate depreciation recapture income is recognized in an installment sale until the taxpayer receives installment obligation payments. Under the bill, all such depreciation recapture income realized is to be recognized at the time of the installment sale. Gross profit, under the installment sale rules, is to be adjusted by reason of such income.

Subject to a transitional rule, the provision applies to installment sales after March 15, 1984.

3. Movies and sound recordings

Under present law, it is unclear whether movies qualify as recovery property. Furthermore, taxpayers have taken the position that movies can be depreciated on the income forecast method and still be eligible for a 10-percent investment credit. Under the bill, movies cannot qualify as recovery property and are eligible for the investment credit only under the special investment credit rules applicable to certain movies.

Subject to a transitional rule, the provisions are effective as of the effective date of the rules defining recovery property (sec. 168).

Under present law, it is unclear whether sound recordings qualify as tangible personal property for depreciation and investment credit purposes. The bill provides that any sound recording may, by election, be treated as 3-year property and eligible for a 6-percent investment credit or, if the taxpayer fails to so elect, depreciated under the income forecast method with no investment credit. Special rules are provided for contingent amounts, foreign production costs, and certain other items. Sound recordings distributed outside the United States are not subject to the tax-exempt entity leasing provisions of this bill.

The provisions are generally effective for sound recordings placed in service after March 15, 1984.

M. Miscellaneous Tax Reform Provisions

1. Inclusion of tax benefit items

Under present law, an individual taxpayer who receives a State tax refund may exclude from income an amount equal to the excess of the zero bracket amount over the taxpayer's other itemized deductions for the year in which the State taxes were deducted. This exclusion is permitted even though the deduction of this amount in the prior year resulted in a tax benefit.

The bill provides that where a taxpayer recovers a previously-deducted amount, the recovered amount is excluded from gross income only to the extent such amount did not reduce income subject to tax. This provision will apply to amounts recovered after 1983.

2. Low-interest and interest-free loans

Under present law, loans between family members generally result in taxable gifts in an amount equal to the value of the interest that is not charged. No income tax consequences result, however, to either the lender or the borrower. A number of cases have held that demand loans by corporations to their shareholders, and by persons for whom services are performed to persons providing the services, generally do not have any Federal tax consequences.

Under the bill, low-interest and interest-free loans generally are to be recharacterized as (1) a loan to the borrower at a statutory interest rate, and (2) either a gift (in the case of a gratuitous transaction), dividend (in a corporation-shareholder transaction), or compensation (in a transaction involving services), or some other payment in accordance with the substance of the transaction. The borrower is treated as paying interest on the loan at the statutory rate, resulting in income to the lender and a deduction to the borrower. An exception is provided for de minimis transactions that are not tax motivated. In addition, in the case of a loan in which the deemed payment by the lender to the borrower is a gift, the amount of deemed interest paid is generally limited to the amount of passive income of the borrower. This provision is effective for below market loans outstanding on the date of enactment, except for term loans made before February 1, 1984.

3. LIFO conformity

Currently, the "Last-In First-Out" (LIFO) method of inventory accounting may not be used for tax purposes unless it is also used in reporting to shareholders, partners, other proprietors, beneficiaries, or for credit purposes. An issue has arisen as to whether a parent company is subject to these LIFO conformity rules when the inventory is held by a subsidiary company. The bill makes the LIFO conformity requirement applicable to financially related corporations as if they were a single taxpayer, effective for taxable years beginning after the date of enactment.

4. Income averaging

Income averaging is presently available to taxpayers with "averageable income". Averageable income is current year taxable income in excess of 120 percent of average taxable income in the four preceding years. In effect, income averaging widens the tax brackets by a factor of five with respect to averageable income.

The bill increases the 120-percent requirement to 140 percent and provides that only the three preceding years are to be taken into account. The bill modifies income averaging so that it, in effect, widens the tax brackets by a factor of four, not five, with respect to averageable income.

These changes are effective for taxable years beginning after December 31, 1983.

5. Personal use of business property

Present law provides for deductions for the expenses of operating an automobile or other business property in connection with a trade or business, except to the extent used for entertainment purposes. The bill provides that unless business use of an automobile or other business property is at least 90 percent of total use, the investment tax credit and accelerated cost recovery system (ACRS) and, for automobiles, deduction of actual operating expenses is not allowed. The bill provides for specific mileage or depreciation deductions to replace the deductions no longer available. This provision is effective for property purchased, or leases entered into, after March 15, 1984.

6. Treatment of certain related party transactions

The bill amends the related party rules (sec. 267) so that a taxpayer would generally be placed on the cash method of accounting for purposes of deducting business expenses and interest owed to a related party cash basis taxpayer. These rules will be extended to amounts accrued by a partnership to its partners and vice versa.

Also, the bill extends the loss disallowance and accrual provisions to transactions between corporations which are members of a controlled group of corporations, using a 50-percent control test.

These provisions generally will apply to taxable years beginning after 1983. However, the provision will not apply to (1) interest on indebtedness incurred on or before September 29, 1983, or incurred pursuant to a contract binding on that date and all times thereafter and (2) other expenses made pursuant to a contract which was binding on September 29, 1983, and at all times thereafter.

7. Section 1231 property

The bill provides that gains and losses from the sale or exchange of business property will be netted over a period including the prior three taxable years and the three succeeding taxable years in order to determine whether there are net capital gains or net ordinary losses.

The provision will be effective for taxable years beginning after December 31, 1984.

8. Disallowance of certain expenses where taxpayer uses property similar to property owned by taxpayer

The bill clarifies the application of the prohibition on deducting personal, living, or family expenses, by providing expressly that no business deductions are allowable with respect to property owned by a taxpayer if the taxpayer uses similar property for personal purposes under circumstances described in the bill. The provision applies to agreements entered into for the use of property after February 22, 1984.

9. Individual minimum tax—foreign income exclusion

Present law imposes a 20-percent minimum tax on individuals, based on their adjusted gross income plus certain tax preferences, to the extent it exceeds their regular income tax. The bill provides that the income excluded under section 911 will be a tax preference. The foreign tax credit will be allowed against the minimum tax attributable to that income. This provision will be effective for taxable years beginning after December 31, 1984.

10. Use of related party structures to reduce tax on coal operations

Under present law, taxpayers may reduce the effective rate of tax on coal mining operations by establishing related party structures to take advantage of the capital gains treatment provided in section 631(c). The Code expressly prohibits such multi-party structures in the case of iron ore. The bill extends the related party prohibition to coal royalties, effective on the date of enactment.

11. Dividend reinvestment plans for utilities

Present law provides an exclusion for up to $750 of dividends reinvested in public utility stock, effective through 1985. The bill repeals the exclusion for dividends received from public utilities, effective for distributions made after 1984.

12. Estimated income tax for individuals

The individual estimated income tax rules are amended to allow the Secretary to waive the penalty for failure to make payments by reason of a casualty, disaster or other unusual circumstance where it would be inequitable to impose the penalty. Estimated tax payments of the alternative minimum tax will be required.

The provision will be effective for taxable years beginning after 1984.

13. Taxation of Federal Home Loan Mortgage Corporation

The bill repeals the tax exemption of the Federal Home Loan Mortgage Corporation ("Freddie Mac"), effective January 1, 1985.

14. Interest deductions on debt used to carry or purchase tax-exempt obligations

Under present law, no deduction is allowed for interest on indebtedness incurred to purchase or carry tax-exempt securities. The bill clarifies the present rule to disallow interest on obligations of a taxpayer or certain related persons which is incurred to purchase or carry tax-exempt obligations of the taxpayer or a related person.

Title II.—Life Insurance Tax Provisions

1. Company taxation

Under present law, life insurance companies may be taxed on different tax bases. As a consequence, different companies derive varying degrees of benefit from the various special deductions generally allowable only to life insurance companies and from the reserve computation rules of present law.

In lieu of the present law three-phase pattern of taxation which applies to life insurance companies, the bill provides a new single-phase tax structure. This structure embodies the tax rules applicable to corporations generally except that certain special rules apply to address issues unique to the life insurance industry.

a. Computation of the deduction for reserves

Under the bill, deductions for additions to reserves more closely reflect each company's liabilities to policyholders than do solvency reserves used for State law purposes. Further, the deductions are computed on the basis of uniform rules regardless of the particular assumptions used for purposes of computing statutory reserves.

Under these rules, a life insurance company can deduct an amount equal to the excess of the higher of (1) the net surrender value of the contract or (2) the Federally prescribed reserve of the contract, over the amount of the reserve for tax purposes at the end of the prior year. The Federally prescribed reserve is the reserve computed using assumptions that generally reflect the minimum assumptions permitted to be made under most State laws.

b. Limitation on mutual company deductions

A mutual life insurance company is owned by its policyholders. These policyholders receive distributions from the company which may represent price reductions or other policyholder benefits, interest, or returns on the policyholders' investment in the enterprise.[1] Under the bill, amounts distributed by a mutual company to policyholders are, in effect, fragmented, and no deduction is allowed at the company level for amounts distributed to policyholders in their capacity as owners of the company. This is accomplished by means of an ownership differential provision. Under this provision, each mutual company's deductions for payments and credits to policyholders are reduced by the amount of an imputed return on the company's equity. There is a special 5-year transition rule for certain mutuals with much higher than average equities.

[1] In contrast, a stock life insurance company is owned by shareholders. Although a stock company may pay policyholder dividends to its policyholders, such amounts would generally include only price reductions and policyholder benefits.

The bill also mandates a study in which the Treasury would analyze the operation of the ownership differential provision in its first 3 years.

c. *Stock life insurance subsidiaries of mutual companies*

As a general rule, under the bill, a stock life insurance subsidiary of a mutual life insurance company is treated as a stock company for tax purposes. However, for purposes of computing the limitation on mutual company deductions, the equity of a stock subsidiary is included in the mutual parent.

d. *Special rule for small companies*

Under the bill, a small life insurance company is allowed a deduction equal to 60 percent of the first $3 million of its otherwise taxable income. This deduction phases out as otherwise taxable income increases from $3 million to $15 million. The amount of this deduction is computed on the basis of a controlled group and does not apply to income related to noninsurance activities. Generally, a small company is one the assets of which (computed on the basis of an affiliated group including both insurance and noninsurance members) are less than $500 million.

e. *Rate reduction*

All life insurance companies are allowed a deduction equal to 20 percent of their otherwise taxable income. This deduction is computed on the basis of a controlled group and does not apply to income related to noninsurance activities. The bill also provides a transition rule for certain rapidly growing companies under which they may elect for the first four years to claim an amount equal to a portion of their qualified first year premiums in lieu of the small life insurance company and special life insurance company deductions.

f. *Tax-exempt income*

Under present law, liabilities to policyholders are treated as funded proportionately out of taxable and tax-exempt income. The bill generally continues this approach.

g. *Reinsurance*

The provision under which the Treasury is granted authority to reallocate income, deductions, assets, reserves, credits, and other items in the case of related party reinsurance contracts is retained and broadened in its application.

h. *Definition of a life insurance company*

For purposes of determining whether a company qualifies as a life insurance company, funds held with respect to contracts that do not involve permanent purchase rate guarantees are not to be treated as insurance reserves.

i. *Effective date*

Generally, the effective date for provisions dealing with the taxation of life insurance companies is January 1, 1984. Income that would otherwise result from recomputation of reserves (including section 818(c) recomputations and statutory-to-tax recomputations) and the change in accounting for policyholder dividends at the beginning of 1984 is forgiven under the bill.

The amount of deferred gain from operations held in the policyholder surplus account of the company (the Phase III account) would be frozen at its 1983 year-end level and distributions from such account would be taxed when distributed under the present law rules, which are retained.

2. *Life insurance products*

a. Definition of life insurance

Present law does not contain a definition of life insurance or of a life insurance contract. It does, however, contain temporary rules for purposes of determining whether benefits paid under certain flexible premium products qualify as life insurance benefits exempt from income tax. The bill adopts a definition that is based on the temporary rules contained in present law. A contract is treated as a life insurance contract if it meets (1) a "cash value accumulation" test, or (2) a "guideline premium" and "cash value corridor" test. Under the cash value accumulation test a contract qualifies if the cash surrender value accumulated under the contract does not exceed the cash surrender value which would arise in a traditional whole life policy assuming a reasonable interest rate is used in computing cash surrender value. Under the guideline premium limitation, contracts are disqualified if the amount of the policyholder's investment in the contract exceeds a traditional level of investment. The cash value corridor disqualifies contracts which build up excessive amounts of cash surrender value relative to life insurance risk. Generally, the new definition applies to contracts issued after December 31, 1984, except for new plans of insurance and certain increasing death benefit policies which must satisfy new rules starting on January 1, 1984. The temporary rules for flexible premium products are also extended through 1984.

For contracts that fail to meet the definition at any time, the pure insurance portion of the contract (i.e., the difference between the face amount and the cash surrender value) will be treated as term life insurance. The cash surrender value will be treated as an annuity. The company issuing the policy will be subject to an excise tax of 10 percent of the cash surrender value at the time of disqualification.

b. Annuities

Under the bill, the present law exception from the 5-percent penalty for distributions of income allocable to investments within 10 years is repealed. Thus, the penalty generally will apply to distributions prior to age 59-1/2. In addition, if the owner of a deferred annuity dies prior to annuitization, the income in the annuity must be distributed within 5 years unless the beneficiary receiving the annuity contract is a spouse, minor child, or handicapped individual.

c. Group-term life insurance

The anti-discrimination rules and the $50,000 limitation on the exclusion from income of premiums for group-term benefits are extended to retired employees. For plans not in existence on January 1, 1984, these rules are effective for taxable years beginning after 1983. The extension of the $50,000 limitation will not apply to group plans existing on January 1, 1984, if the covered individual was 55 years or older on January 1, 1984. The new anti-discrimination rules will apply to existing plans starting March 15, 1987, for employees retiring after that date.

Title III.—Revision of Private Foundation Provisions

1. Charitable deduction rules

The bill conforms the income tax treatment of contributions by individuals to private nonoperating foundations to that provided for contributions to public charities or private nonoperating foundations, effective for contributions made after 1984.

2. Divestiture of excess business holdings

Post-1969 gifts or bequests.—The IRS will have discretionary authority under certain circumstances to extend for an additional five years the period for disposing of certain excess business holdings acquired by a private foundation after 1969 by gift or bequest.

Pre-1969 holdings.—The bill allows a foundation to retain excess business holdings acquired prior to May 26, 1969, if (1) the management of the foundation and the management of the business enterprise are sufficiently unrelated, (2) no disqualified person who was not a foundation manager on March 12, 1984, can become a foundation manager, (3) no disqualified person receives compensation (other than reasonable directors' fees) from both the foundation and the business enterprise, (4) the foundation continues to meet the payout rules of present law, and (5) the foundation and any disqualified persons comply with the section 4943 rules applicable to post-1969 holdings.

The bill also provides that if the combined holdings of a private foundation and disqualified persons exceeded 95 percent on May 26, 1969, the foundation will have a 20-year period to reduce pre-1969 excess business holdings (rather than a 15-year period). In addition, a special rule excepts a qualified employee stock ownership plan from the definition of a disqualified person, only for purposes of section 4943, with respect to excess business holdings of a foundation acquired pursuant to the provisions of a pre-1969 will. A technical amendment to current law clarifies that the Herndon Foundation could continue to hold a majority interest in certain business enterprises.

"Downward ratchet" rule.—The bill provides an exception to the so-called "downward ratchet" rule. Under the exception, certain reductions of less than two percent in a foundation's holdings are disregarded where resulting from certain stock issuances.

3. Expenditure responsibility and reliance rules

The Treasury Department is to review its expenditure responsibility regulations for purposes of modifying requirements which are found to be unduly burdensome or unnecessary.

The bill provides that a foundation making a grant to a charitable organization may rely in specified circumstances on an IRS determination of the organization's public charity or operating foundation status, effective for grants made after 1984.

4. Abatement of first-tier penalty taxes

The bill provides the Internal Revenue Service with discretionary authority to abate the automatic first-tier penalty taxes (other than the sec. 4941 tax on self-dealing) if the foundation establishes that the violation was due to reasonable cause and not to willful neglect, and corrects the violation. This provision applies to taxable events occurring after 1984.

5. Definitions

The bill provides that the lineal descendants who are considered members of the family of a substantial contributor or other disqualified person, and thus themselves are considered to be disqualified persons (sec. 4946), are limited to the individual's children, grandchildren, and their spouses, effective January 1, 1985.

In addition, the bill provides rules under which a person's status as a substantial contributor (sec. 507(d)) terminates in certain circumstances after 10 years with no connection to the foundation, effective for post-1984 taxable years. Also, the bill provides special retroactive relief from the excise tax on self-dealing in a particular case where continued status as a disqualified person had triggered tax on a 1978 transaction, provided that the foundation received fair market value.

6. Public disclosure requirements

The bill provides that, beginning in 1985, private foundation notices which must be published annually in a newspaper (sec. 6104(d)) are to include the telephone number of the foundation's principal office. Also, the Internal Revenue Service is directed to enforce fully the present-law rules concerning Form 990-PF information returns.

7. Certain operating foundations

The bill provides that a private operating foundation (such as a museum or library) that previously had been publicly supported for at least 10 years (or qualified as an operating foundation on January 1, 1983), that has a governing body broadly representative of the general public (with at least 75 percent consisting of persons unrelated to the foundation), and none of whose officers otherwise are disqualified persons, will be exempt from the two percent excise tax on net investment income, and grants to such foundations will not be subject to the expenditure responsibility rules. These provisions are effective for post-1984 taxable years and grants.

Title IV.—Enterprise Zones

The bill provides for the designation of certain distressed areas as enterprise zones and for tax incentives and regulatory relief for economic activity within the zones. Under these provisions, up to 75 enterprise zones are to be designated by the Secretary of the Department of Housing and Urban Development, beginning on January 1, 1985, over a period of 3 years, although no more than 25 designations may be made during each year. At least one-third of the designated zones will be in rural areas. Each enterprise zone is eligible for Federal tax and regulatory relief. The duration of each zone is 20 years, plus a 4-year phaseout period. Areas are to be nominated for enterprise zone designation by one or more local governments and the State in which the area is located. Areas nominated for such a designation have to meet certain criteria of economic distress, and designations are made through a competitive process weighing suggested plans for developing the area through tax and regulatory relief, improved services, and involvement of neighborhood and community organizations and private entities in development efforts.

Under the bill, the following Federal tax incentives are available in enterprise zones: An additional 3-percent or 5-percent investment tax credit for investments in personal property and a 10-percent credit for investments in new structures in the zone; a 10-percent credit to employers for increases in payroll to qualified zone employees and a credit for hiring disadvantaged workers for zone employment; a 5-percent credit to zone employees for wages received from zone employers; an exclusion from tax on capital gains attributable to zone property; allowance of full ACRS deductions for facilities in zones financed by industrial development bonds despite the limitation of such deductions for comparably financed facilities elsewhere, and the continued availability of the small issue exemption for industrial development bonds in zones after December 31, 1986, despite its termination on that date elsewhere.

Title V.—Foreign Sales Corporations

Present law provides a system of tax deferral for Domestic International Sales Corporations (DISCs) and their shareholders. A DISC is a domestic subsidiary of a U.S. company engaged in exporting. The income attributable to exports may be apportioned between the parent and the DISC using special pricing rules.

The bill provides for the establishment of foreign sales corporations (FSCs) which typically will be foreign incorporated subsidiaries of U.S. parent corporations engaged in exporting. To qualify as a FSC, a corporation will have to be organized under the laws of a jurisdiction outside the U.S. customs area and meet certain foreign presence requirements.

The provisions of the bill will apply to the export income of a FSC if it is managed outside the United States and if some economic processes of the transaction take place outside the United States. In addition, the proposal will apply to the export income of a small FSC attributable to up to $5,000,000 of export receipts whether or not its management or economic processes are foreign.

Under the optional administrative pricing rules, a FSC may earn the greater of 17 percent of the combined taxable income that it and a related party derive from an export transaction, or 1.83 percent of the gross receipts from the transaction.

The bill will exempt a portion of the export income of a FSC from U.S. tax. If a transaction is subject to one of the administrative transfer pricing rules, the exempt portion will be 17/23 of the FSC's income from the transaction. The rest of export income (including generally 6/23 of the FSC's income) will be subject to U.S. tax. Dividends from export income paid by a FSC to a U.S. corporate shareholder will be tax-exempt at the corporate shareholder level.

Companies may continue to use the present DISC rules for up to $10 million of export receipts but will be required to pay interest on the deferred tax. In addition, the bill treats accumulated DISC income (and the previously untaxed income of an Export Trading Company (ETC) if such company elects to discontinue operating as an ETC) as having been previously taxed, so that tax on those amounts would be forgiven.

This provision will apply to transactions after December 31, 1984.

Title VI.—Highway Revenue Provisions

1. Heavy vehicle use tax and diesel fuel tax

Under present law, the highway use tax is scheduled to increase beginning July 1, 1984, reaching a maximum rate of $1,900 per year on the heaviest vehicles by July 1, 1988. The bill restructures the use tax to eliminate tax on vehicles under 55,000 pounds, reduce the rate of tax on vehicles between 55,000 and 80,000 pounds, and reduce the maximum rate of tax applicable to vehicles over 80,000 pounds to $600 per year, effective July 1, 1984. Rules applicable to small owner-operators are amended, effective July 1, 1984. The rate of tax on certain vehicles registered to haul harvested forested products will be reduced to one-half the rate otherwise applicable, beginning July 1, 1984. The Department of Transportation is instructed to study the effects of the use tax on international carriers.

The bill increases the excise tax on diesel fuel sold for use in highway vehicles by 6 cents per gallon (the diesel differential) to 15 cents per gallon, effective July 1, 1984. The bill provides for a rebate, generally claimed annually on income tax forms, for the diesel differential paid with respect to taxable diesel fuel used in vehicles of 10,000 pounds or less.

2. One-year extension of refund of taxes on fuels used in certain taxicabs

The bill extends for one year, through September 30, 1985, the present rule permitting a 4-cents-per-gallon refund with respect to Federal excise taxes paid on fuels used in certain taxicabs. The bill further requires a Treasury Department study of the effectiveness of this exemption, to be submitted to Congress not later than January 1, 1985.

3. Modification of excise tax exemption for alcohol fuels, mixtures and alcohol fuels; alcohol fuels credit; and duty on imported alcohol fuels

The bill increases the present 5-cents-per-gallon excise tax exemption for alcohol fuels mixtures (e.g., gasohol) to 6 cents per gallon. The alcohol fuels credit and the duty on imported alcohol fuels are correspondingly increased to 60 cents per gallon from their present level of 50 cents per gallon.

The bill retains the present 9-cents-per-gallon excise tax exemption for alcohol fuels (e.g., methanol) that are at least 85 percent pure and permits a 4½-cents-per-gallon exemption for qualified methanol and ethanol fuels comprised of such alcohol derived from natural gas.

These provisions are effective on July 1, 1984.

4. Exemption from sales tax for piggyback trailers

Present law imposes a 12-percent tax on the first retail sale of heavy truck trailers. Piggyback trailers are not specifically exempt from this tax. The bill will exempt piggyback trailers and semitrailers sold after December 2, 1982, from this tax and the prior law 10-percent manufacturers excise tax.

5. Floor stocks refunds with respect to certain tax-reduced tires and retread rubber

The bill provides that floor stocks refunds will be available with respect to tires on which Federal excise tax was reduced, but not repealed, on January 1, 1984. Additionally, these refunds will be permitted with respect to tread rubber on retread tires held for sale on January 1, 1984. This provision will be effective on enactment.

Title VII.—Tax-Exempt Bond Provisions

1. Mortgage subsidy bonds and mortgage credit certificates

The bill extends the authority of State and local governments to issue qualified mortgage bonds for four years, until December 31, 1987. The bonds are subject to the eligibility requirements and volume limitations that applied before expiration of the prior law qualified mortgage bond provisions on December 31, 1983. In addition, issuers of qualified mortgage bonds are required to file information reports on each issue of such bonds.

The bill restricts the issuance of mortgage subsidy bonds under the transition rules of the Mortgage Subsidy Bond Tax Act of 1980. The transition rules of that Act allowing issuance of tax-exempt mortgage subsidy bonds for new mortgages are repealed, with the exception of certain projects, for bonds issued after December 31, 1984. The volume of mortgage subsidy bonds issued under these rules after April 21, 1984, reduces the applicable volume limitation on a State's authority to issue qualified mortgage subsidy bonds.

The bill permits State and local governments to exchange qualified mortgage bond authority in any year for authority to issue mortgage credit certificates (MCCs). The State or local government could issue certificates to provide tax credits of 20 percent of the interest paid on new mortgages in principal amount equivalent to the principal amount of MSB authority surrendered, or to provide a greater (or lesser) rate of tax credits on a smaller (or larger) principal amount. MCCs entitle homebuyers to nonrefundable tax credits of from 10 to 50 percent of the interest paid on home mortgage indebtedness. MCCs are limited to first-time homebuyers having incomes below the local area median income, with adjustments for family size, and to the purchase of residences with an acquisition price that does not exceed 90 percent of the applicable average area purchase price. The bill allows MCCs to be used for interest on blanket mortgages deemed paid by a qualifying tenant-shareholder in a housing cooperative and, under Treasury regulations, for certain manufactured housing. Authority to trade-in qualified mortgage bond authority for authority to issue MCCs terminates on December 31, 1987.

2. Other private activity bonds

The bill imposes new restrictions on industrial development bonds and on student loan bonds.

a. Restrictions on cost recovery deductions for IDB-financed property.—The bill extends the cost-recovery periods for IDB-financed property which is presently restricted to deductions based on the straight-line method over ACRS periods. The new recovery periods will be as follows:

Type of property:	New recovery period
3-year property	4 years
5-year property	7 years
10-year property	13 years
15-year public utility property	20 years
20-year nonresidential real property	22 years

These provisions apply generally to property placed in service after June 30, 1984, to the extent the property is financed with the proceeds of bonds issued after March 15, 1984. An exception is provided for facilities (1) where the original use commences with the taxpayer and construction of the facility commenced before March 15, 1984, or (2) with respect to which a binding contract existed on March 15, 1984, committing the purchaser to incur significant expenditures for construction or acquisition of the facilities.

b. Restrictions on Federal guarantees of tax-exempt obligations.—The bill denies tax-exemption to State and local obligations to the extent the proceeds of the obligations are insured by FDIC, FSLIC, or other Federal deposit insurance, effective for obligations issued after April 15, 1983, except for obligations issued pursuant to a written commitment binding on March 4, 1983, and at all times thereafter. Additionally, for bonds issued after the date of enactment, tax-exemption is denied if the bonds were guaranteed under the Small Business Administration's pollution control or certified development loan program, unless the SBA charged a fair market value loan guarantee fee equal to at least one percent of the bond amount.

c. Restrictions on use of small issue IDBs where beneficiary has significant IDB use.—The bill restricts the use of small issue IDBs if the total amount of all IDBs that would be outstanding after the issue for the beneficiary of the current issue exceeds $40 million. In determining whether the $40 million limit has been reached, both exempt purpose and small issue IDBs are counted.

d. Denial of tax-exempt IDB financing for certain facilities.—The bill denies tax-exemption for bond issues if any portion of the proceeds of an issue are to be used to finance any airplane, skybox or other private luxury box, any facility used for gambling, or any store the principal business of which is the sale of alcoholic beverages for consumption off-premises. This prohibition applies both to exempt purpose and small issue IDBs.

e. Application of small issue limitation to entire project.—The bill changes the present-law rule under which it may be possible to divide a project into several nominally separate facilities, each costing $10 million or less, and to finance each separate facility with small issue IDBs. Under the provision, where two or more issues of IDBs are used to finance a single building, enclosed shopping mall, or a strip of offices, stores, or warehouses that use substantial common facilities, the two or more issues are treated as a single issue for purposes of determining qualification under the small issue exception. Additionally, all principal users of any of the facilities are treated as principal users of the entire facility.

f. Extension of substantial user rule to all members of a partnership and an S corporation.—The bill amends the rules of present law under which interest on IDBs is not exempt from tax if the bonds are owned by a substantial user of the facilities financed with the IDBs or the bondholder is a related person to that substantial user. Under the amendment, all partners of a partnership and all shareholders of an S corporation are treated as related persons to the partnership or S corporation.

g. Extension of Internal Revenue Code rules to certain obligations.—The bill extends the Internal Revenue Code rules relating to tax-exempt bonds to bonds which are exempt under provisions of Federal law outside of the Code. The bill provides authority for the Virgin Islands and American Samoa to issue IDBs.

h. Arbitrage restrictions.—The bill applies modified arbitrage restrictions, similar to the existing arbitrage rules for mortgage subsidy bonds, to industrial development bonds (other than student loan bonds and certain bonds for housing and sewage and solid waste facilities) issued after December 31, 1984.

i. Certain bonds of the Power Authority of the State of New York.—The bill exempts certain bonds of the Power Authority of New York from the restrictions applicable to IDBs generally.

j. Student loan bond and other provisions.—The bill contains several provisions regarding tax-exempt student loan and certain other bonds. Under these provisions, issuers of student loan bonds are required to devote all profits attributable to bond proceeds to the acquisition of additional student loan notes under the issuer's loan program.

Following a study of the role of tax-exempt bonds for student loans, existing arbitrage rules for student loan bonds would be superseded by new Treasury regulations. These regulations are effective upon the later of (1) the expiration or reauthorization of the Guaranteed Student Loan (GSL) program or (2) six months after publication. The regulations will not apply to certain bonds issued to refund obligations issued before the effective date of the regulations or to satisfy certain binding commitments to acquire student loans.

Effective on the date of enactment, entities authorized to issue tax-exempt student loan bonds are permitted to elect to treat any issue as taxable without prejudice to the tax-exempt status of any other outstanding or future issue.

The bill provides that the proceeds of tax-exempt bonds issued after the date of enactment generally may not be used to acquire notes or other obligations of individuals other than student loan notes under the GSL program, except as otherwise explicitly provided in the Internal Revenue Code. Transitional rules are provided for existing non-GSL student loan programs. In addition, this prohibition does not apply to non-GSL student loan bonds issued after September 30, 1986.

k. Effective dates.—The provisions described in items c, d, e, f, and g, which are similar to provisions contained in H.R. 4170, as reported by the House Committee on Ways and Means, on March 5, 1984, generally are effective for bonds issued after December 31, 1983. Exceptions are provided for facilities (1) financed with an obligation where the original use of the facility commences with the taxpayer and where its construction began before October 19, 1983, or (2) with respect to which a binding contract to incur significant expenditures was entered into before October 19, 1983. Transitional rules are provided to various provisions with respect to certain projects presently in progress.

Title VIII.—Miscellaneous Revenue Provisions

A. Estate and Gift Tax Provisions

1. Qualification of certain holding company stock for installment payment of estate tax

Under present law, estate tax attributable to interests in certain closely held businesses can be paid in installments over up to 14 years, with principal payments being deferred for up to 5 years of that time. Additionally, a special 4-percent interest rate is available for certain amounts of deferred tax. Generally, only directly owned interests in active business operations are eligible for this benefit.

The bill permits executors to elect to consider the value of indirectly owned non-readily tradeable stock in an active business for certain purposes under the installment payment provision if the business interest would qualify were it owned directly. Thus, multiple tiers of holding companies may be looked through and certain interests in multiple active businesses aggregated. If this election is made, the 4-percent interest rate and 5-year deferral of principal payments are not available.

The bill further provides that investment assets held by any business are to be disregarded for all purposes under the installment payment provision. This rule is consistent with the present-law rule for valuing businesses carried on as proprietorships.

These provisions are effective for estates of individuals dying after the date of enactment.

2. Repeal of the generation-skipping transfer tax

The bill repeals the tax on generation-skipping transfers, generally effective for transfers occurring after June 11, 1976.

3. Tax treatment of certain disclaimers of interests transferred before November 15, 1958

Under present law, property with respect to which a qualified disclaimer is made is treated as if it had never been transferred to the person making the disclaimer. Therefore, the person making the disclaimer is not treated as making a gift. For property transferred after 1976, the Code has included specific rules for making qualified disclaimers. For property transferred before 1977, Treasury regulations, adopted on November 15, 1958, provided the rules governing disclaimers.

The bill provides that disclaimers of property transferred before November 15, 1958, will be treated as qualified disclaimers if the disclaimers meet the requirements of present law (Code sec. 2518), except for the requirement that a disclaimer be made within 9 months after the date the property is transferred. Therefore, property with respect to which a person has accepted any benefits may not be disclaimed under this provision.

The provision is effective upon date of enactment and applies to disclaimers that are made within 90 days after enactment with respect to property interests transferred before November 15, 1958.

4. Clarification that certain usufruct interests qualify for estate tax marital deduction

The Economic Recovery Tax Act of 1981 permitted executors to elect to claim an estate marital deduction for the value of certain qualifying income interests for life (so-called "QTIP" property). An income interest qualifies as QTIP property only if the surviving spouse is entitled to all of the income from the interest (payable at least annually) and no person has a power to appoint the property to any person other than the surviving spouse (except for powers exercisable only at or after the spouse's death).

The bill clarifies that certain usufructs for life under the Louisiana Civil Code may qualify as QTIP property, if certain requirements are satisfied.

This provision is effective as if included in the Economic Recovery Tax Act.

5. Special estate tax credits for the Estate of Nell J. Redfield and the Estate of Elizabeth Schultz Rabe

The bill provides a special credit against Federal estate tax for the estates of Nell J. Redfield and Elizabeth Schultz Rabe. The credit will apply to the transfer to the Secretary of Agriculture, within 90 days after the bill's enactment, of certain real property located within or adjacent to the Toiyabe National Forest that is included in the estates in question. The amount of the credit will be equal to the lesser of the fair market value of the property as of the date it is transferred or the transferor estate's Federal estate tax liability (plus interest).

B. Charitable Contributions Provisions

1. Expansion of circumstances in which a deduction may be claimed for qualified conservation contributions

Present law permits a deduction for contributions of qualified property interests for conservation purposes if certain requirements are satisfied. One of these requirements is that surface mining must be prohibited on the property with respect to which the contribution is made. The bill repeals the surface mining prohibition if the following two requirements are satisfied: (1) the surface and mineral estates in the property were separated before June 13, 1976, and (2) the probability of surface mining occurring on the property is so remote as to be negligible.

2. Contributions to the U.S. Olympic Committee

The bill provides that individuals may elect to have $1 ($2 on a joint return) of their tax refund designated to the U.S. Olympic Committee, or to pay an additional income tax of $1 ($2 on a joint return). The Treasury will pay over amounts so designated, less administrative costs, to the U.S. Olympic Committee. A trust fund is established in the Treasury to administer the collection and payment of such funds. The provision will be effective for returns filed for taxable years beginning after December 31, 1983, and ending before January 1, 1989.

3. Charitable expense deduction for use of automobile

The bill increases, from 9 cents per mile to 12 cents per mile, the standard mileage rate allowed as a charitable deduction (if the actual expense method is not used) for use of a passenger automobile in rendering services to a charitable organization, effective January 1, 1985.

4. Permanent rules for reforming governing instruments creating charitable remainder trusts and other charitable interests

Under present law, a charitable deduction is permitted for an interest in a split-interest trust (i.e., a trust with both charitable and noncharitable beneficiaries), only if the trust takes specified forms. The bill provides permanent rules for reforming (amending) charitable split-interest trusts that do not meet the specified form. Under the bill, a trust will be deemed to be reformed properly if property passes directly to charity under the terms of the governing trust instrument. The provision applies generally to reformations occurring after December 31, 1978, other than reformations permitted under the law as in effect before the bill's enactment.

5. Charitable contribution deduction limitations

The bill increases, from 50 percent to 60 percent of the donor's adjusted gross income, the limitation on the charitable deduction for contributions by an individual of cash or ordinary-income property. Also, the carryover of charitable contributions exceeding an applicable percentage limitation is extended from five years to 15 years. These changes are effective for contributions made after 1984.

C. Excise Tax Provisions

1. Sport Fish Restoration and Boating Safety Funds; excise tax on certain arrows

The bill replaces the present manufacturers excise tax on fishing equipment with an expanded tax imposed on the last sale of sport fishing equipment before retail. Certain articles are subject to the new tax at a 10-percent rate and others (i.e., tackle boxes, fishfinders, and electric outboard motors) at a 3-percent rate. The bill also extends the time for payment of the tax by manufacturers having $100,000 or less of gross sales receipts in the preceding calendar year, with payments by such taxpayers to be required on a quarterly basis.

Further, the bill alters the financing sources and expenditure purposes for the existing sport fish restoration and boating safety programs and the financing sources for the Land and Water Conservation Fund. Among these changes, the bill transfers part of the revenues from the existing tax on motorboat fuels to the sport fish restoration program. The bill also transfers administration of funding for the sport fish restoration and boating safety programs to a new Aquatic Resources Trust Fund to be included in the Internal Revenue Code.

Also, the bill expands the existing excise tax on arrows to include arrows used by crossbow hunters.

These provisions generally are effective on October 1, 1984; the tax on tackle boxes and fishfinders will apply on October 1, 1985.

2. Increase in the distilled spirits excise tax rate

The bill increases the excise tax rate on distilled spirits from $10.50 per proof gallon to $12.50 per proof gallon, effective on January 1, 1985. This change will increase the excise tax paid on a fifth of 86-proof whiskey by approximately 32 cents.

3. Exemption from aviation excise taxes for certain helicopter operations

The present exemption from the airways fuels and passenger ticket taxes for helicopters engaged in timber operations or hard mineral exploration, and not using the federally aided airport or Federal airways control systems, are extended by the bill to helicopters engaged in oil and gas exploration, effective on April 1, 1984.

4. Technical amendments to the Hazardous Substance Response Revenue Act of 1980

Present law imposes an excise tax on certain chemical substances, the revenue from which go into the Hazardous Substance Response Trust Fund. The bill makes technical modifications to this excise tax in three areas. First, an exemption is provided for light hydrocarbons used in the production of motor fuels. Second, certain copper, lead, or zinc compounds which have a transitory existence during metal refining are exempted from tax. Third, the administrative mechanism through which the exemption for fertilizer may be claimed is simplified.

D. Employee Benefits

1. Unemployment compensation for pre-1978 periods

The bill amends the Revenue Act of 1978 to provide that the provisions of that statute which make includible in income a portion of unemployment compensation benefits apply to payments of unemployment compensation made after 1978 except payments for weeks of unemployment ending before December 1, 1978. The bill also extends until one year after enactment the period for claiming any credit or refund attributable to this amendment.

2. Employee stock options

The bill provides that an employee may defer income on the exercise of certain employee stock options until the employee disposes of the stock. These options may not be issued solely to highly compensated officers and shareholder-employees. This provision is effective for options exercised after the date of enactment. Two technical amendments are made to the incentive stock option provision.

3. Income tax exclusion for certain employee achievement awards

The bill provides a new income-tax exclusion to employees for certain awards received (after the date of enactment) from an employer for productivity, safety, or length of service. The exclusion allowed to an employee in one year applies to the extent that the employer's cost for all awards to that employee in the year does not exceed $4,800 in the case of qualified plan awards, or $1,200 for other awards. The exclusion is available only for watches, clocks, rings, emblematic jewelry, certain personal accessories, and other traditional retirement or nonretirement awards. Any excess of the lesser of the employer's cost for or the value of such awards over the exclusion dollar limits will be expressly includible in the employee's gross income, as will the value of nontraditional employee achievement awards or any other awards to employees.

Certain limitations will apply to the exclusion for the employee (and to the deduction allowed to the employer). These include limitations on the number of employees in a business who can be given productivity or safety awards; on how frequently a particular employee can receive productivity, etc. awards; and on the use of nominal awards in calculating the average cost limitation for the definition of a qualified award plan. Also, certain nondiscrimination rules will apply. Recordkeeping and reporting requirements for an employer's award programs can be imposed by the IRS.

4. Moratorium on fringe benefit regulations

The bill extends for two years (through 1985) the moratorium on issuance of Treasury regulations relating to the income tax treatment of nonstatutory fringe benefits. Also, the extended moratorium applies with respect to certain campus housing provided to employees by educational institutions during 1984 and 1985.

5. Exclusion for educational assistance benefits; timing of deduction for deferred educational benefits

The provisions of present law which exclude employer-provided educational assistance benefits from an employee's income and wages for income and payroll tax purposes do not apply for taxable years beginning after December 31, 1983. The bill extends this exclusion to apply to taxable years beginning on or before December 31, 1985.

Under a recent court case, a plan providing deferred educational benefits for the children of a corporation's employees was held to be a welfare benefit plan, thus allowing the employer a deduction for plan contributions in the year made. The bill provides that such a plan is to be treated as a nonqualified deferred compensation plan, so that deductions for plan contributions will not be allowed until the benefit payments under the plan are included in the employee's gross income.

6. FICA and FUTA exemption for employer payment of certain employee contributions to State and local retirement plans

The bill makes a technical correction to the Social Security Amendments of 1983 to provide that employer payments ("pick-ups") of employee contributions under a State or local retirement plan are subject to FICA and FUTA only if the pickup is pursuant to a salary reduction agreement.

E. Miscellaneous Treasury Administrative Provisions

The bill makes a number of minor amendments relating to Treasury administrative provisions. The bill simplifies certain requirements of the Treasury Department to make reports to the Congress, removes the $1 million limitation of the Treasury working capital fund, increases the authorization limit from $1 million to $10 million on the revolving fund for the redemption of real property, allows the Secretary of the Treasury to accept gifts and bequests for the Treasury Department, allows an extension of time for court review of a jeopardy assessment where the government is not promptly served, removes the $1 million limitation on the Secretary of the Treasury's special authority to dispose of obligations, allows the Internal Revenue Service a minimum of 60 days to assess unpaid taxes shown on an amended return, provides the government a lien on the assets of all financial institutions which issue an unpaid guaranteed draft for the payment of taxes, allows the disclosure of windfall profit tax returns to State tax agencies, and repeals the requirement that the Secretary approve changes in taxpayer's financial reporting of the investment credit.

The bill repeals the present occupational tax on manufacturers of stills and makes the present statutory requirement that the Treasury Department be notified upon removal of any still from the place of manufacture discretionary with the Treasury. The bill also modifies the rules governing allowance of drawbacks with respect to distilled spirits used for food or medicinal purposes. Additionally, the Treasury Department is authorized to disclose certain information about alcohol fuel producers to administrators of State alcohol laws. The requirement that certain containers of distilled spirits bear Government-supplied strip stamps is repealed; these containers will continue to be required to bear tamper-proof closure devices. The bill also expands the circumstances in which distilled spirits can be withdrawn from bond without payment of tax to permit tax-free withdrawal of such spirits for use in the production of nonbeverage (e.g., cooking) wine.

The bill requires payment of excise taxes on all taxable alcohol and tobacco products not later than 14 days after the end of each semimonthly period. In addition, taxpayers who were liable for more than $5 million in any such tax in the preceding calendar year are required under the bill to pay such taxes during the succeeding year by electronic funds transfer to a Federal Reserve bank. This provision is effective on July 1, 1984.

Present law provides an exclusion from income for certain payments to a utility in aid of construction if expenditures are made in the following two years. The bill extends the statute of limitations with respect to the treatment of these payments until expiration of the statute on the last year in which expenditures may be made if the payment is to be excluded from income.

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Simplification and Extension of Income Tax Credits

1. Simplification of income tax credits

In general, the bill groups existing income tax credits into logical categories and provides uniform tax liability limitations and carryover rules. The business credits (i.e., investment tax credit, targeted jobs credit, alcohol fuels credit, and ESOP credit) will be combined into one credit and allowed up to 100 percent of the first $25,000 of tax liability and 85 percent of the remainder. The research credit will continue to be allowable against 100 percent of tax liability. A 3-year carryback and 15-year carryforward period on a FIFO basis will be allowed for the business credits.

This provision will apply to taxable years beginning after 1983.

2. Business energy tax credits

The bill extends the 15-percent renewable energy credit, the 15-percent ocean thermal credit and the 10-percent biomass credit (with certain modifications) through the end of 1988. The affirmative commitment rules for synfuel projects are extended to encompass projects for which the engineering and permitting requirements are satisfied by January 1, 1987, if the contracting requirements are satisfied by January 1, 1990, and the project is completed by January 1, 1993. The water temperature requirement for geothermal property is reduced from 50 degrees Celsius to 40 degrees Celsius. Allocation rules are provided for equipment that uses an alternative energy resource at least 50 percent of the time.

Special affirmative commitment rules extend the solar, wind, and geothermal credit and the ocean thermal credit through 1989 for projects on which the engineering and permitting requirements are met by the end of 1988 and the contracting requirements met by July 1, 1989.

3. Residential energy tax credits

The bill repeals the residential energy conservation tax credits on the date of enactment and extends the residential solar, wind, and geothermal energy tax credits through 1987.

4. Extension of targeted jobs credit

Under present law, the targeted jobs credit is available with respect to individuals who begin work for the employer before 1985. The bill extends the targeted jobs credit for three additional years. Under the bill, the credit will be available with respect to any member of a targeted group who begins work for the employer before 1988.

// Tax treatment of Capital Gains and Losses

Six-Month Long-Term Holding Period and Reduction of Capital Loss Offset Against Ordinary Income

Gains and losses from the sale or exchange of capital assets held for more than 1 year are long-term capital gain or loss and gains and losses from capital assets held for 1 year or less are short-term, under present law. For noncorporate taxpayers, net capital losses may be deducted against $3,000 of ordinary income. However, only

50 percent of long-term losses realized after 1969 may be deducted against ordinary income.

The bill reduces the long-term capital gain and loss holding period to 6 months for assets acquired after February 29, 1984. For taxable years after 1984, the $3,000 ordinary income ceiling against which capital losses may be deducted is reduced to $1,000, and the special treatment of long-term losses realized prior to 1970 is repealed.

F ~~H.~~ Miscellaneous Revenue Matters

1. Modification of rules governing rehabilitation investment credit

The bill provides an alternative to the present requirement that at least 75 percent of a building's external walls be retained as external walls in the case of rehabilitations with respect to which a rehabilitation credit is allowable. Under the alternative, the external walls test is deemed met if (1) at least 50 percent of the building's external walls are retained as external walls; (2) at least 75 percent of the building's external walls are retained as either internal or external walls; and (3) at least 75 percent of the building's internal structural framework is retained. This provision is effective for rehabilitation expenditures incurred with respect to property placed in service after December 31, 1983.

2. Taxation of regulated investment companies

a. Personal holding companies permitted to qualify

Under present law, a regulated investment company (RIC) is treated, in essence, as a conduit for tax purposes. If a corporation is a RIC, it is allowed a deduction for dividends paid to its shareholders. One of the requirements that a corporation must meet in order to be a RIC is that it cannot be a personal holding company.

The bill modifies the definition of a regulated investment company (RIC) to permit a personal holding company (PHC) to qualify as a RIC. In the case of a RIC which is a PHC, any undistributed investment company taxable income of the RIC will be taxed at the highest corporate rate. This provision is effective for taxable years beginning after December 31, 1982. The bill also denies RIC status to companies first becoming a RIC after 1982 if the company has earnings and profits accumulated as a non-RIC.

b. Timing of income from short-term government securities

Under present law, the amount of discount income on short-term government securities is includible in income at the earlier of the date of maturity or the date of sale.

The bill allows a RIC to elect to include discount income on short-term government securities as it accrues. This provision is effective for taxable years beginning after 1978.

3. Cooperative housing corporations

Under present law, in order for the tenants of a cooperative housing corporation to receive deductions for interest and taxes paid by the cooperative housing corporation, at least 80 percent of the income of a cooperative housing corporation must be derived from tenant-shareholders.

The bill allows corporations and certain other persons who are not individuals to be tenant-shareholders of a cooperative housing corporation, even if the cooperative housing corporation retains the right to disapprove occupancy by any nominee of the corporation. The bill also disallows a deduction to a corporation or other person who uses its units in a trade or business for rental payments attributable to amounts which must be capitalized by the cooperative housing corporation. The amendment is effective for taxable years beginning after the date of enactment.

4. FUTA exemption for certain fishing boat crew members

Remuneration paid to fishing boat crew members generally is subject to tax under the Federal Unemployment Tax Act (FUTA) if the services performed are related to catching halibut or salmon for commercial purposes or if the services are performed on a vessel of more than ten net tons. However, under a provision which expired on December 31, 1982, remuneration paid to fishing boat crew members was exempt from FUTA if the crew members are treated as self-employed for social security tax purposes and the remuneration of whom is exempt from the Federal Insurance Contributions Act (FICA) tax and income tax withholding. Fishing boat crew members are so treated if their remuneration depends on the boat's catch and the crew normally consists of fewer than ten members.

The bill extends through December 31, 1985, the exemption from FUTA tax for remuneration paid to fishing boat crew members who are treated as self-employed for purposes of social security taxes.

5. Extension of PIK rules to 1984 wheat program

Present law provides special tax treatment for commodities received by a producer under a 1983 PIK program for withdrawing land from production. Under these rules, producers may defer recognition of income on PIK commodities until the commodities are sold; PIK participants are not disqualified from various special tax provisions available to taxpayers engaged in the business of farming; and the applicability of income, employment and estate tax provisions is not affected solely as a result of a taxpayer's participation in the PIK program. The bill generally extends these special PIK tax rules to the 1984 wheat program.

6. Exceptions to debt-financed property rules

Under present law, generally a tax-exempt organization is subject to tax on any income (including income from debt-financed property) from an unrelated trade or business. However, the income or gain received with respect to debt-financed real property held by a qualified pension trust is not treated as unrelated trade or business income under certain circumstances. The rules for debt-financed real property are extended to certain educational institutions and are amended to limit the present law exception to situations in which the property subject to the exemption is not financed by the seller or a related party and, in the case of property owned by a partnership, each partner separately qualifies for the exception. The provisions apply with respect to indebtedness incurred after the date of enactment.

7. Title holding companies

Under present law, a title holding company may be exempt from taxation if the company holds assets of related tax-exempt organizations. Under the provision, a title holding company may be exempt from tax even though the company holds assets of certain unrelated tax-exempt organizations, provided that the title holding company's officers and board of directors are independent of the company's investment advisors. In addition, these title holding companies are eligible for the special exceptions relating to debt-financed real property if they submit to the restrictions applicable to qualified pension trusts with respect to this exception, as amended by the bill. The provisions are effective for taxable years beginning after December 31, 1984.

8. Physicians' and surgeons' mutual protection associations

Under present law, amounts paid to a corporation as contributions to capital are not included in the income of the corporation. Also, in general, capital payments made by a policyholder or member of an insurance association, that are in addition to premium payments made, are not deductible by the policyholder. The bill provides a specific rule for the tax treatment of the company and the policyholder with respect to initial capital contributions made by members of certain medical malpractice mutual protection associations. For the policyholder, the rules provide an election, to be made when the initial capital contribution is made, that will allow a policyholder to deduct a portion of that amount over the first 6 years of coverage to the extent that the annual premiums that would have been charged by an independent insurance company for the medical malpractice insurance coverage would have exceeded the actual annual premium charged by the mutual protection association for such coverage. For the company, the rules provide that initial capital contributions are not includible in income to the extent the amounts are not deductible to the policyholder, and any refund of such capital amounts is not deductible. These special rules apply only to such associations that were in operation under the laws of any State prior to January 1, 1984.

9. Sale-leasebacks of principal residences

Under present law, qualification of a transaction with respect to a principal residence as a sale-leaseback of a principal residence sometimes is uncertain. The bill provides a "safe harbor," easing the rules applicable in determining whether a valid sale-leaseback has occurred in the case of sales by taxpayers 55 or older. The provisions are effective for transactions entered into after the date of enactment and before January 1, 1989.

10. Changes in earned income credit

Under present law, eligible taxpayers, i.e., individuals or couples with children, are allowed a refundable tax credit equal to 10 percent of the first $5,000 of earned income, for a maximum credit of

$500. The maximum credit is phased down to zero as income increases from $6,000 to $10,000. The bill increases the rate of the earned income credit to 10.5 percent, thereby increasing the maximum credit to $525. The bill also raises the income level at which the credit is fully phased-out to $11,000. These changes in the earned income credit will apply to taxable years beginning after 1984.

11. Capital construction fund for fishery facilities

Under present law, tax benefits are available for certain taxpayers making deposits into capital construction funds to be used with respect to qualified vessels. The bill extends those benefits to certain taxpayers engaged in the fisheries industry and for deposits into capital construction funds to be used with respect to certain fisheries facilities.

The provisions are effective as of the date of enactment.

12. Leases with terminal rental adjustment clauses

Leases of motor vehicles often contain terminal rental adjustment clauses (TRACs). A TRAC passes on to the lessee the risk (or reward) that the vehicle will be worth less (or more) at the end of the lease term than the parties projected when the lease was entered into. Under present law, it has been held that a lease with a TRAC in it does not qualify as a lease for Federal income tax purposes.

Under the bill, TRACs are to be disregarded in determining whether certain motor vehicle leases qualify as leases for Federal income tax purposes. The provisions are effective for transactions entered into before, on, and after the date of enactment.

13. Home won as prize and designed for handicapped foster child of the taxpayer

The bill provides that no interest or penalties will be payable on the Federal income tax liability attributable to receipt of a residence won as a prize, and specially designed for a handicapped foster child of the taxpayer, where certain conditions apply, but only if the tax liability is paid within one year after the date of enactment.

14. Housing allowance for ministers

In 1983, the IRS ruled that ministers may not take deductions for mortgage interest and real estate taxes on their residence to the extent that such expenditures are allocable to tax-free housing allowances provided for ministers. The new deduction disallowance rule generally applied beginning July 1, 1983. Under a transitional rule, in the case of a minister who owned and occupied a home before January 3, 1983 (or had a contract to purchase a home before that date), the deduction disallowance rule generally will not apply until January 1, 1985. The bill extends this transitional rule date to January 1, 1986.

15. Church audits

Present law provides that the IRS may examine church books of account (i.e., financial records) only to the extent necessary for a determination of tax. The IRS is also required to provide special advance notice before examining church books of account.

The bill provides several new restrictions on IRS investigations and audits of churches. Under these provisions, the IRS may commence an investigation of church tax liabilities only if an IRS regional commissioner reasonably believes that a church is not tax-exempt or has taxable income. The IRS will be required to provide expanded notice before examining church books and records and to offer a pre-examination conference to church officials. In addition, an audit of church tax liabilities will generally be required to be completed within two years after commencing an investigation. These provisions are effective for investigations, examinations, and proceedings commencing after the date of enactment.

16. Exclusion from gross income for cancellation of certain student loans

The bill makes permanent the exclusion (enacted in the Tax Reform Act of 1976) for amounts realized by reason of cancellation of certain student loans. The bill limits the exclusion to cases in which the recipient performs certain professional services for any of a broad class of employers.

17. Transitional rule for safe-harbor leasing

The safe-harbor leasing rules are generally not applicable to agreements entered into after December 31, 1983. Under the bill, those rules, as in effect prior to TEFRA, are applicable to certain coal gasification property.

18. Tip reporting

Under present law, if a large employer, for tip reporting purposes, demonstrates to the Secretary that the actual tip rate of his establishment is less than 8 percent, the Secretary may lower the percentage allocated (but not to less than 5 percent). The bill allows employers or a majority of their employees to petition the Secretary for permission to allocate based on a tip rate as low as 2 percent and requires the IRS to provide rules for recordkeeping with respect to tips within a year.

19. Treatment of Indian tribal governments as State governments for tax purposes

The bill makes permanent the present treatment of Indian tribal governments as State governments for most purposes of the Internal Revenue Code. As under present law, tribal governments will continue to be barred from issuing tax-exempt bonds, other than bonds to finance traditional government functions.

20. Amortization of expenditures to rehabilitate low-income rental housing

The bill reenacts for three years, through December 31, 1986, the provision of prior law that permitted amortization over 60 months of certain rehabilitation expenditures incurred with respect to low-income rental housing.

21. Reenactment of denial of deductions for costs of demolishing certified historic structures

The bill reenacts and makes permanent the provision of prior law that denied income tax deductions for costs associated with demolition of certified historic structures. This provision is effective on January 1, 1984.

22. Architectural barrier removal expenses

The bill provides a deduction for up to $35,000 per year of expenses incurred in eliminating architectural and transportation barriers to the handicapped and elderly, effective for taxable years beginning in 1984 and 1985. This provision is similar to an expired provision of prior law.

23. Tax status of nonprofit child care organizations

The bill provides that nonprofit day care centers qualify for tax-exempt status (under sec. 501(c)(3)), and eligibility to receive tax-deductible contributions, if both (1) substantially all of the dependent care provided to children by the organization is for the purpose of enabling individuals to be gainfully employed, and (2) the services provided by the organization are available to the general public. This provision is effective for taxable years beginning after the date of enactment.

24. Tax incentives for research and vocational education

The bill makes certain modifications to the tax incentives for research expenditures enacted in ERTA, generally effective January 1, 1985. The bill also adds new incentives for vocational education.

Extension of credit.—The 25-percent credit allowed for increases in qualified research expenditures, which is scheduled to expire after 1985, is made permanent.

Research definition.—A statutory definition of credit-eligible expenditures is provided, separate from (and not affecting) the definition of research expenditures qualifying for special deduction rules under present law. The new definition targets the credit to technological innovations developed through a process of experimentation relating to new or improved function, performance, etc. (rather than to style, taste, cosmetic, or seasonal design factors). The costs of developing computer software for internal use by the taxpayer could qualify only where the software is used directly in qualified research or certain production processes, or where otherwise permitted by Treasury regulations for certain significant innovative developments. Also, other exclusions and rules are provided as part of the statutory definition of qualified research.

Trade or business test.—Qualified research expenditures of start-up corporations, of existing corporations for new trades or businesses, and of certain partnerships will be eligible for the credit.

University basic research.—In computing the incremental credit under present law, qualified expenditures include 65 percent of corporate expenditures for university basic research; similarly, this amount is treated as qualified research expenditures in a base period year when the corporation calculates the credit in subsequent years. The bill provides a new 25-percent credit for the excess of (1) 65 percent of corporate cash expenditures for university basic research over (2) the sum of the greater of two maintenance-of-effort floors (relating to 1981-83 university basic research expenditures or one percent of 1981-83 total qualified research expenditures) plus an amount relating to university nonresearch contributions in a base period. Also, the bill makes certain other modifications to the university basic research provision.

Scientific equipment donations.—The existing augmented charitable deduction rule is expanded to cover corporate donations of scientific or technological equipment (including used property and new computer software) to universities for certain uses in mathematics, physical or biological sciences, or engineering, and is modified in certain other respects.

Scholarships, loan forgiveness.—Gross income will not include amounts received by graduate students in certain scientific fields as a scholarship, fellowship grant, or qualified student loan forgiveness, notwithstanding that the recipient is required to perform future teaching services for any of a broad class of colleges or universities, provided that such amounts are not received as compensation.

Vocational education.—The bill provides an augmented charitable deduction for corporate donations of certain types of newly manufactured technical and scientific equipment to public community colleges or public technical institutes for certain vocational education uses, if the value of the donated item exceeds $250, and if certain other requirements are satisfied. The augmented deduction is not available for donations of computer software, microcomputers, or certain other computers. In addition, a tax credit is allowed to a corporation for providing qualified teachers from its employees for postsecondary vocational education courses or for hiring qualified vocational instructors on a temporary basis. The amount of the credit would equal $100 for each course taught by an employee (up to five courses), plus $100 for each instructor temporarily hired by the corporation, subject to certain limitations. These provisions are effective for taxable years beginning after 1984.

25. Percentage depletion on secondary and tertiary production

Under present law, the allowance for percentage depletion on secondary and tertiary oil production expired at the end of 1983. The bill corrects the technical error leading to this termination and clarifies that percentage depletion will not be available after 1983 for secondary or tertiary production from proven properties transferred after 1974, unless one of the present law exceptions to the antitransfer rules applies.

26. Study of alternative tax systems

The bill instructs the Secretary of the Treasury to conduct a study within 6 months covering the advisability of developing an alternative tax system that would reduce the complexity of the present income tax system and improve the efficiency and equity of the tax system. Alternative tax systems that should be evaluated include a simplified income tax based on gross income, a consumption-based tax, restructuring and broadening of the current income tax base combined with lowering of current tax rates, a national sales tax, and a value-added tax.

27. Treasury study of foreign taxation of certain U.S. services

Under present law, taxpayers who perform services in the United States for use in foreign countries are subject to full U.S. tax on their income from those services. The foreign country where the services are used may also subject the income from those services to tax. The bill directs the Treasury Department to study the practices of foreign countries that impose taxes on the basis of services that are performed in the United States, including the status of treaty negotiations with such countries, and options to alleviate the resulting double tax burden on U.S. taxpayers. The Treasury Department is to report to the committee on the results of its study no later than August 31, 1984.

28. Migratory bird hunting and conservation stamps ("Duck Stamps")

The Secretary of the Interior is authorized to allow reproductions in color and black and white of migratory bird hunting stamps for commercial purposes. Revenues will be deposited in the Migratory Bird Conservation Fund and will be used to help finance the purchase of additional wetlands acreage to be included in the National Wildlife Refuge.

29. Tax treatment of grants related Boundary Water Canoe Area

The bill allows tax-free reinvestment before 1986 of Federal assistance grants made to motorboat franchisors whose business activities had to be modified to conform to new statutory limits following conversion of their operating areas to the Boundary Waters Canoe Area Wilderness under the jurisdiction of the Forest Service.

TITLE IX. SPENDING REDUCTION PROVISIONS

A. Health Provisions

1. Medicare

Part B premium

Permanently establishes Part B Premium at 25 percent of program costs.

One-month delay in medicare entitlement

Delays eligibility for Parts A and B of Medicare until the first day of the month after the month in which the individual turns 65 years of age.

Modification of working aged provision

Medicare would become the secondary payor for individuals who elect to be covered under a younger spouse's employer-based health plan.

Limitation on physician fee prevailing and customary charge levels; participating physician incentives

Freezes all customary and prevailing fees for 1 year beginning July 1, 1984. Continues freeze for 1 additional year on prevailings of non-participating physicians.

Limitation on increase in hospital costs per case

Limits for 2 years the increase in the hospital cost portion payment amounts to the market basket minus one-half percentage point. Limits increase in DRG portion of the payment amounts to the market basket plus one-half percentage point.

Fee schedule for clinical laboratory services

Directs that a fee schedule be established for all outpatient clinical laboratory services provided to Medicare beneficiaries.

Revaluation of assets acquired by hospitals

Disallows the revaluation of hospital assets acquired in fiscal year 1985 and thereafter for purposes of Medicare reimbursement.

Repeal of preadmission diagnostic testing provision

Repeals provision of current law which provides for a higher rate of reimbursement for preadmission testing done by hospitals and physicians.

Skilled nursing facility reimbursement

Maintains reimbursement rates in effect prior to TEFRA for accounting periods beginning on or after October 1, 1982 and establishes new rates, beginning July 1984, and thereafter.

Rounding of part B payments

Rounds Part B payments on charge based claims down to the next lower whole dollar amount.

Agreements for Medicare claims processing

Permits the Secretary of Health and Human Services to negotiate contracts with carriers and intermediaries on a non-cost related basis.

Lesser of cost or charges

Requires the Secretary to issue regulations to isolate the calculation of lesser of cost or charges for outpatient services from the calculation for inpatient services.

Hepatitis B vaccine

Permits Medicare coverage of Hepatitis B vaccine for End Stage Renal Disease dialysis patients.

Limitation on certain foot care services

Requires the Secretary to issue regulations establishing coverage guidelines under the Medicare program for debridement of mycotic toenails.

Coverage of hemophilia clotting factor

Permits Medicare coverage for the supplies and products necessary for the self-administration of the clotting factor used by individuals who have hemophilia.

Indexing of Part B deductible

Indexes the amount of the Part B deductible in calendar years 1985 and 1986 by the percentage by which the Medicare economic index increases each year.

Cost sharing for durable medical equipment furnished as a home health benefit

Reduces reimbursement to home health agencies for durable medical equipment to 80 percent of reasonable costs, and permits the agencies to bill beneficiaries for the remaining 20 percent.

2. Medicaid and MCH

Extension of medicaid payment reductions and offsets

Extends for 3 years reductions in Federal Medicaid payments at a level of 3 percent.

Mandatory assignment of rights of payment by medicaid recipients

Mandates that States require Medicaid applicants to assign to the State their rights to third party medical payments.

Increase in Medicaid ceiling amount for Puerto Rico, the Virgin Islands, Guam, the Northern Mariana Islands, and American Samoa

Increases funding to Puerto Rico, the Virgin Islands, Guam, the Northern Mariana Islands, and American Samoa.

Increase in the authorization for the Maternal and Child Health (MCH) Block grant

Permanently increases the authorization level for the MCH block grant to $455 million in 1986 and thereafter

Medicaid coverage for pregnant women

Mandates States to provide Medicaid coverage beginning with the medical determination of pregnancy to every woman who would be eligible for Aid to Families with Dependent Children if the child were born.

Recertification of skilled nursing facility and intermediate care facility patients

Modifies the frequency with which physicians recertify Medicaid patients institutionalized in nursing homes and modifies the related penalty provisions.

3. Other Medicare and Medicaid Provisions

Study of physician reimbursement for cognitive services

Directs the Office of Technology Assessment to report to the Congress on ways to modify the existing system for determining Medicare allowances to eliminate inequities that exist between reimbursement levels for medical procedures and cognitive services.

Elimination of Part B deductible for certain diagnostic laboratory tests

Eliminates application of the annual Part B deductible in the case of diagnostic tests performed in a laboratory which has entered into a negotiated rate agreement with Secretary.

Payment for services following termination of participation agreements with home health agencies or hospices

Changes the ending date of coverage for services provided under a plan of care following termination of a participation agreement with a home health agency or hospice.

Repeal of special tuberculosis treatment requirements under Medicare and Medicaid

Repeals special tuberculosis treatment requirements under Medicare and Medicaid.

Medicare recovery against certain third parties

Establishes the statutory right of Medicare to recover directly from a liable third party if the beneficiary himself does not do so.

Indirect payment of supplementary medical insurance benefits

Permits Part B payments to be paid to a health benefits plan whose payment is accepted by the physician or other supplier as payment in full.

Elimination of health insurance benefits advisory council

Eliminates the Health Insurance Benefits Advisory Council (HIBAC).

Confidentiality of accreditation surveys

Extends the same disclosure protections given the survey information of the Joint Commission on the Accreditation of Hospitals (JCAH) to similar survey information provided to the Secretary by the American Osteopathic Association or other national accreditation organizations.

Flexible sanctions for noncompliance with requirements for End Stage Renal Disease (ESRD) facilities

Allows the Secretary to apply intermediate sanctions, such as a graduated reduction of reimbursement, to ESRD facilities when noncompliance does not jeopardize patient health or safety or justify decertification of such facilities.

Use of additional accrediting organizations under Medicare

Extends the Secretary's authority to permit reliance on accrediting organizations in determining whether rural health clinics, laboratories, clinics, rehabilitation facilities, and public health agencies meet Medicare requirements.

Repeal of exclusion of for-profit organizations from research and demonstration grants

Extends the existing research and demonstration grant authority to for-profit organizations.

Requirements for medical review and independent professional review under Medicaid

Makes consistent State Medicaid plan requirements for medical review in skilled nursing facilities and independent professional review in intermediate care facilities.

Flexibility in setting rates for hospitals furnishing long-term care services under Medicaid

Eliminates the specific Medicaid requirements for setting payment rates applicable only to certain hospitals furnishing long-term care services.

Authority of the Secretary to issue and enforce subpoenas under Medicaid

Authorizes the Secretary to issue and seek enforcement of subpoenas under Medicaid to the same extent as under the Medicare program.

Repeal of authority for payments to promote closing and conversion of underutilized hospital facilities

Repeals the present law authority under which the Secretary may make Medicare and Medicaid payments to cover capital and increased operating costs associated with the conversion or closing of underutilized hospital facilities.

Presidential appointment of and pay level for the Administrator of the Health Care Financing Administration (HCFA)

Provides for appointment of the Administrator of HCFA by the President, with the advice and consent of the Senate.

Exclusion of certain entities owned or controlled by individuals convicted of Medicare- or Medicaid-related crimes

Extends the Secretary's current authority to exclude from Medicare and Medicare parties convicted of program related crimes.

Judicial Review of Provider Reimbursement Review Board Decisions

Clarifies the effective date of certain provisions of the "Social Security Amendments of 1983" (P.L. 98-21) dealing with judicial review.

Access to home health services

Permits physicians with certain financial interests in certain home health agencies to carry out certification and plan-of-care functions for patients of those agencies.

Provider representation in Peer Review Organizations (PROs)

Provides that a PRO governing body may include a governing body member, officer, or managing employee of a health care facility.

Prospective payment assessment commission

Includes a number of amendments to clarify the manner in which the Commission is to function.

Medicaid clinic administration

Makes it clear that the administrator of a clinic need not be a physician in order for the clinic to participate in Medicaid.

Enrollment and premium penalty with respect to working aged provision

Waives the Part B delayed enrollment penalty for workers age 65 through 69 who elect private coverage under the provisions of TEFRA for the period of such coverage.

Emergency room services

Modifies Section 1861(v) of the Social Security Act to include a definition of "bona fide" emergency.

Payment for services of a nurse anesthetist

Requires that the costs a hospital incurs in employing Certified Registered Nurse Anesthetists (CRNAs) be reimbursed on a reasonable cost basis.

Prospective payment wage index

Directs the Secretary of HHS to remedy certain problems which exist in the calculation of the wage index for hospital workers.

Hospice contracting for core services

Allows the Secretary to waive the nursing care "core services" requirements for certain hospices.

Exemption of public psychiatric hospitals from provision limiting reimbursement to SNF rates

Delays until July 1, 1985, the application of any reimbursement reductions required to be made to public psychiatric hospitals due to the level of care received by Medicaid patients in such hospitals.

Certification of psychiatric hospitals

Permits psychiatric hospitals and psychiatric units of general hospitals to participate in Medicare and Medicaid on the basis of a survey by the Secretary of HHS or, if found appropriate, accreditation by the American Osteopathic Association or the Joint Commission on the Accreditation of Hospitals.

Payments to teaching physicians

Modifies the calculation of Medicare reimbursement for certain teaching physicians in States with low Medicaid payment rates.

Pacemaker reimbursement review and reform

Directs the Secretary to study the impact technology should have on the costs of physician services, publish guidelines on the frequency and appropriate payment levels for trans-telephonic monitoring, establish an FDA-administered pacemaker registry, and study the reasonableness of Part A payments for pacemaker implants.

Open enrollment period for health maintenance organizations and competitive medical plans

Allows the Secretary up to three years to coordinate an open enrollment period in each area serviced by two or more participating HMO's.

Waivers for Social Health Maintenance Organizations

Requires the Secretary to approve certain waivers for a project to demonstrate the concept of a social HMO at four sites.

Funding for PSRO review

Provides that the automatic Trust Fund Peer Review Organization funding provisions be extended to PSRO's. Delays for 3 months, two implementation dates contained in current law.

B. Income Maintenance Provisions

Parents and siblings of dependent child included in AFDC family

Establishes a standard filing unit for the AFDC program.

Households headed by minor parents

Requires that in order to qualify for AFDC benefits, an unmarried minor parent and her child would have to reside in the home of the minor parent's own parent or guardian, except in certain instances.

Clarification of earned income provision

Clarifies current law with regard to the definition of the term "earned income".

CWEP work for federal agencies permitted

Clarifies a provision of the 1981 Omnibus Budget Reconciliation Act which authorized the operation of Community Work Experience Programs (CWEP) by the States.

Earned income of full-time students

Permits States to exclude the earnings of a child from the 150 percent limit on gross family income for the determination of eligibility for the AFDC program.

Adjustments in SSI benefits on account of retroactive benefits under Title II

Provides for the adjustment of retroactive benefits under the Supplemental Security Income (SSI) and social security programs on account of benefits already paid under either of these programs.

Regulatory initiative on medical support

The Committee agreed to direct the Secretary to require State Child Support Enforcement (CSE) agencies to petition the court to include medical support as part of the child support order.

C. Social Security Provisions

Special Social Security treatment for church employees

Permits churches and certain church-controlled organizations, opposed for religious reasons to the payment of the employer FICA tax, to elect not to be subject to FICA tax liability or to any requirement to withhold social security taxes on behalf of employees with respect to services performed after December 31, 1983. This election is a one-time irrevocable decision, available only to such organizations which were not covered by social security on December 31, 1980. The employees of electing organizations are treated, for purposes of social security taxes, similarly to the self-employed, and are taxed at the net SECA rate; however, a deduction for unreimbursable business expenses is not allowed. The employer's election remains in effect only if certain information reporting requirements are met.

Social Security coverage for legislative branch employees not covered by the Civil Service Retirement System

Requires that an individual in legislative branch employment maintain continuous participation in the Civil Service Retirement System in order to retain an exemption from social security.

Employees of nonprofit organizations who are required to participate in the Civil Service Retirement System

For purposes of social security, would treat like Federal employees those employees of nonprofit organizations which are covered on a mandatory basis by the Civil Service Retirement System.

D. Grace Commission Provisions

Income and eligibility verification procedures

Authorizes and requires data on earned and unearned income from IRS and SSA to be made available to agencies administering means-tested Federal benefit programs. Requires programs to utilize such data. Directs each State to maintain a system of quarterly wage reporting.

Collection and deposit of payments to executive agencies

Authorizes the Secretary of the Treasury to prescribe the collection mechanisms of Federal agencies. Allows the Secretary to impose sanctions for noncompliance.

Collection of nontax debts owed to Federal agencies

Authorizes the Internal Revenue Service to reduce the amount of any refund of internal revenue taxes by the amount of certified nontax debt owed to the Federal Government.

E. Cover Over Provisions

Clarification of definition of articles produced in Puerto Rico or the Virgin Islands

Clarifies the definition of goods produced in Puerto Rico and the Virgin Islands for purposes of the application of a special excise tax/cover provision.

Limitation on transfers of excise tax revenues to Puerto Rico and the Virgin Islands

Limits the transfer of certain taxes collected on distilled spirits into the Treasuries of Puerto Rico and the Virgin Islands.

III. GENERAL REASONS

Despite the recovery of the U.S. economy in 1983, there is now concern that the budget deficits projected by both the Office of Management and Budget and the Congressional Budget Office will threaten continued economic growth and investment at a low rate of inflation. The main objective of the bill is to reduce these budget deficits in order to safeguard the economic recovery. A related objective is to prevent further erosion of the tax base as a result of tax sheltering activity. The budget deficit has been aggravated by the growth of tax shelter partnerships and the creative use of structural tax rules to achieve tax benefits far in excess of those intended by Congress. Additional objectives are to ensure that all taxpayers pay a fair share of the tax burden and to improve the administration and efficiency of the tax system and certain spending programs. Many of the changes in spending programs involve extensions or modifications of provisions already reported by the committee and included in S. 2062. Finally, the bill is designed to provide tax incentives for investment and continued economic growth.

Deficit Reduction

In February 1984, the Congressional Budget Office estimated that current fiscal policy would produce a substantial growth in the Federal deficit from $195 billion in fiscal year 1983 to $326 billion in 1989. Furthermore, an increasing portion of the budget deficit appears to be attributable to structural features of tax and spending programs rather than adverse cyclical conditions. The Congressional Budget Office estimates that the structural budget deficit will more than double relative to gross national product, from 2.4 percent in 1983 to 5.5 percent in 1989. This rising stream of deficits is projected to add more than $1.5 trillion to the national debt over the 1984-89 period, increasing Federal borrowing from one-third to one-half of gross national product. The cost of servicing the debt is projected to increase from 11 percent to 16 percent of Federal budget outlays from 1983 to 1989, which will make it even more difficult to cut the deficit in future budget cycles if nothing is done this year.

Unless some action is taken to reduce these budget deficits, there is concern that it may be difficult to sustain real economic growth and price stability. If monetary policy continues to be anti-inflationary, the competition between public and private borrowing as the economy approaches full employment will put upward pressure on interest rates. High real interest rates harm private capital formation and contribute to the appreciation of the dollar, relative to foreign currencies, which adversely affects the merchandise trade balance. The ill effects of mounting budget deficits and high real interest rates are already apparent in the deteriorating trade balance, which recorded a deficit in 1983 exceeding $60 billion.

In recognition of the deficit problem, the President proposed a $150 billion "down payment" on the budget deficit over the next three years. The bill includes revenue measures which raise $2.5 billion in fiscal 1984, $10.6 billion in 1985, $16.0 billion in 1986, and $18.9 billion in 1987, for a total revenue increase of $48.0 billion over the four-year period. Thus, the bill achieves approximately one-third of the deficit reduction target through revenue increases.

The bill contains numerous provisions which are designed to reduce the budget deficit in a fair and equitable manner. The bill postpones seven tax reductions scheduled to take effect in this and subsequent years. This tax reduction deferral, which does not raise any taxes above their level at the end of 1983, is a fair way to reduce the deficit, and causes far less disruption than the imposition of new tax increases.

Another important deficit reduction provision is an increase in the cost recovery period for new and used depreciable real property from 15 to 20 years. The highly accelerated depreciation deductions provided under current law, in conjunction with exemption from the "at-risk" rules and special recapture rules for real property, have contributed to the rapid growth of real estate tax shelters. The bill reduces the incentive to promote tax-oriented real estate partnerships, and to engage in other tax-motivated transactions such as the sale and lease-back of office buildings. The bill also protects low-income families by exempting low-income housing from the extension of the depreciation period.

Insofar as possible, the committee has attempted to meet its deficit reduction target without harming the average taxpayer or average program beneficiary. When provisions do affect the average taxpayer, this has been because the committee believed that present law provided unnecessary benefits. For example, the bill modifies the income averaging formula because use of this provision has expanded dramatically in recent years and the averaging threshold need not be as generous in view of the tax rate cuts and tax indexing enacted in 1981.

Much of the bill's deficit reduction involves the scaling back of unwarranted tax advantages for businesses. The bill eliminates certain tax benefits by broadening the definition of a corporation's earnings and profits to measure more accurately its economic income. This will prevent shareholders from avoiding tax on a portion of dividends in situations where the current earnings and profits rules understate the corporation's economic income. Also, the bill increases the present law reduction in certain corporate tax preferences from 15 to 20 percent, and requires corporations to capitalize, rather than expense, construction period interest and taxes on residential property other than low-income housing. The bill also reduces the tax benefits available to business property if more than 10 percent of the property's use is for personal purposes. This provision reduces the tax benefits claimed by taxpayers on property that is not used exclusively for the production of income.

Prevention of Tax Base Erosion

The committee believes that the proliferation of tax shelters has seriously eroded the tax base and has adversely affected the efficiency and equity of the tax system. The increase in tax shelter activity has aggravated the nation's deficit problem, particularly in the case of "abusive" shelters where the tax write-offs are several times larger than the equity investment. The proliferation of tax sheltered investments shifts the tax burden to those taxpayers who do not or cannot participate in such investments, and the organization and promotion of tax shelters diverts thousands of skilled professionals from more productive activities. Accordingly, the committee bill contains a number of provisions designed to eliminate unintended tax results achieved in certain partnership transactions.

Many tax shelter transactions derive unintended tax benefits by exploiting the Code's failure to take into account the time value of money. For example, the tax law has been slow to require economic accrual of interest on obligations issued at a discount. The bill requires the economic accrual of interest on deferred payments made in connection with the sale or exchange of property and services in certain transactions that are excluded under current law. This will limit the extent to which taxpayers can achieve substantial reductions in tax liability merely by changing the form in which property is sold. A related provision of the bill prevents the deferral of depreciation recapture in situations where depreciable property is sold using the installment method.

Another area where the tax base has been seriously eroded is the use of tax-exempt bonds for private purposes. In recent years, the use of such bonds has grown far beyond what was originally intended by Congress and has significantly raised interest rates on the general obligation bonds that State and local governments issue to finance their operations. The committee bill places certain limits on the benefits of private purpose tax-exempt bonds in order to curb the uncontrolled Federal tax expenditure for private property financed with these bonds.

The committee is also concerned about the use of leasing and sale-leaseback arrangements by Federal agencies, State and local governments, and other tax-exempt entities in order to obtain the advantage of accelerated depreciation and other tax benefits. In these lease transactions, a portion of the tax benefit available to the lessor is passed through to the nontaxable lessee in the form of lower rents. Thus, the leasing arrangement allows certain tax benefits to flow through to nontaxable entities which are not eligible for them on their own account. The difference between the cost of leasing and purchasing property is a benefit which is effectively paid by the Federal government to the tax-exempt entity. Moreover, the cost to the Federal government is more than the benefit received by the tax-exempt entity—some of the benefits go to the owner of property and to financial and other intermediaries. The committee bill eliminates the excessive tax benefits for property used by tax-exempt entities.

Tax Equity

The committee is concerned that the tax system be as equitable as possible and, equally important, be perceived by taxpayers as fair. Compliance with the tax law is likely to decline if taxpayers believe that the burden is unfairly distributed as a result of inequities in the tax system.

One inequity arises where employers provide employee benefits through the establishment of a tax-exempt employees' beneficiary association (VEBA). Some VEBAs are currently being used to allow employers to earn tax-exempt interest on excessive reserves. The bill would limit abusive overfunding of welfare benefit plans merely to facilitate the deferral of income tax by the owner-employees.

The committee believes that the present law limitation on contributions to an individual retirement account (IRA) unfairly discriminates against married taxpayers where one spouse does not have earned income. In recognition of the value of work done by a homemaker, the bill increases the limit for contributions to a spousal IRA, over a seven-year period, to the level which applies to spouses who work outside the home.

The committee is also concerned about the fairness of the tax system with respect to low-income households. Under limits established in 1979, low-income taxpayers are eligible for a refundable 10-percent credit on the first $5,000 of income ($500 maximum credit) which is phased-down to zero as income increases from $6,000 to $10,000. Since 1979, increases in the social security tax and the cost of living have increased the relative burden of the income tax on certain low-income households. The bill increases the earned-income credit to 10.5 percent on the first $5,000 of income ($525 maximum credit), and the credit is phased out at an income of $11,000. This change provides relief to low-income taxpayers while preserving incentives to work. The bill also extends the targeted jobs tax credit through 1987. This provision benefits economically disadvantaged groups of workers that have historically experienced unemployment rates above the national average.

The committee believes that the structure of the taxation of life insurance companies should be fundamentally revised to ensure similar tax treatment of different segments of the industry. The Life Insurance Company Tax Act of 1959 (on which present law is based) was designed to ensure that the life insurance industry as a whole paid a target amount of tax and that the distribution of this tax burden within the industry was balanced. The three-phase structure of present law is extremely complex, and in the past few years the presence of high interest rates and new investment-oriented life insurance products has substantially redistributed the industry's tax burden. The committee believes that a simpler single-phase tax, more like that imposed on corporations in other industries, will ensure that life insurance companies face comparable tax burdens.

The committee has also recommended changes in the heavy vehicle use tax provisons of the Surface Transportation Act of 1982. These changes are designed to more equitably distribute the burden of such taxes among users of the nation's highway system while maintaining adherence to cost allocation principles adopted in earlier legislation.

Improved Administration and Simplification

The committee has examined numerous provisions of the tax law, and has recommended simplification or administrative improvements in several areas.

Under current law, interest paid by a U.S. borrower to a foreign lender is subject to a 30-percent withholding tax unless a statutory exemption applies or the tax is reduced by treaty. This tax raises the cost of foreign capital to U.S. borrowers. Some U.S. companies have established finance subsidiaries in the Netherlands Antilles, taking advantage of current treaty arrangements, in order to borrow funds from the Eurobond market free of the withholding tax. The bill provides for a phase-down of the 30-percent tax on portfolio interest, and elimination after July 1, 1988. Elimination of the tax will provide access to the Eurobond market free of tax to all corporate borrowers, as well as governmental borrowers, without establishing a Netherlands Antilles subsidiary merely for the purpose of borrowing and re-lending funds from the Eurobond market to the U.S. parent.

.Under current law, many companies have established domestic international sales corporations (DISCs) which permit a deferral of corporate income tax on a portion of the income attributable to exports and qualified DISC assets. The DISC system of taxation has been an irritant in trade negotiations, and to avoid further dispute, the United States has agreed to change the tax treatment of exports. The bill creates a new system of taxing the export income of foreign sales corporations (FSCs). The FSC system of taxation is designed to comply with the letter and spirit of the General Agreement on Trade and Tariffs (GATT) code, and to be revenue-neutral compared to the DISC system. The committee believes that the FSC system will allow U.S. exporters to compete on substantially equal terms with foreign exporters, taking into account our trading partners' greater reliance on indirect taxes, and differences in principles regarding the taxation of foreign-source income.

The committee has recommended changes in reporting requirements and penalties in order to improve compliance with the tax system. The committee believes that unless continued efforts are made to reverse the rising trend of noncompliance, the integrity of the tax system will be severely eroded. The compliance provisions in this bill complement and strengthen the compliance measures enacted in the Tax Equity and Fiscal Responsibility Act of 1982.

Incentives for Investment and Continued Economic Growth

The committee believes that the promotion of continued economic growth requires a balanced tax program of deficit-reducing measures and tax incentives designed to stimulate research and capital formation. Future economic growth depends on current decisions to invest in new plant and equipment as well as in long-term programs of research and development. The bill makes the 25-percent credit for incremental research and experimental expenditures, adopted on a temporary basis in 1981, a permanent part of the tax

Code. An expanded charitable deduction would also be allowed for certain donations of scientific and technological equipment to universities. A related incentive provision of the bill extends the current suspension of Treasury regulations which require the allocation of research and experimental expenses between U.S. and foreign sources. This effectively lowers the U.S. tax liability of certain U.S. corporations that engage in research activities and pay relatively high foreign taxes.

The committee believes that all regions of the country should participate in the nation's economic growth. Thus, the bill contains a new provision for creating enterprise zones in those areas of the country which are most in need of development assistance. The bill authorizes the Secretary of the Department of Housing and Urban Development to designate up to 25 enterprise zones per year, over a three-year period, meeting certain criteria of economic distress. Firms in enterprise zones will be eligible for numerous special tax incentives for capital investment and for hiring zone employees, as well as regulatory relief, for a period of 20 years plus a four-year phase-out period.

Grace Commission Report

The committee believes that the President's Private Sector Survey on Cost Control developed a number of important proposals for controlling Federal outlays and improving administrative practices. In an effort to increase government efficiency, the committee has recommended three changes proposed by the Grace Commission. First, the bill authorizes the Internal Revenue Service to offset delinquent nontax debts owed the Federal Government against Federal income tax refunds. Second, the bill authorizes and requires the Internal Revenue Service to make available data on unearned income to Federal and State agencies that administer means-tested Federal benefit programs, and requires States to collect quarterly wage data for purposes of income verification. Last, the bill directs the Treasury Department to issue regulations requiring agencies to implement the Grace Commission recommendations for accelerating the collection and deposit of nontax Federal receipts.

Spending Reduction Provisions

The Administration budget estimates current law benefit and administrative outlays under Medicare at $76.8 billion in fiscal year 1985. Of this amount, benefit payments account for $74.8 billion. This represents an increase of 15.9 percent over fiscal year 1984 benefit payments of $64.6 billion.

Both in terms of total outlays and total benefits per enrollee receiving reimbursement, the rate of growth for Part B of Medicare continues to exceed that for Part A. Whereas, Part A benefits per enrollee receiving reimbursement are 58 percent higher than the projected fiscal year 1985 medical care component of the CPI, Part B benefits are 100 percent higher.

The spending provisions for the most part address Part B of Medicare, the Supplemental Medical Insurance (SMI) program. In fiscal year 1984, the general fund of the U.S. Treasury will have to contribute an estimated $16.8 billion to the SMI trust fund in order to keep it solvent. That general fund obligation is expected to grow by 13.3 percent to $19 billion in fiscal year 1985.

The major provisions which affect SMI spending reductions include holding reasonable charges for all physicians to prior year levels for a twelve month period followed by a second twelve month period during which a limited fee freeze is imposed on those physicians who do not accept assignment, establishing a fee schedule for clinical laboratory services, modifying the premium liabilities for Part B enrollees, delaying entitlement to Medicare benefits until the month after an individual becomes 65 years of age, and allowing a non-working spouse aged 65 to 69 to elect primary coverage under the working spouse's employer group health plan even though the working spouse is not yet 65 years of age.

The provisions which delay entitlement and modify current law with respect to the working aged also affect Part A of Medicare, the Hospital Insurance (HI) program.

Hospital Insurance, Part A, benefits for fiscal year 1985 are projected to be $50.7 billion, that is, $6.6 billion or 15 percent higher than fiscal year 1984. Inpatient hospital services will account for 95 percent of Part A benefit payments.

Several spending provisions are specific to the HI program. The major provision which reduces HI spending limits the rate of increase in payments to hospitals.

The committee recognizes the tremendous improvement that has been made in the health status of the elderly as a result of the creation of Medicare in 1965. Certainly the committee firmly believes in the need to preserve this essential program. In considering spending reductions, it was the committee's desire not to simply cut another program. It was rather to protect one of the most important programs the Nation offers its citizens.

The Administration budget projects total Federal-State Medicaid costs for fiscal year 1985 under current law to be $41.4 billion, of which the Federal share is $23.2 billion. Of the Federal amount, $22.0 billion represents payments for benefits, with the remaining $1.2 billion going for State and local administrative costs. This represents an increase in total Federal outlays of 14.5 percent over fiscal year 1984, attributable in part to the discontinuation of the current 4.5 percent reduction in Federal payments.

The remaining health related spending provisions address the Medicaid program. Principal among these is a provision to extend the current reduction in Federal matching payments to the States for three more years. The reduction would be set at three rather than the current 4.5 percent, however offsets, which allow the States to decrease the Federal reduction, would be permitted as under current law.

Other Medicaid related provisions increase spending ceilings for Puerto Rico and the Territories, extend medicaid coverage to certain pregnant women, and reduce the frequency at which physicians certify the institutional needs of nursing home patients. The nursing home patient certification provision also reduces spending for Part A of Medicare, while a provision delaying application of a single skilled nursing care rate to hospital-based nursing care units increases outlays. Additionally, the committee has included a provision to increase the authorization level for the Maternal and Child Health Block Grant program and a number of provisions without budgetary effect which modify various elements of the Medicare and Medicaid programs.

Additional items were added by the committee which deal with the Aid to Families with Dependent Children (AFDC) Program and the Supplemental Security Income (SSI) Program. For the most part, these provisions provide administrative simplification of technical clarifications for the Programs.

First, the committee agreed to a provision which would establish a standard filing or assistance unit for AFDC family. A related provision would require a minor parent of an AFDC child to remain with her own parent or legal guardian whenever possible. These provisions will not only target assistance to those with limited resources, but they will also simplify State administration of the program. Two additional technical amendments were approved, as well as a provision with negligible outlay effect. This provision permits States to exclude the earnings of a full time student from the eligibility determination calculation.

Second, the committee agreed to a provision which provides for the collection of windfall benefits from Supplemental Security Income benefits as well as from benefits paid under the Old Age Survivors and Disability Insurance programs. This provision is basically a technical correction to an amendment adopted in 1980.

IV. REVENUE AND OUTLAY EFFECTS

Revenue Effects

The revenue provisions of the committee bill involving statutory changes are estimated to increase net budget receipts by $2.5 billion in fiscal year 1984, $10.6 billion in fiscal year 1985, $16.0 billion in fiscal year 1986, and $18.9 billion in fiscal year 1987. Thus, the total net revenue raised during the fiscal years 1984 through 1987 equals $48.0 billion.

The changes to the earned income credit affect both revenues and outlays, both of which are included in the above total. As a result, these changes will reduce fiscal year receipts by $3 million in 1985, $93 million in 1986, $85 million in 1987, $77 million in 1988, and $73 million in 1989, and increase outlays by $5 million in 1985, $129 million in 1986, $120 million in 1987, $110 million in 1988, and $100 million in 1989.

Table IV-1 presents a summary of the estimated revenue effects of the tax provisions of the committee bill for fiscal years 1984-1989 for the major tax categories of the bill (Titles I-VIII).

Table IV-2 shows the estimated revenue effects of each specific tax provision of the committee bill (Titles I-VIII) for fiscal years 1984-1989.

Budget Outlays

The outlay reduction provisions (other than the earned income credit refunds noted above) of the committee bill are estimated to reduce fiscal year budget outlays by $0.1 billion in 1984, $2.8 billion in 1985, $5.3 billion in 1986, and $6.6 billion in 1987. Thus, spending budget outlays will be reduced by $14.8 billion during the fiscal years 1984-1987. Details on spending reduction provisions are shown in Table IV-3.

Table IV-1.—Summary of Estimated Revenue Effects of Tax Provisions of Committee Deficit Reduction Provisions Approved by the Committee on Finance, Fiscal Years 1984-89

[In millions of dollars]

Provision	1984	1985	1986	1987	1988	1989
Title I. Tax Reforms Generally	2,241	11,274	18,136	23,317	25,205	26,118
Title II. Life Insurance Provisions [1]	−120	−353	−397	−476	−529	−603
Title III. Private Foundation Provisions	0	−21	−24	−26	−29	−32
Title IV. Enterprise Zones [2]	([2])	([2])	([2])	([2])	([2])	([2])
Title V. Foreign Sales Corporations	0	−43	−33	36	88	−98
Title VI. Highway Revenue Provisions	−128	50	−69	−133	−42	−72
Title VII. Tax Exempt Bond Provisions	−26	−114	−247	−401	−523	−503
Title VIII. Miscellaneous Revenue Provisions	510	−70	−963	−2,610	−3,295	−2,767
Total, tax provisions	**2,477**	**10,625**	**15,983**	**18,932**	**19,858**	**20,992**

[1] The figures represent the estimated effects of the life insurance provisions assuming that certain temporary provisions enacted in the Tax Equity and Fiscal Responsibility Act of 1982 (TEFRA), which provide for the taxation of insurance companies, are terminated. If these provisions were not allowed to expire at the end of 1983, the estimates would show increases in fiscal year receipts of $763 million in 1984, $884 million in 1985, $923 million in 1986, $997 million in 1987, and $1,076 million in 1988.

[2] The budget effects of this provision will depend on the number, size, and characteristics of the enterprise zones designated by the Secretary of Housing and Urban Development (see "Revenue Effect" statement in text). Grand totals in this table reflect Treasury Department estimates which show decreases of fiscal year budget receipts of $98 million in 1985, $420 million in 1986, $775 million in 1987, $1,017 million in 1988, and $1,051 million in 1989.

Table IV-2.—Estimated Revenue Effects of Tax Provisions of Committee Deficit Reduction Provisions Approved by the Committee on Finance, Fiscal Years 1984-89

[In millions of dollars]

Provision	1984	1985	1986	1987	1988	1989
Title I. Tax Reforms Generally:						
A. Deferral of Certain Tax Reductions:						
Amount of used property eligible for the investment tax credit		44	104	112	65	
Finance lease provisions	63	348	862	1,381	1,424	741
Election to expense certain depreciable business assets	230	399	433	386	−118	−427
Communications tax			1,168	2,016	803	
Three-year postponement of net interest exclusion		1,024	2,858	3,100	2,065	
Foreign earned income of individuals	4	31	80	106	107	79
Subtotal	297	1,846	5,505	7,101	4,346	393
B. Tax-Exempt Entity Leasing	492	998	1,811	3,127	5,008	7,089
C. Treatment of Bonds and Other Debt Instruments:						
Discount obligations	154	663	93	92	90	72
Zero coupon municipals	3	5	7	8	10	13
Subtotal	157	668	100	100	100	85

Table IV-2.—Estimated Revenue Effects of Tax Provisions of Committee Deficit Reduction Provisions Approved by the Committee on Finance, Fiscal Years 1984-89—Continued

[In millions of dollars]

Provision	1984	1985	1986	1987	1988	1989
D. Corporate Provisions:						
Limitations on dividends received deduction:						
Dividends received deduction reduced where portfolio stock is debt financed	(6)	(6)	(6)	(6)	(6)	(6)
Treatment of dividends from regulated investment companies		19	34	36	39	42
Treatment of certain distributions:						
Corporate shareholder's basis in stock reduced by nontaxed portion of extraordinary dividends		140	100	100	100	100
Distribution of appreciated property by corporations	3	18	64	114	169	227
Extension of holding period for losses attributable to capital gain dividends of regulated investment companies or real estate investment trusts		(5)	83	89	96	103
Miscellaneous provisions:						
Denial of deductions for certain expenses incurred in connection with short sales	22	32	38	43	48	54
Nonrecognition of gain or loss by corporation on options with respect to its stock	(5)	(5)	(5)	(5)	(5)	(5)
Amendments to accumulated earnings tax		62	78	33	35	36
Corporate tax rate change	70	212	185	190	192	194
Corporate preference disallowance		260	367	410	460	524

Denial of deductions for certain extraordinary payments to employees; imposition of excise tax—Golden parachutes	([5])	([5])	([5])	([5])	([5])	([5])
Changes in computation of earnings and profits		108	308	343	389	430
Two-year delay in the effective date of the 1976 Act changes to the limitation on net operating losses	([2])	([2])	([2])	([2])	([2])	([2])
Change in treatment of type "C" reorganizations	([6])	([6])	([6])	([6])	([6])	([6])
Change in treatment of type "D" reorganizations	([6])	([6])	([6])	([6])	([6])	([6])
Modification of treatment of collapsible corporations (including foreign corporations)		8	81	256	351	382
Subtotal	95	859	1,338	1,614	1,879	2,092
E. Partnership Provisions:						
Partnership allocations with respect to contributed property	4	61	147	178	240	298
Determination of distributive shares when partner's interest changes		50	75	100	100	100
Payments to partners for property or certain services		20	51	60	69	78
Contributions to a partnership of unrealized receivables, inventory items, or capital loss property		24	63	66	67	69
Transfers of partnership interests by corporations		([5])	50	50	50	50

Table IV-2.—Estimated Revenue Effects of Tax Provisions of Committee Deficit Reduction Provisions Approved by the Committee on Finance, Fiscal Years 1984-89—Continued

[In millions of dollars]

Provision	1984	1985	1986	1987	1988	1989
Section 1031 not applicable to partnership interests; limitation on the period during which like-kind exchanges may be made		226	630	667	788	842
Subtotal	4	381	1,016	1,121	1,314	1,437
F. Trust Provisions	(6)	64	261	409	438	467
G. Time Value of Money and Other Accounting Changes:						
Certain amounts not treated as incurred before economic performance:						
Premature accruals	209	458	448	393	351	321
Prepayment of expenses	10	22	7	8	10	12
Deferred payments	(6)	228	721	1,253	1,789	2,349
Deferred rent on real and tangible personal property	60	284	552	785	1,067	1,237
Construction period interest and taxes		67	164	220	242	236
Preopening expenditures		23	36	31	26	19
Subtotal	279	1,082	1,928	2,690	3,485	4,174
H. Provisions Relating to Tax Straddles	406	163	82	60	48	39

I. Pensions, Welfare Benefit Plans, ESOPs:						
General provisions:						
Pensions (deduction limits, top-heavy provisions, distribution rules, estate tax exclusion, aggregation provisions, loan provisions)	-31	-71	8	46	81	82
Welfare benefit plans		20	48	60	72	90
Retirement savings incentives:						
Spousal IRAs		-118	-331	-455	-652	-720
Distribution requirements for IRAs	[1]	[1]	[1]			
Alimony as compensation for IRA purposes	[4]	[4]	[4]	[4]	[4]	[4]
Employee stock ownership provisions		301	160	-67	-158	-266
Miscellaneous:						
Elimination of retroactive application of amendments made by Multiemployer Pension Plan Amendments Act of 1980	[1]	[1]	[1]	[1]	[1]	[1]
Special rule for trans-Alaskan pipeline employees	[1]	[1]	[1]	[1]	[1]	[1]
Treatment of certain distributions from a qualified terminated plan	[1]	[1]				
Treatment of distributions of accrued benefits from certain plans	[1]	1	2	2	4	6
Pension portability	[1]	[1]	[1]	[1]	[1]	[1]
Subtotal	-31	133	-113	-414	-653	-808
J. Foreign Provisions:						
Treatment of related person factoring income	[6]	306	534	576	622	672
Taxation of certain transfers of property outside the United States			12	127	324	540

Table IV-2.—Estimated Revenue Effects of Tax Provisions of Committee Deficit Reduction Provisions Approved by the Committee on Finance, Fiscal Years 1984-89—Continued

[In millions of dollars]

Provision	1984	1985	1986	1987	1988	1989
Section 1248 to apply to certain indirect transfers of stock in a foreign corporation		(5)	(5)	(5)	(5)	(5)
Treatment of certain transportation income	5	13	17	18	19	20
Source of insurance premiums	(5)	(5)	(5)	(5)	(5)	(5)
Interest and dividends paid by certain United States-owned foreign corporations treated as derived from United States sources	13	60	64	70	76	82
Certain dividends treated as interest for purposes of the limitation on the foreign tax credit	(5)	67	118	129	142	157
Excise tax on insurance premiums paid to foreign insurers and reinsurers		21	34	39	44	49
Amendment of foreign personal holding company rules	(5)	(5)	(5)	(5)	(5)	(5)
Definition of foreign investment company		(6)	(6)	(6)	(6)	(6)
Witholding of tax on dispositions of United States real property interests by certain foreign persons required	44	40	10	10	11	14
Exemption of foreign investors from U.S. tax on portfolio interest		−38	−67	−100	−150	−188
Subtotal	62	469	772	869	1,088	1,346

K. Reporting, Penalty and Other Provisions:						
Taxpayer compliance provisions		40	102	175	232	255
Reporting of State and local refunds	−2	−21	−22	−16	−17	−19
Statements required in case of certain substitute payments	[6]	[6]	[6]	[6]	[6]	[6]
Charitable contributions		14	40	46	52	57
Disclosure of tax information to cities	[5]	[5]	[5]	[5]	[5]	[5]
Penalty provisions			20	18	17	15
Reporting on independent contractors	[1]	[1]	[1]	[1]	[1]	[1]
Subtotal	−2	33	140	223	284	308
L. Depreciation Provisions:						
Twenty-year accelerated cost recovery for real estate	95	496	1,295	2,341	3,464	4,639
Recapture on an installment sale	39	91	177	192	209	226
Nonaccelerated cost recovery for movies and sound recordings		5	10	10	10	10
Subtotal	134	592	1,482	2,543	3,683	4,875
M. Miscellaneous Reform Provisions:						
Inclusion of tax benefit items in income		229	253	274	300	330
Loans with below-market interest rates	108	126	143	150	158	166
LIFO conformity rules applied on controlled group basis		105	185	200	200	200
Modification of income averaging	133	1,994	1,886	2,053	2,226	2,404
Denial of deduction for personal use of business property	61	514	661	582	482	500
Amendments to section 267	46	109	176	253	346	416
Sales of section 1231 property		27	76	109	168	230
Tax swaps of property	[1]	[1]	[1]	[1]	[1]	[1]
Individual minimum tax		5	28	35	38	46

Table IV-2.—Estimated Revenue Effects of Tax Provisions of Committee Deficit Reduction Provisions Approved by the Committee on Finance, Fiscal Years 1984-89—Continued

[In millions of dollars]

Provision	1984	1985	1986	1987	1988	1989
Capital gains on coal		32	32	36	40	44
Repeal of dividend reinvestment exclusion		167	278			
Modification of rules concerning payment of estimated taxes by individuals		611	37	40	42	45
Taxation of Federal Home Loan Mortgage Corporation		67	109	142	185	240
Clarification of application of section 265 (2) among related parties	([5])	([5])	([5])	([5])	([5])	([5])
Subtotal	348	3,986	3,864	3,874	4,185	4,621
Total, tax reforms generally	**2,241**	**11,274**	**18,136**	**23,317**	**25,205**	**26,118**
***Title II. Life Insurance Provisions*[3]**	**−120**	**−353**	**−397**	**−476**	**−529**	**−603**
Title III. Private Foundation Provisions		**−21**	**−24**	**−26**	**−29**	**−32**
Title IV. Enterprise Zones	([7])	([7])	([7])	([7])	([7])	([7])
Title V. Foreign Sales Corporations		**−43**	**−33**	**36**	**88**	**−98**
Title VI. Highway Revenue Provisions:						
Highway use/diesel tax:						
Highway use tax	−245	−562	−635	−696	−603	
Diesel fuel tax	143	687	643	645	649	−66
Net effect	−102	125	8	−51	46	−66

Other Provisions:						
Fuels tax exemption for taxicabs		−2	(1)			
Tax rate on gasohol/alcohol fuels	−12	−63	−65	−69	−74	−6
Tax on piggyback trailers	−14	−10	−12	−13	−14	
Floor stocks refunds for tires and tread mobiles	(1)	(1)				
Total, highway revenue provision	**−128**	**50**	**−69**	**−133**	**−42**	**−72**
Title VII. Tax-Exempt Bond Provisions	**−26**	**−114**	**−247**	**−401**	**−523**	**−503**
Title VIII. Miscellaneous Revenue Provisions:						
A. Estate and Gift Tax Provisions:						
Estate installm·.nt payments	(4)	−13	−19	−24	−29	−36
Repeal of generation-skipping transfer tax	−5	−10	−10	−10	−10	−10
Treatment of pre-1959 disclaimers	−10	−30	(4)	(4)	(4)	(4)
Marital deduction for a usufruct	(4)	(4)	(4)	(4)	(4)	(4)
Special relief for estates of Redfield and Rabe	−22					
Subtotal	−37	−53	−29	−34	−39	−46
B. Charitable Provisions:						
Conservation easements		−25	−25	−25	−25	−25
Olympic checkoff						
Increase in charitable volunteer mileage		−5	−37	−43	−51	−60
Charitable split-interest trusts	(4)	(4)	(4)	(4)	(4)	(4)
Increase in certain deduction limits for charitable contribution deduction		−8	−26	−29	−29	−28
Subtotal		−38	−88	−97	−105	−113
C. Excise Tax Provisions:						
Sport fishing equipment; trust fund; excise tax on bows and arrows		12	13	14	14	15

Table IV-2.—Estimated Revenue Effects of Tax Provisions of Committee Deficit Reduction Provisions Approved by the Committee on Finance, Fiscal Years 1984-89—Continued

[In millions of dollars]

Provision	1984	1985	1986	1987	1988	1989
Increase in tax on distilled spirits		371	479	510	520	535
Aviation tax exemption for fuel used by certain helicopters	−3	−4	−4	−5	−2	
Amendments relating to Superfund taxes						
Subtotal	−3	379	488	519	532	550
D. Employee Benefits Provisions:						
Pre-1978 unemployment compensation	([1])	([1])	([1])	([1])	([1])	([1])
Social Security coverage for church employees	−50	−12	−9	−5	−7	−3
Treatment of certain employee nonqualified stock options	([4])	([4])	−5	−10	([4])	([4])
Tax treatment of employee awards	−23	−55	−89	−144	−205	−229
Moratorium on issuance by the Treasury Department of regulations relating to fringe benefits	([1])	([1])	([1])			
Educational assistance	−7	−39	1	22	24	26
Technical correction of FICA and FUTA exemption for certain state retirement plan contributions (PERS pickup)						
Subtotal	−80	−106	−102	−137	−188	−206

E. Miscellaneous Treasury administrative provisions:						
Administrative provisions	(1)	(1)	(1)	(1)	(1)	(1)
Electronic funds transfers for alcohol and tobacco excise taxes	683	8	−159	7	7	7
Subtotal	683	8	−159	7	7	7
F. Miscellaneous Distilled Spirits Programs (other than electronic funds transfers)	(1)	(1)	(1)	(1)	(1)	(1)
G. Simplification and extension of income tax credits:						
Credits grouped together in more logical order and business energy credits	97	160	25	−61	−170	−198
Residential energy credits	8	169	262	−494	−665	−134
Targeted jobs credit		−163	−536	−914	−797	−521
Subtotal	105	166	−249	−1,469	−1,632	−853
H. Capital Gains and Losses	(2)	−60	307	315	333	350
I. Other Provisions:						
Modification of rehabilitation credit	(4)	(4)	(4)	(4)	(4)	(4)
Regulated investment companies	(1)	(1)	(1)	(1)	(1)	(1)
Tax treatment of cooperative housing corporations	(2)	(2)	(2)	(2)	(2)	(2)
FUTA tax for fishermen	−1	−1				
Extension of payment-in-kind program	−7	−8	15	(1)		
Physicians' and surgeons' mutual protection and indemnity associations	(4)	(4)	(4)	(4)	(4)	(4)
Sale-leasebacks of principal residences		−6	−20	−35	−56	−84
Extension of the earned income credit [8]		−8	−222	−205	−187	−173

Table IV-2.—Estimated Revenue Effects of Tax Provisions of Committee Deficit Reduction Provisions Approved by the Committee on Finance, Fiscal Years 1984-89—Continued

[In millions of dollars]

Provision	1984	1985	1986	1987	1988	1989
Inclusion of capital construction funds for shore-based fishery processing facilities	-14	-24	-20	-16	-14	-15
Exception to the rules relating to debt-financed property held by certain educational organizations and title holding companies	-24	-46	-58	-73	-91	-114
Terminal rental-adjustment clauses	-38	-41	-9	-2	-3	-4
Abatement of penalties-contest award	(1)	(1)	(1)	(1)	(1)	(1)
Allowance for minister's housing expenses		(4)	(4)			
Church audits	(1)	(1)	(1)	(1)	(1)	(1)
Extension of moratorium on allocation of domestic research and development expenses to foreign sources	-61	-127	-66			
Exclusion from gross income for cancellation of certain student loans	(4)	(4)	(4)	(4)	(4)	(4)
Technical modification to tip reporting requirements	(1)	(1)	(1)	(1)	(1)	(1)
Transition rule for safe-harbor leasing	-3	-5	-4	-4	-6	-6
The Tribal Indian Tax Status Act made permanent	(4)	(4)	(4)	(4)	(4)	(4)
Amortization of rehabilitation expenditures	-2	-7	-18	-32	-43	-34
Denial of deduction for costs of demolishing certified historic structures, and capitalization of certain demolition expenses	(5)	(5)	(5)	(5)	(5)	(5)

Removal of architectural barriers to the handicapped	−8	−16	−7			
Exempt status for dependent care facilities	([4])	([4])	([4])	([4])	([4])	([4])
Research and experimental tax incentives; vocational incentives		−77	−722	−1,347	−1,803	−2,026
Technical correction relating to percentage depletion for secondary and tertiary production						
Involuntary conversion involving boundary water canoes	([1])	([1])				
Subtotal	−158	−366	−1,131	−1,714	−2,203	−2,456
Total, miscellaneous revenue provisions	510	−70	−963	−2,610	−3,295	−2,767
Grand total, Tax Provisions	2,477	10,625	15,983	18,932	19,858	20,992

Footnotes to Table IV-2:

[1] Negligible.

[2] Loss of less than $10 million.

[3] The figures represent the estimated effects of the life insurance provisions assuming that certain temporary provisions enacted in the Tax Equity and Fiscal Responsibility Act of 1982 (TEFRA), which provide for the taxation of insurance companies, are terminated. If these provisions were not allowed to expire at the end of 1983, the estimates would show increases in fiscal year receipts of $763 million in 1984, $884 million in 1985, $923 million in 1986, $997 million in 1987, and $1,076 million in 1988.

[4] Loss of less than $5 million.

[5] Gain of less than $5 million.

[6] Gain of less than $10 million.

[7] The budget effects of this provision will depend on the number, size, and characteristics of the enterprise zones designated by the Secretary of Housing and Urban Development (see "Revenue Effect" statement in text). Grand totals in this table reflect Treasury Department estimates which show decreases of fiscal year budget receipts of $98 million in 1985, $420 million in 1986, $775 million in 1987, $1,017 million in 1988, and $1,051 million in 1989.

[8] The changes to the earned income credit will reduce revenues by $3 million in 1985, $93 million in 1986, $85 million in 1987, $77 million in 1988, and $73 million in 1989, and increase outlays by $5 million in 1985, $129 million in 1986, $120 million in 1987, $110 million in 1988, and $100 million in 1989.

Table IV-3. --Finance Committee Recommendations—Outlay Impacts

[Outlays in millions of dollars]

Provision	Fiscal year				4-year total
	1984	1985	1986	1987	
Medicare:					
Part B premium	0	0	−384	−884	−1,268
Delay entitlement	0	−145	−230	−255	−630
Working aged	0	−260	−380	−415	−1,055
Physician fees	−40	−750	−910	−1,070	−2,770
Hospital costs	0	−190	−430	−460	−1,080
Lab fees	−70	−255	−320	−400	−1,045
Asset revaluation	0	−50	−110	−170	−330
SNF reimbursement	+20	+30	+35	+40	+125
Round part B payments	−15	−65	−70	−75	−225
Claims processing	0	−15	−25	−35	−75
Lesser costs or charges	0	−80	−90	−105	−275
Hepatitis B vaccine	+3	−1	−2	−2	−2
Foot care services	−5	−11	−11	−12	−39
Index part B deductible	0	−35	−90	−100	−225
Cost sharing for DME	−10	−20	−25	−25	−80
Medicaid:					
Extend payment reductions	0	−562	−353	−432	−1,347
Assignment of rights	0	−7	−7	−8	−22
Increased ceiling for territories	+20	+20	+20	+20	+80
Pregnant women	+4	+11	+12	+13	+40
Recertification of SNF/ICF Patients	−3	−4	0	+1	−6
Psychiatric hospitals	+5	+10	+6	+3	+24
MCH block grant	+33	+30	+12	−14	+61
Health subtotal	**−58**	**−2,349**	**−3,352**	**−4,385**	**−10,144**
AFDC:					
Parents and siblings	−35	−135	−140	−145	−455
Minor parents	−5	−20	−20	−20	−65
Earned income	−8	−24	−24	−24	−80
SSI:					
Retroactive benefits	*	−12	−17	−18	−47
Income maintenance subtotal	**−48**	**−191**	**−201**	**−207**	**−647**
Grace Commission:					
Income verification	0	+31	−300	−391	−660
Cash management	0	0	−800	−800	−1,600
IRS refund offsets	0	0	−300	−500	−800
Grace subtotal	**0**	**+31**	**−1,400**	**−1,691**	**−3,060**

Table IV-3.—Finance Committee Recommendations—Outlay Impacts—Continued

[Outlays in millions of dollars]

Provision	Fiscal year				4-year total
	1984	1985	1986	1987	
Puerto Rican excise tax payments	0	−305	−333	−357	−995
Sport fish recreation program	0	+7	+15	+21	+43
Total, outlay reductions [1]	**−106**	**−2,807**	**−5,271**	**−6,619**	**−14,803**

*Less than $1 million.

[1] Totals do not include the impact of raising the earned income tax credit, which raises outlays $5 million in fiscal year 1985, $129 million in fiscal year 1986, and $120 million in fiscal year 1987.

V. EXPLANATION OF PROVISIONS

TITLE I—TAX REFORMS GENERALLY

A. Deferral of Certain Tax Reductions

1. Postponement of Increase in Amount of Used Property Eligible for Investment Tax Credit (sec. 12 of the bill and sec. 48(c)(2) of the Code)

Present Law

The maximum amount of a taxpayer's investment in used property that is eligible for the regular investment tax credit in a taxable year is $125,000. In the case of a married individual who files a separate return, the limit is $62,500. These limits are scheduled to increase to $150,000 and $75,000, respectively, for taxable years beginning after 1984.

Reasons for Change

The committee believes that delaying a relatively small increase in the amount of used property eligible for the investment credit can have no important effect on overall investment in the economy, but will make a certain contribution in reducing budget deficits.

Explanation of Provision

The bill holds the maximum amount of used property eligible for the investment credit at its current level of $125,000 per year until taxable years beginning after 1987, when this limit is increased to $150,000.

Effective Date

The provision is effective with respect to taxable years ending after 1983.

Revenue Effect

This provision is estimated to increase fiscal year budget receipts by $44 million in 1985, $104 million in 1986, $112 million in 1987, and $65 million in 1988.

2. Postponement of Finance Lease Provisions (sec. 13 of the bill and secs. 168(f)(8) and 168(i) of the Code)

Present Law

Overview

Prior to the enactment of the Economic Recovery Tax Act of 1981 (ERTA), the law contained rules (pre-safe harbor lease rules) to determine who owns an item of property for tax purposes when the property is subject to an agreement which the parties characterize as a lease. Such rules are important because the owner of the property is the person entitled to claim cost recovery deductions and investment tax credits with respect to the property. The pre-safe harbor lease rules attempted to distinguish between true leases, in which the lessor owned the property for tax purposes, and conditional sales or financing arrangements, in which the user of the property owned the property for tax purposes. These rules generally were not written in the Internal Revenue Code. Instead they evolved over the years through a series of court cases and revenue rulings and revenue procedures issued by the Internal Revenue Service. Essentially, the law was that the economic substance of a transaction, not its form, determined who was the owner of property for tax purposes. Thus, if a transaction was, in substance, simply a financing arrangement, it would be treated that way for tax purposes, regardless of how the parties chose to characterize it. Lease transactions could not be used solely for the purpose of transferring tax benefits. They had to have nontax economic substance.

ERTA provided a new set of rules which represented a major departure from the prior law. These provisions were intended to be a means of transferring tax benefits rather than a means of determining which person is in substance the owner of the property. Under these rules (safe-harbor lease rules), certain transactions involving tangible personal property were treated as leases for Federal income tax purposes regardless of their nontax economic substance. If a transaction met the safe harbor requirements, the lessor in the agreement was treated as the owner for Federal income tax purposes, entitled to cost recovery deductions and investment credits. Under these rules, by entering into a nominal sale and safe-harbor leaseback, a person who acquired and used the property could have, in effect, sold tax benefits associated with the property, while retaining all other economic benefits and burdens of ownership. The pre-safe harbor leasing rules continued to apply for transactions not qualifying under the safe-harbor lease rules or when the safe harbor was not elected.

The Tax Equity and Fiscal Responsibility Act of 1982 (TEFRA) generally repealed safe-harbor leasing. In its place, TEFRA substituted a modified form of safe-harbor leasing called finance leasing. Under the finance leasing provisions, taxpayers are still to some extent able to sell tax benefits with respect to property while retaining economic benefits and burdens of ownership. The pre-safe harbor lease rules continue to apply for transactions as to which the finance lease rules are unavailable.

Pre-safe harbor leasing rules

In general, the determination of lease treatment under the pre-safe harbor leasing rules required a case-by-case analysis based on all facts and circumstances. A discussion of those rules appears below in connection with sections 21 and 22 of the bill (relating to tax-exempt entity leasing).

Safe-harbor leasing rules

The safe-harbor leasing provisions of ERTA were intended to permit owners of property who were unable to use depreciation deductions and investment credits to transfer those benefits to persons who were able to use them, without having to meet the pre-safe harbor lease requirements for characterizing the transaction as a lease. The safe-harbor leasing provisions operated by guaranteeing that, for Federal income tax purposes, qualifying transactions were treated as leases, and that the nominal lessor was treated as the owner of the property, even though the lessee was in substance the owner of the property and the transaction otherwise would not have been considered a lease.[1]

Finance leasing rules

Under TEFRA's finance leasing rules, an agreement with respect to certain property may be treated as a lease notwithstanding the fact that (i) the lessee has a right to purchase the property at a fixed price not less than 10 percent of its original cost to the lessor or (ii) the property is of a type not readily usable by a person other than the lessee. No regulations have been issued under the finance leasing provisions.

Except for certain farm property, the finance lease rules apply to agreements entered into after December 31, 1983. However, three transitional rules generally apply. First, no more than 40 percent of certain property placed in service by the lessee during any calendar year beginning before January 1, 1986, may qualify for finance lease treatment. Second, except for property placed in service after September 30, 1985, in taxable years beginning after that date, a lessor may not use the finance lease rules to reduce its tax liability for any taxable year by more than 50 percent. Third, except for property placed in service after September 30, 1985, the investment credit for finance lease property is allowable ratably over 5 years only rather than entirely in the year the property is placed in service.

With respect to certain farm property, the finance lease rules apply to agreements entered into after July 1, 1982, and before

[1] For a discussion of the safe-harbor lease eligibility requirements, see the General Explanation of the Revenue Provisions of the Tax Equity and Fiscal Responsibility Act of 1982, prepared by the staff of the Joint Committee on Taxation (December 31, 1982).

January 1, 1984. Furthermore, the 40 percent lessee cap, 50 percent lessor cap, and 5-year spread of investment credit described in the preceding paragraph are generally inapplicable to such farm property.

Reasons for Change

The committee believes that delaying the effective dates of most of the finance lease provisions for 4 years will contribute to reducing budget deficits without having an adverse effect on the economy.

Moreover, the committee believes that transactions treated as leases for Federal income tax purposes should have meaningful economic substance independent of the associated tax benefits. The committee also believes that the tax system exists fundamentally to collect tax from taxable entities, and is not meant to be used as a mechanism for freely transferring the benefits of income tax credits and deductions.

Explanation of Provisions

In general, the effective dates of the finance lease provisions are postponed for 4 years. Thus, except for certain farm property, the finance lease rules will apply only to agreements entered into after December 31, 1987. The three transitional rules currently scheduled to apply during 1984 and 1985 will apply during 1988 and 1989. First, no more than 40 percent of certain property placed in service by the lessee during any calendar year beginning before January 1, 1990, will qualify for finance lease treatment. Second, except for property placed in service after September 30, 1989, in taxable years beginning after that date, a lessor will not be able to use the finance lease rules to reduce its tax liability for any taxable year by more than 50 percent. Third, except for property placed in service after September 30, 1989, the investment credit for finance lease property will be allowable ratably over 5 years only rather than entirely in the year the property is placed in service.

The rules applicable with respect to farm property covered by agreements entered into after July 1, 1982, and before January 1, 1984, are extended for 4 years, to agreements entered into before January 1, 1988.

Effective Date

These provisions are effective March 7, 1984. However, the postponements of the finance lease provisions are not applicable to agreements with respect to property which the lessee had entered into a binding contract to acquire or construct before March 7, 1984. Nor are they applicable to agreements covering (1) property if the property was acquired by, or if construction of the property was begun by or for, the lessee before March 7, 1984, (2) certain property which consists, or is an integral part, of a cogeneration facility, or (3) certain automotive manufacturing property having a cost basis of not more than $150 million to the lessee.

Revenue Effect

The provisions will increase fiscal year budget receipts by $63 million in 1984, $348 million in 1985, $862 million in 1986, $1,381 million in 1987, $1,424 million in 1988, and $741 million in 1989.

3. Postponement of Increases in Amount of Property Eligible for Expensing (sec. 14 of the bill and sec. 179 of the Code)

Present Law

A taxpayer (other than a trust or estate) may elect, in lieu of capital cost recovery under the Accelerated Cost Recovery System (ACRS), to deduct the cost of qualifying property in the taxable year it is placed in service. In general, qualifying property must be acquired by purchase for use in a trade or business and must otherwise be eligible for the investment tax credit. No investment credit is allowable for the portion of the cost of property expensed under this rule.

For taxable years beginning in 1983, the dollar limitation on the amount that can be expensed is $5,000 a year. This limitation is scheduled to increase to $7,500 for taxable years beginning in 1984 and 1985, and to $10,000 for taxable years beginning after 1985. In each case, the limitation that applies to a married individual who files a separate return is one-half the dollar limitation described above.

Reasons for Change

The committee believes that postponement of the scheduled increases will contribute to deficit reduction and will not have adverse economic effects, because the benefits to the taxpayer of claiming the investment credit and recovering costs under ACRS are generally the same in present value as actual expensing.

Explanation of Provision

The bill postpones for four years the scheduled increases in the maximum amount of property that can be expensed. Thus, the dollar limitation on the amount that can be expensed will remain at $5,000 for taxable years beginning before 1988, increase to $7,500 for taxable years beginning in 1988 and 1989, and increase to $10,000 for taxable years beginning after 1989.

Effective Date

The provision is effective with respect to taxable years ending after 1983.

Revenue Effect

This provision is estimated to increase fiscal year budget receipts by $230 million in 1984, $399 million in 1985, $433 million in 1986, and $386 million in 1987, and to decrease fiscal year budget receipts by $118 million in 1988 and $427 in 1989.

4. Extension of Telephone Excise Tax (sec. 16 of the bill and sec. 4251 of the Code)

Present Law

A 3-percent excise tax is imposed on amounts paid for local telephone service, toll telephone service, and teletypewriter exchange service (sec. 4251). The tax is paid by the person who pays for service to the person rendering the service, who in turn remits the tax to the general fund of the Treasury.

Exemptions from the tax are provided for communications services furnished to news services (except local telephone service to news services), international organizations, the American National Red Cross, servicemen in combat zones, nonprofit hospitals and educational organizations, and State and local governments. Other exemptions are provided for amounts paid for installation charges and for certain calls from coin-operated telephones (sec. 4253).

This excise tax is scheduled to terminate, effective with respect to amounts paid pursuant to bills first rendered after December 31, 1985.

Reasons for Change

The committee determined that continuation of the telephone excise tax at the present rate is appropriate at this time due to the existing budgetary deficit situation. This excise tax has been in effect since 1941; the tax rate was 10 percent until 1973. In the past, the tax has typically included an expiration date; however, before each scheduled expiration, Congress has found it necessary to extend the tax because of revenue needs.

Explanation of Provision

The bill extends the current 3-percent telephone excise tax rate for two years, calendar years 1986 and 1987.

Effective Date

The 3-percent rate is extended to amounts paid pursuant to telephone bills rendered before January 1, 1988.

Revenue Effect

This provision will increase net fiscal year budget receipts by $1,168 million in 1986, $2,016 million in 1987, and $803 million in 1988.

5. Postponement of Net Interest Exclusion (sec. 17 of the bill and sec. 128 of the Code)

Present Law

Background

In the Economic Recovery Tax Act of 1981 (ERTA), Congress repealed the $200 ($400 on a joint return) interest and dividend exclusion for taxable years beginning after 1981.[1] Congress also established a temporary program of tax-exempt certificates (generally known as All Savers Certificates). All Savers Certificates were issuable by qualified savings institutions from September 30, 1981, through December 31, 1982. A lifetime exclusion from gross income of $1,000 ($2,000 in the case of a joint return) of interest earned on qualified tax-exempt certificates was provided.

ERTA also liberalized the requirements governing eligibility for and deductibility of contributions to individual retirement accounts (IRAs).[2]

Net interest exclusion

For taxable years beginning after 1984 (i.e., one year after the expiration of the All-Savers Certificate program), ERTA provides for an exclusion of 15 percent of net interest received up to $3,000 of net interest ($6,000 on a joint return). Net interest is generally defined as eligible interest received by the taxpayer in excess of the amount of interest payments by the taxpayer for which an income tax deduction is allowed. Eligible interest generally includes interest paid on deposits in banks and thrift institutions, corporate debt in registered form or in a form generally sold to the public, United States Government debt, certain Federally sponsored participation trusts, and certain amounts held by life insurance companies.

Mortgage interest and trade or business interest are not taken into account to reduce eligible interest income. For this purpose, mortgage interest is interest paid on debt incurred to acquire, construct, reconstruct, or rehabilitate property the taxpayer uses primarily as a dwelling. The Technical Corrections Act of 1982 clarifies that an individual who does not itemize deductions will not be required to reduce eligible interest income by interest payments that the individual makes, and that a person itemizing deductions will be required to reduce eligible interest income by no more than the amount of his or her excess itemized deductions.

[1] For subsequent years, the $100 dividend exclusion previously in effect was reinstated, amended to permit an exclusion of up to $200 to be claimed on a joint return without regard to which spouse actually receives the dividend.

[2] *See* ERTA, section 311; H.R. Rep. No. 201, 97th Cong., 1st Ses. 132-37 (1981); S. Rep. No. 144, 97th Cong., 1st Sess. 111-15 (1981).

Reasons for Change

Congress enacted the net interest exclusion for taxable years beginning after 1984 because it believed that a permanent savings incentive based on net savings should replace the temporary All Savers Certificate program. However, in light of the unexpected popularity and high level of use of IRAs as a savings device following the 1981 liberalization of the IRA tax rules, the committee believes that Congress should reconsider the need for the net interest exclusion as a savings incentive.

The committee continues to believe that savings in the country should be encouraged by tax incentives. On the other hand, revenues lost by those tax incentives will have the effect of increasing Federal deficits. In this regard, revenue losses from the ERTA liberalization of the IRA tax rules have been significantly larger than projected. In light of these unexpectedly large revenue losses, the committee believes that present fiscal restraints warrant postponement of additional tax incentives for savings.

Accordingly, the committee believes that the net interest exclusion should be postponed for three years at which time the committee expects that the fiscal position of the Federal Government will permit institution of the net interest exclusion provision. The three year delay also will provide additional time to study the effect of the net interest exclusion on savings.

Explanation of Provision

The bill postpones the effective date of the net interest exclusion enacted in ERTA for three years. Under the bill, the net interest exclusion will be available for taxable years beginning after 1987 rather than for taxable years beginning after 1984.[3]

Effective Date

This provision of the bill will become effective on the date of enactment.

Revenue Effect

This provision will increase fiscal year budget receipts by $1,024 million in 1985, $2,858 million in 1986, $3,100 million in 1987, and $2,065 in 1988.

[3] A provision postponing the net interest exclusion was also contained in S. 2062, reported by the Senate Committee on the Budget on November 4, 1983. The earlier provision postponed the net interest exclusion for two years rather than three years.

6. Postponement of Increase in Foreign Earned Income Exclusion (sec. 18 of the bill and sec. 911 of the Code)

Present Law

Certain U.S. citizens and resident aliens who lived abroad were allowed to exclude from taxable income up to $80,000 of foreign earned income in 1983. Under the Economic Recovery Tax Act of 1981, this amount is scheduled to increase to $85,000 in 1984, to $90,000 in 1985, and to $95,000 in 1986 and thereafter. These individuals also are allowed to exclude or deduct certain foreign housing expenses. The excludable amount does not apply to amounts of foreign income for which the taxpayer elects to claim a foreign tax credit.

Reasons for Change

The committee believes that Americans working abroad help promote the export of U.S. manufactured goods and services. Consequently, the committee wishes to retain an exclusion from taxable income for a substantial amount of foreign earned income. However, the committee believes that delaying increases in the amount of the foreign earned income exclusion will have no important effect on U.S. exports, but will make a contribution in reducing Federal budget deficits. Reducing budget deficits should improve the United States' balance of trade.

Explanation of Provision

The bill holds the maximum foreign earned income exclusion at its 1983 level of $80,000 per year until taxable years beginning in 1988, when this limit increases to $85,000. The limit will increase to $90,000 in taxable years beginning in 1989 and to $95,000 in taxable years beginning in 1990 and thereafter.

Effective Date

The provision is effective on the date of enactment and will reduce the excludable amount to $80,000 for the entire calendar year 1984.

Revenue Effect

This provision is estimated to increase fiscal year budget receipts by $4 million in 1984, $31 million in 1985, $80 million in 1986, $106 million in 1987, $107 million in 1988, and $79 million in 1989.

B. Tax-Exempt Entity Leasing[1]

(Secs. 21 and 22 of the bill and secs. 48 and 168 of the Code)

Present Law

Summary

Under present law, the rules for determining who is entitled to the tax benefits associated with the ownership of property generally are not written in the Internal Revenue Code. Rather, they are embodied in a series of court cases and revenue rulings and revenue procedures issued by the IRS. Essentially, these rules focus on the economic substance of a transaction, not its form, for determining who is entitled to the tax benefits of the ownership of property. Thus, in a purported lease or similar arrangement, the person claiming ownership for Federal income tax purposes must show that he has sufficient economic indicia of ownership.

In general, the tax benefits of ownership of property include depreciation or accelerated cost recovery deductions and investment tax credits. Generally, ACRS or other depreciation deductions and investment credits are allowed only for property used for a business or income-producing purpose. The accelerated cost recovery system generally permits taxpayers to depreciate qualifying property on an accelerated basis over relatively short periods. For most property, the ACRS recovery period is shorter than the actual useful life of the property. Investment credits permit taxpayers to reduce their tax liability by a percentage of their investment in eligible property. Eligible property includes certain depreciable personal property. Special rules apply to certain energy property and to certain improvements to older buildings.

As a general rule, governmental units and tax-exempt organizations are not entitled to ACRS or other depreciation deductions or investment credits for property owned by them. Moreover, no investment credit is allowed for property used (though not owned) by a tax-exempt organization in its exempt function or by a governmental unit (nontaxable use restriction). The nontaxable use restriction does not affect the allowance of ACRS deductions and certain other tax benefits.

Property used by a foreign government or person is not subject to the nontaxable use restriction. However, if the property is used predominantly outside the United States (foreign-use property), then, in general, ACRS deductions are reduced and no investment credit is allowed.

[1] These provision were contained in S. 2062 as reported by the Senate Committee on the Budget on November 4, 1983. Subsequent Finance Committee amendments to the tax-exempt entity leasing provisions are noted in the footnotes as "New."

The traditional reasons for leasing stem from tax, accounting, and a variety of business considerations. Tax-exempt organizations and governmental units have leased equipment for many of the same reasons as taxable entities. The recent increase in leasing and similar arrangements is due, in part, to budgetary limitations on the purchase of property and, in the case of some State and local governments, limitations on their ability to issue tax-exempt bonds. From a tax perspective, leasing allows certain tax benefits to flow through (in the form of reduced rents) to nontaxable entities or thrift institutions that are not eligible for such benefits on their own account. In some cases, the reasons for arranging a transaction as a service contract or in some other form stem from a desire to avoid the nontaxable use restriction on the investment credit and other Federal income tax rules.

What follows is a description of the present-law rules governing the determination of ownership of property for Federal income tax purposes, in the context of purported leases or similar arrangements, and a description of the nontaxable use restriction on the investment credit. The rules governing ACRS and the investment credit for foreign-use property and other rules are also discussed.

The ownership issue

Overview

The determination of the Federal income tax ownership of property requires a case-by-case analysis of all facts and circumstances. Although the determination of ownership is inherently factual, a number of general principles have been developed in court cases, revenue rulings, and revenue procedures.

In general, both the courts and the IRS focus on the substance of the transaction rather than its form. The courts do not disregard the form of a transaction simply because tax considerations are a significant motive, so long as the transaction also has a bona fide business purpose and the person claiming tax ownership has sufficient burdens and benefits of ownership.

In general, for Federal income tax purposes, the owner of property must possess meaningful burdens and benefits of ownership. The lessor must be the person who suffers, or benefits, from fluctuations in the value of the property. Thus, lease treatment is denied, and the lessee is treated as the owner, if the lessee has the option to acquire the property at the end of the lease for a price that is nominal in relation to the value of the property at the time the option is exercisable (as determined at the time the parties entered into the agreement) or which is relatively small when compared with the total lease payments to be made.

Where the lessor's residual value in the property is nominal, the lessor is viewed as having transferred full ownership of the property for the rental payments. Where the purchase option is more than nominal but relatively small in comparison with fair market value, the lessor is viewed as having transferred full ownership because of the likelihood that the lessee will exercise the option. Furthermore, if the lessor has a contractual right to require the lessee to purchase the property at the end of the lease (a put), the transaction could be denied lease treatment because the put eliminates the lessor's risk of loss in value of the residual interest and the risk that there will be no market for the property at the end of the lease.

Objective guidelines used in structuring transactions

To give taxpayers guidance in structuring leveraged leases (i.e., leases in which the property is financed by a nonrecourse loan from a third party) of equipment, the IRS issued Revenue Procedure 75-21, 1975-1 C.B. 715, and a companion document, Revenue Procedure 75-28, 1975-1 C.B. 752 (the guidelines). If the requirements of the guidelines are met and if the facts and circumstances do not indicate a contrary result, the IRS generally will issue an advance letter ruling that the transaction is a lease and that the lessor is the owner for Federal income tax purposes.

The guidelines are not by their terms a definitive statement of legal principles and are not intended for audit purposes. Thus, if all the requirements of the guidelines are not met, a transaction might still be considered a lease if, after considering all the facts and circumstances, the transaction is a lease under the general principles described above.

The specific requirements for obtaining a ruling under the guidelines are as follows:

1. Minimum investment.—The lessor must have and maintain a minimum 20 percent unconditional at-risk investment in the property.

2. Purchase options.—In general, the lessee may not have an option to purchase the property at the end of the lease term unless, under the lease agreement, the option can be exercised only at fair market value (determined at the time of exercise). That rule precludes fixed price purchase options, even at a bona fide estimate of the projected fair market value of the property at the exercise date.

3. Lessee investment precluded.—Neither the lessee nor a party related to the lessee may furnish any part of the cost of the property.

4. No lessee loans or guarantees.—As a corollary to the prior rule, the lessee must not loan to the lessor any of the funds necessary to acquire the property. In addition, the lessee must not guarantee any such loan to the lessor.

5. Profit and cash flow requirements.—The lessor must expect to receive a profit and have a positive cash flow from the transaction independent of tax benefits.

6. Limited use property.—Under Revenue Procedure 76-30, 1976-2 C.B. 647, property that can be used only by the lessee (limited use property) is not eligible for leveraged lease treatment.

Nontaxable use restriction on the investment credit

General rule

Property that is "used by" a tax-exempt organization in an exempt function or by a governmental unit generally is ineligible for the investment credit (secs. 48(a)(4) and 48(a)(5)), including the investment credit for energy property. For this purpose, a governmental unit includes the United States government, any State or local government, most international organizations, and any instrumentality of the foregoing. A tax-exempt organization is almost any organization exempt from Federal income tax, such as a charitable or educational organization.

To determine whether property is subject to the nontaxable use restriction, it is first necessary to evaluate the economic substance of the transaction under the general principles for determining who is the tax owner of property.[2]

Under the nontaxable use restriction, the investment credit is unavailable with respect to property that is treated for Federal income tax purposes as being owned by a governmental unit or a tax-exempt organization for use in its exempt function. In addition, property leased to a governmental unit or a tax-exempt organization for use in its exempt function is generally subject to the nontaxable use restriction. However, in addition to several statutory exceptions to the nontaxable use restriction, one court has held (and the IRS has ruled) that the investment credit can be claimed where the governmental unit essentially has contracted for a service, to be provided by the owner of property, rather than for the use of the property itself.

Statutory exceptions to the nontaxable use restriction

Tax-exempt organizations.—Under present law, certain farmers' cooperatives (which are considered exempt from tax even though they are subject to the rules of subchapter T, relating to cooperatives and their patrons) are excluded from the restriction on use by a tax-exempt organization. Also, the credit is allowed for property used by a tax-exempt organization in a taxable unrelated trade or business.

Foreign governmental units.—Although international organizations generally are subject to the restriction, property used by the International Satellite Consortium, the International Maritime Satellite Organization, and any successor organizations is excluded from the restriction on governmental use. Foreign governments and possessions of the United States are not subject to the restriction. Thus, a computer leased to the United States Government is denied the credit, but a computer leased to a foreign embassy located in the United States is allowed the credit.

Rehabilitated buildings.—Under present law, rehabilitation tax credits are available for qualified rehabilitation expenditures incurred for older buildings leased to tax-exempt organizations or to governmental units.

Foreign persons.—Property used by foreign persons is not subject to the nontaxable use restriction. However, special rules (discussed below) apply if the property is used predominantly outside the United States.

[2] Rev. Rul. 68-590, 1968-2 C.B. 66. Revenue Ruling 68-590 involved arrangements between a taxable corporation and a political subdivision of a State providing for the tax-exempt financing, construction, and operation of an industrial project. The IRS did not apply the nontaxable use restriction even though the governmental unit held legal title under a sale-and-leaseback. Rather, the IRS held that the corporation was the tax owner of the property. The IRS reasoned that, in view of the economic substance of the arrangement, the sale-leaseback arrangement was nothing more than a security device for the protection of the holders of the tax-exempt bonds.

"Casual or short-term lease" exception

Under Treasury regulations, there is an exception to the nontaxable use restriction for property that is leased on a "casual or short-term basis" (Treas. Reg. sec. 1.48-1(j) and (k)).

Casual leases.—The term "casual lease" has been interpreted to mean a lease that lacks the formalities inherent in a written lease.[3] Another example of a casual lease might be the lease of an automobile from a car rental company by a government employee traveling on governmental business.[4]

Short-term leases.—The exception for short-term leases has been recognized as a means of allowing a governmental unit to fulfill an unforeseen or extraordinary need for obtaining the short-term use of property from the private sector, without causing the taxpayer to lose the credit.[5] Thus, property not ordinarily intended for lease to a tax-exempt organization or governmental entity may be leased under the exception for a short period in unforeseen or extraordinary circumstances.

In determining whether the exception for short-term leases applies, the courts have rejected the contention that the relevant consideration is whether the nonqualifying use constitutes a substantial portion of the useful life of the property.[6] The courts have also rejected the position that short-term use should be determined on the basis of the minimum legally enforceable period of a lease.[7]

"Service contract" exception

Internal Revenue Service rulings.—Under Treasury regulations (sec. 1.48-1(j) and (k)), property used by a governmental unit or tax-exempt organization means property owned by or leased to one of those nontaxable entities. In Revenue Ruling 68-109, 1968-1 C.B. 10, the IRS ruled that property provided to a governmental unit as an integral part of a service is not "used by" the government within the meaning of section 48(a)(5).

Revenue Ruling 68-109 involved communications equipment installed by a public utility on the premises of tax-exempt organizations or governmental units. In ruling that the taxpayer's agreements with its customers were not sales or leases, but rather service contracts, the IRS relied on the fact that the taxpayer retained all ownership in and possession of, and control over, the equipment.

The IRS has issued a number of other rulings, including private rulings,[8] interpreting the service contract exception. For example, the investment credit has been denied in situations involving trucks operated under a service contract by government employees (Rev. Rul. 72-40[illegible] 1972-2 C.B. 10) and school buses operated by a private party under contract with a local school district (LTR 8104001 (February 27, 1980)). However, in LTR 8217040 (January

[3] See, *Xerox Corporation v. United States*, 656 F.2d 659 (Ct. Cl. 1981).

[4] *Id.*

[5] *World Airways, Inc. v. Commissioner*, 564 F.2d 886 (9th Cir. 1977), *aff'g* 62 T.C. 786 (1974).

[6] *World Airways Inc. v. Commissioner*, 62 T.C. 786 (1974), *aff'd*, 564 F.2d 886 (9th Cir. 1977).

[7] Thus, the mere fact that a lease contains a cancellation clause will not result in application of this exception. *Xerox Corporation v. United States*, 656 F.2d 659 (Ct. Cl. 1981); *Stewart v. U.S.*, 77-2 U.S.T.C. 9648 (D.Neb. 1977).

[8] A private ruling is not binding as precedent on the IRS with respect to taxpayers other than the taxpayer who received the ruling, or the courts.

27, 1982), the IRS allowed the investment credit in a situation involving a time charter of a vessel to the Federal government. The IRS ruled that the taxpayer could claim an investment credit for the vessel based on the taxpayer's representations that the taxpayer bore the risk of loss with respect to the vessel, the taxpayer had to retain possession and control over the vessel, the taxpayer was required to provide maintenance and secure insurance for the vessel, the taxpayer had to furnish and control the crew of the vessel, and the time charter transferred no legal interest in the property to the Federal government.

The case law.—The only judicial decision dealing with the service contract exception to the nontaxable use restriction is *Xerox Corporation* v. *United States*, 656 F.2d 659 (Ct. Cl. 1981). In *Xerox*, a manufacturer provided duplicating machines to the Federal government. The IRS had issued a revenue ruling involving the same basic facts as in *Xerox* that held that the agreements were leases (Rev. Rul. 71-397, 1971-2 C.B. 63). The Court of Claims rejected the taxpayer's contention that its agreements were short-term leases, which are eligible for an exception to the governmental use restriction. However, the court held that the machines were eligible for the investment credit because they were provided as an integral part of a service contract.

Essentially, the Court of Claims based its decision on the IRS's own formulation of the service contract exception, as set forth in the holdings of published and private rulings (other than Rev. Rul. 71-397). The court rejected the government's contention that the service contract exception cannot ever apply where the customer's own personnel operate the machines, because this factor was present in the first ruling applying the exception (i.e., Rev. Rul. 68-109). The court emphasized that *Xerox* was not a case in which the cost or value of the property dominated the price of the total arrangement. The court also noted that, conceivably, its decision would have been different if Treasury regulations had formulated the precise confines of the service contract exception.

Although the published and private rulings do not articulate any single test for use in determining whether an agreement is a service arrangement or a lease, the court felt that the factors deemed common to service contracts in those rulings related to two broad areas of inquiry: (1) the nature of the possessory interest retained by the taxpayer and (2) the degree to which the property supplied is a component of an integrated operation in which the taxpayer has other responsibilities.

In holding that the interest conveyed to the customer was not sufficient to constitute a leasehold interest, the *Xerox* court focused on the following factors drawn from the IRS rulings in which a service contract was held to exist: (1) the taxpayer retained ownership of the machines; (2) the taxpayer decided whether to repair, replace, or alter the machines, and the customer was prohibited from altering or moving the machines; (3) the taxpayer bore the cost of adjustments, repairs, and replacements; (4) the taxpayer was responsible for loss or damage, except in the case of the customer's negligence; and (5) the customer could cancel upon 15 days notice.

Finally, in holding that the taxpayer's contractual arrangements could reasonably be deemed to be within the purpose of the investment credit, the court focused on the fact that the taxpayer manufactured machines for all customers, not just the government, and that governmental use represented only 5 or 6 percent of the taxpayer's machines.

Foreign-use limitations

Overview

Property used predominantly outside the United States is subject to reduced ACRS deductions and is not allowed the investment credit (secs. 168(f)(2) and 48(a)(2)).

In general, property "used predominantly outside the United States" means property used outside the United States for more than half of the taxable year. However, there are a number of exceptions to this general rule. For example, communications satellites are excepted from the rules for foreign-use property. U.S.-flag vessels operated in the foreign or domestic commerce of the United States are excepted, as are aircraft registered by the Federal Aviation Agency and operated to and from the United States[9] or operated under contract with the United States, even if operated by a foreign airline. Special rules are also provided for certain rolling stock, drilling rigs, motor vehicles, containers, submarine cable, and other property.

ACRS deductions

The recovery period for computing ACRS deductions for recovery property used predominantly outside the United States is equal to the present class life (mid-point life) for the property, as of January 1, 1981, under the prior law ADR system. For personal property for which there is no ADR mid-point life as of January 1, 1981, a 12-year recovery period must be used. The determination of useful lives based on facts and circumstances is not permitted. The owner of foreign-use personal property generally is allowed to use the 200-percent declining balance method of depreciation for the early years of the recovery period and the straight-line method for later years.

For foreign real property (including all components of a building), the recovery period is 35 years. The owner of foreign real property is generally allowed to use the 150-percent declining balance method for the early years of the recovery period, switching to the straight-line method in later years.

In the case of foreign-use personal property or foreign real property, the straight-line method of depreciation can be used in lieu of the prescribed accelerated methods. In addition, for foreign-use personal property, the taxpayer may elect the straight-line method over one of the longer recovery periods allowed for domestic property (but the period elected may not be shorter than the ADR mid-point life, or, for property without an ADR mid-point life as of January 1, 1981, 12 years). For foreign real property, the taxpayer may

[9] The IRS has ruled that a plane returning to the United States only once every two weeks qualifies as being operated to and from the United States. Rev. Rul. 73-367, 1973-2 C.B. Furthermore, an airplane can be leased for temporary use outside the United States without any investment credit recapture. Under section 47(a)(7)(A), 3 1/2 years qualifies as temporary use for this purpose.

elect to use the straight-line method over a recovery period of 45 years (instead of 35 years).

Other limitations

Thrift institutions

Present law limits the investment credit with respect to property owned by organizations to which section 593(a) applies (thrift institutions) to 50 percent of the investment credit otherwise available (sec. 46(e)(2)(A)). However, property leased to such organizations may qualify for a credit determined without regard to any 50 percent cutback.

Public utility property

Special depreciation and investment credit rules apply to "public utility property" (e.g., sec. 168(c)(2)(E) and sec. 46(f)(5)). Public utility property generally includes property used predominantly in the trade or business of the furnishing or sale of utility services subject to rate regulation. While property leased to a public utility constitutes public utility property, property used to provide services to the public utility under a service contract or similar arrangement may not.

Reasons for Change

Overview

The committee believes that reform of the tax law is essential, insofar as it relates to property used by tax-exempt entities under a lease, a lease formulated as a service contract, or other similar arrangements. When tax-exempt entities use property under these arrangements, they pay reduced rents that reflect a pass-through of investment tax incentives from the owner of the property. Tax-exempt entities thereby benefit from investment incentives for which they do not qualify directly, and effectively gain the advantage of taking income tax deductions and credits while having no corresponding liability to pay any tax on income from the property. In this way, investment incentives that were intended to reduce the tax on taxable entities have been turned into unintended benefits for tax-exempt entities. The benefits are equivalent to an open-ended spending program, operated within the tax system, that increases the Federal deficit, encourages tax-exempt entities to dispose of the assets they own and forego control over the assets they use, disorders public budgeting processes, and feeds a popular perception that the tax system is open to manipulation.

The committee is greatly concerned about these problems, the scale of which has been magnified by the recent surge in leasing to tax-exempt entities and other arrangements devised to transfer tax benefits to them. In response, the committee bill restricts tax benefits for property used by tax-exempt entities so that the Federal tax outflow will be eliminated and tax-exempt entities will be able to lease property on the same tax-free basis as they can purchase it.

Background

In 1962, Congress first enacted the investment tax credit for certain property used in a trade or business or for the production of income. The purpose of the credit is to reduce the income tax liability of taxpayers and thereby encourage their purchase and use of capital goods. When enacting the investment credit, Congress expressly disallowed it for property used by governmental units and tax-exempt organizations, which of course have no income tax liability to reduce. However, the provision was necessary to prevent those tax-exempt entities from indirectly gaining—through leasing, for example—the benefits of both tax-exemption and the income tax credit. This policy has been continued to the present. It is grounded in the fundamental principle that the tax system exists to collect tax from taxable entities, not to make payments to tax-exempt entities.

The committee believes that the policy of providing tax-reducing incentives to those who are subject to the income tax and denying them to those who are not subject to the income tax should be maintained and that three major amendments are needed to improve its application. The amendments relate to (a) accelerated depreciation deductions, (b) transactions structured to avoid the present denial of the investment credit, and (c) the treatment of foreign tax-exempt entities.

Accelerated depreciation deductions

Over the last two decades, Congress has acted to accelerate cost recovery (depreciation) deductions for property used in a trade or business or for the production of income. The introduction of the Asset Depreciation Range System in 1971 and the enactment of the Accelerated Cost Recovery System in 1981 were two significant steps in this direction. The purpose of accelerating cost recovery deductions is to reduce the income tax liability of taxpayers in order to encourage their purchase and use of capital goods. Taking into account the time value of money, accelerated deductions reduce the present value of tax to be paid by deferring payment to later years.

The cumulative effect of legislation relating to cost recovery allowances is that these deductions currently operate, like the investment credit, as a significant investment incentive, by reducing the value of the tax that would otherwise be imposed on the investment. However, present law does not generally deny the benefits of accelerated cost recovery for property leased to tax-exempt entities. As a result, the transfer of benefits to these entities through the tax system that Congress acted to prevent with respect to the investment credit is now occurring due to accelerated depreciation deductions. Therefore, the committee bill provides for less rapid write-offs of property used by tax-exempt entities such that the Federal tax outflow will be eliminated and tax-exempt entities will be able to lease property on the same tax-free basis as they can purchase it.

Transactions structured to avoid investment credit restrictions

The committee understands that the value of the investment credit is sufficiently great to have prompted attempts to structure transactions in a form other than a lease such that property used by a tax-exempt entity or dedicated primarily to its use will nevertheless qualify for the credit. The committee is concerned that Congress has not provided statutory guidance for determining when property is in substance used by a tax-exempt entity or other persons. Therefore, the committee bill provides criteria for this purpose so that the economically insubstantial restructuring of a lease as a service contract or similar arrangement will not result in unintended, preferential tax treatment. For the same purpose of averting unintended results, the committee bill provides rules to prevent the use of leasing to convey the benefit of the full investment credit to thrift institutions, which are eligible for only a partial credit when they purchase property, and to public utilities.

In addition, the committee is concerned about the excessive tax benefits that are currently available for amounts spent to rehabilitate buildings used by tax-exempt entities. Rehabilitation tax credits are not available when tax-exempt entities themselves make rehabilitation expenditures because the{e entities are not subject to income tax. However, the benefit of these credits can be passed through to tax-exempt entities when they use rehabilitated property under a lease or a similar arrangement. The committee believes it is necessary, therefore, to extend the current policy of denying investment credits for personal property used by tax-exempt entities to deny rehabilitation credits for certain real property used by tax-exempt entities.

Foreign tax-exempt entities

The present-law denial of investment credit for property used by tax-exempt entities is incomplete because it does not apply to substantial amounts of certain types of property leased to foreign governments and other foreign persons who are not subject to Federal income tax. Although the committee believes that tax benefits for property used by foreign tax-exempt entities should be scaled back from present levels, it also believes that not all of the tax incentive for those entities to lease should be eliminated. The committee is well aware that American producers compete in international markets against foreign producers who benefit from measures their governments have taken to stimulate exports. The committee believes that the lower rents made possible by lessors' tax benefits are effective in encouraging the foreign use of American-made products. Therefore, the committee bill reflects the policy that a portion of the current tax incentive for foreign entities to lease should be retained.

Additional reasons

The committee has additional reasons for believing that the tax benefits (in excess of tax exemption itself) currently available to tax-exempt entities through leasing should generally be eliminated.

First, the Federal budget is in no condition to sustain the substantial revenue loss, which will certainly increase as more and more tax-exempt entities, financial entities, and tax-oriented investors learn how to take advantage of the tax system in this way. Nothing is accomplished to reduce budget deficits when spending cuts are matched or exceeded by revenue losses. These losses are especially large in transactions involving debt-financed property.[10] The investment credit, ACRS deductions, and interest deductions for debt-financed property can be combined to produce tax write-offs the present value of which exceeds the income derived from the property. In that event, the investor's after-tax return consists in part of a negative tax, and a Federal revenue loss results by the amount that the negative tax exceeds the income tax paid on the interest income received by the lender.

Second, the committee is concerned about possible problems of accountability of governments to their citizens, and of tax-exempt organizations to their clienteles, if substantial amounts of their property should come under the control of outside parties solely because the Federal tax system makes leasing more favorable than owning. The committee is convinced that the tax system should not encourage tax-exempt entities to dispose of the assets they own or to forego control over the assets they use.

Third, the committee believes that Federal aid to tax-exempt entities (above and beyond tax exemption) should be made by appropriations rather than by tax benefit transfers paid through the tax system. The tax benefits in leasing are open-ended and hence uncontrollable in amount and composition, whereas appropriations are limited and adjustable to current priorities from year to year. Moreover, tax benefits appear in the Federal budget only as reduced tax collections, unassociated with any particular public purpose. Thus, with Federal aid conveyed through the tax system, it is very difficult to discover what tax-exempt purposes have been federally assisted, by how much they have been assisted, and whether the assistance has been rendered in ways consistent with other objectives of public policy. These matters can be known, debated, and decided in the appropriations process.

Fourth, the committee is concerned about waste of Federal revenues. Although under present law tax benefits exist to be shared by the tax-exempt user of property and the taxable owner, there is no assurance that the tax-exempt entity will be the prime beneficiary. For example, when a substantial portion of the benefit is retained by lawyers, investment bankers, and investors, the Federal revenue loss becomes more of a gain to financial entities than to tax-exempt entities. In proportion to that inefficiency, the Treasury loses more than $1 to provide $1 of aid to tax-exempt entities through leasing, whereas the aid could be provided on a dollar-for-dollar basis through appropriations. This problem exists within the Federal government also. To the extent that a Federal agency as lessee pays rents that do not reflect a full pass-through of the lessor's income tax benefits, the Federal government pays more to lease an asset than it would to buy it.

Fifth, the committee stresses the need to sustain popular confidence that the tax system is generally working correctly. A system which entices Federal agencies not to own their essential equipment, nor colleges their campuses, nor cities their city halls, and

[10] With respect to tax benefits for debt-financed property, see Joint Committee on Taxation staff pamphlet "Description of S. 1564 Relating to Tax Treatment of Property Leased to Tax-Exempt Entities" (JCS-34-83).

which also rewards taxpayers who participate in such transactions with a lighter tax, risks eroding that confidence.

Explanation of Provisions

1. Overview

In general, the committee bill reduces the tax benefits that would otherwise be available for property used by tax-exempt entities. The bill defines the term "tax-exempt entities" to include Federal, State, local, and foreign governments, possessions of the United States, international organizations, certain instrumentalities of the foregoing, and certain foreign persons, as well as most organizations that are exempt from Federal income tax or were exempt at any time within a prescribed 5-year period.

For all Federal income tax purposes, the bill also provides criteria for use in determining whether an arrangement characterized by the parties as a service contract or carrying some other label should be treated as a lease. However, the bill creates no inferences regarding the present-law treatment of purported service contracts under the nontaxable use restriction on the investment credit.

To the extent a rehabilitated building is tax-exempt use property, rehabilitation credits are denied.

Special rules are provided for certain short-lived property, property subject to short-term leases, and certain other property.

Present-law rules for determining the owner of property for income tax purposes are unchanged. Thus, the bill leaves open the possibility that a tax-exempt entity could be treated as the owner of property under a purported lease, service contract, or other arrangement. The bill creates no inferences regarding who under present law should be treated as the tax owner of property involved in such a transaction.

2. Definition of Tax-Exempt Entity

Under the bill, a tax-exempt entity, for purposes of both the depreciation and investment credit provisions, includes the United States, any State (including the District of Columbia) or local governmental unit, any possession of the United States (including Puerto Rico), and any agency or instrumentality of any of the foregoing. However, any agency or instrumentality of the United States or any State or local governmental unit all the income of which, if any, is fully subject to United States income tax is not treated as a tax-exempt entity.

The term also includes any organization, other than a farmers' cooperative described in section 521, that is exempt from United States income tax and, except as indicated below, any organization (and any predecessor organization engaged in substantially similar activities) that was exempt from United States income tax (other than by virtue of section 521) at any time during the 5-year period ending on the date the property involved is first used by such organization. However, the bill does not treat property owned by any such former tax-exempt organization as tax-exempt use property.

For example, assume that a tax-exempt hospital has historically leased or owned property which is not short-lived property for use in carrying out its tax-exempt function. On January 15, 1984, the hospital creates a wholly-owned taxable subsidiary to lease property which is not short-lived property and provide services to the hospital. Any such property leased by the subsidiary any time prior to January 15, 1989, will be tax-exempt use property.

An organization which was tax-exempt under section 501(c)(12) (relating to certain cooperatives) at any time during the 5-year period ending on the date the property involved is first used by such cooperative (and any successor organization which is engaged in substantially similar activities) will not be treated as a tax-exempt entity if it makes an election to remain taxable for the period beginning with the taxable year the property is placed in service and ending with the 15th taxable year after the expiration of the recovery period of the property. Once made, any such election, which is to be made in the time and manner prescribed by regulations, will be irrevocable.

In addition, the term "tax-exempt entity" includes any foreign government, any international organization, any agency or instrumentality of either of the foregoing, and any other person who is not a United States person, but only with respect to property 20 percent or less of the gross income, (if any) derived by the foreign lessee from the use of which is subject to United States income tax in the hands of the foreign lessee. Income taxed to a United States shareholder under section 951 for its taxable year in which or with which the taxable year of the foreign lessee ends will be treated as being subject to United States income tax.

In determining whether the 20-percent threshold is satisfied, the portion of the gross income derived by the foreign lessee from the use of the property that is subject to U.S. income tax is to be determined after taking into account all exclusions and exemptions, whether derived from a statute, a treaty, or otherwise, but total gross income from the use of the property is to be determined without regard to any such exclusions or exemptions.

3. Tax-Exempt Use Property

Personal property

For purposes of the depreciation and investment credit provisions of the bill, property which is not 15-year real property or 20-year real property (as provided by sec. 171 of the bill) will be tax-exempt use property if it is owned by, leased to, or otherwise used by a tax-exempt entity. A special rule applies with respect to certain property held by certain international organizations.[11]

Real property

In general

For purposes of the depreciation and investment credit provisions of the bill, 15-year or 20-year real property will be treated as tax-exempt use property if it is owned by a tax-exempt entity, or to the extent it is used by a tax-exempt entity or entities if at least one of the following circumstances exists:

[11] New.

(1) All or a part of the property was financed with the proceeds of obligations the interest on which is exempt from tax under section 103 and the tax-exempt entity (or a related party) participated in such financing;

(2) The use is pursuant to a lease containing or accompanying (i) a fixed or determinable price purchase option exercisable by the tax-exempt entity (or a related party), (ii) a fixed or determinable price sale option pursuant to which the lessor can require the tax-exempt entity (or a related party) to purchase the property, or (iii) the equivalent of either such an option;

(3) The use occurs after a sale, lease, or other disposition or transfer of the property from the tax-exempt entity (or a related party); or

(4) The use is pursuant to a lease with a term exceeding 20 years.

However, in no event will any portion of any 15-year or 20-year real property be treated as tax-exempt use property unless more than 50 percent (35 percent in the case of use by one tax-exempt entity and related tax-exempt entities) of the property is used by tax-exempt entities in a use of a type or types described above. For purposes of this rule, each building will be treated as a separate property unless two or more buildings are part of one project. In the latter case, the entire project will be treated as one property. Furthermore, uses of the types described above by unrelated tax-exempt entities will be aggregated in determining whether property is tax-exempt use property under the 50-percent threshold, and uses by unrelated tax-exempt entities will be aggregated in determining the extent to which property is tax-exempt use property once the 35-percent or 50-percent threshold has been met. Use by one tax-exempt entity related to another tax-exempt entity will be treated as use by the latter as well as the former. Finally, the extent to which property is tax-exempt use property will be measured by those factors producing the greatest amount of tax-exempt use. For example, assume that a tax-exempt entity sells a building, leasing 50 percent of it back for 25 years and leasing the other 50 percent back for 10 years. Because the entire building was sold and leased back, the entire building is tax-exempt use property even though only one-half of it was leased to the tax-exempt entity for a term exceeding 20 years. On the other hand, assume that a tax-exempt entity, which leases 50 percent of a building for 5 years, has an option to purchase the entire building at a fixed price. Absent other factors, only 50 percent of the building is tax-exempt use property since the tax-exempt entity is using only 50 percent of the property.

The committee intends that a tax-exempt entity or entities will be treated as using the percent of a building equal to the percent of the net rentable floor space in the building it or they are leasing. Net rentable floor space is not to include common areas.

To illustrate the application of the rules for determining whether and to what extent 15-year or 20-year real property is tax-exempt use property, assume in the examples that follow that a tax-exempt entity participates in industrial development bond financing for the acquisition of a new building by a taxpayer. The tax-exempt entity leases 80 percent of the building for 5 years. Eighty percent of the building is tax-exempt use property under the bill. If the tax-exempt entity leased only 32 percent of the building for 25 years, no portion of the building would be tax-exempt use property. If the tax-exempt entity leased only 32 percent of the building for 5 years and an unrelated tax-exempt entity leased 10 percent of the building for 20 years, none of the building would be tax-exempt use property. If the tax-exempt entity leased 36 percent of the building for 5 years and an unrelated tax-exempt entity leased 20 percent of the building for 25 years, 56 percent of the building would be tax-exempt use property.

If no tax-exempt financing had been used and if each of two unrelated tax-exempt entities leased 20 percent of a building for 25 years, none of the building would be tax-exempt use property. However, if each lease was for 30 percent of the building, 60 percent of the building would be tax-exempt use property.

A special rule applies with respect to certain property held by certain international organizations.[12]

Participation in tax-exempt financing

Whether a tax-exempt entity (or a related party) will be treated as having participated in financing the acquisition of all or a part of the property through tax-exempt obligations depends on all the circumstances. However, a tax-exempt entity will be treated as having participated if it (or a related tax-exempt entity) issues the obligations and it is reasonable to expect at the time of issuance that the tax-exempt entity will be a user of all or a portion of the property. A tax-exempt entity will also be treated as having participated in the financing if, prior to the financing, it commits to lease space in the building subject to the successful completion of the financing and acquisition. For example, an organization described in section 501(c)(3) will be treated as having participated in a bond financing if, prior to the issuance of the bonds, it commits to enter into a lease of all or part of the property after it has been acquired by the taxpayer. If a tax-exempt entity finances the acquisition or construction of a building with tax-exempt obligations, sells the new building to the taxpayer before using it, and then leases all or a part of it, the tax-exempt entity will be treated as having participated in the financing.

Purchase or sale options

A fixed or determinable price purchase or sale option exists if the tax-exempt entity (or a related party), directly or indirectly, has a legally enforceable option to buy the property involved from the lessor, or the lessor has a legally enforceable right to "put" the property to the tax-exempt entity (or a related party), at some date at either a pre-established price or at a price that is determinable pursuant to a formula. An option or put at fair market value at the time of exercise will not be treated as a fixed or determinable price option or put. Nor will an option or put be so treated if the selling price is determinable pursuant to a formula which the parties, when agreeing to it, reasonably expected would produce a

[12] New.

number approximately equal to fair market value at the time of exercise. An option to purchase in 15 years for an amount equal to 50 percent of original cost will be an option at a fixed or determinable price. However, an option to purchase at a price derived by a formula which incorporates rents then paid by taxable entities for the use of the same or similar property and then prevailing interest rates will not be an option at a fixed or determinable price, so long as the parties, when they agreed to the formula, reasonably expected it to produce a number approximately equal to fair market value at the time of exercise.

Furthermore, any provision which has the effect of passing on to the lessee or a related party the risk that the property's residual value will decrease will be treated as the equivalent of a fixed or determinable price put. For example, assume that a tax-exempt entity leases land to a taxable entity for 20 years. The taxable entity constructs a building, which has an economic useful life of 50 years, on the land and leases it to the tax-exempt entity for the balance of the term of the ground lease. Because the tax-exempt entity has dominion over the building for its entire economic useful life, the tax-exempt entity may be treated as its tax owner under present law. However, if the tax-exempt entity is not treated as the owner, the property would be tax-exempt use property in any event because the tax-exempt entity has the equivalent of a fixed price purchase or sale option. Similarly, assume that a lease provides that if the lessee cancels or fails to renew the lease or if the property involved is destroyed, the lessee will pay or cause to be paid to the lessor the difference between the amount necessary to preserve the lessor's net economic return and the fair market value of the property. The lease is treated as containing the equivalent of a determinable price sale option.

Neither an option nor a put needs to be contained in the lease. Either may be (or be included in) a separate agreement. An option to buy or put stock in a corporation (or equity interests in any other entity) which owns the property may be treated as an option to buy or put the property.

Uses after transfers

The use by a tax-exempt entity after a disposition or other transfer of the property by the entity (or a related party) includes all forms of transactions in which, pursuant to a plan, a tax-exempt entity (or a related party), directly or indirectly, sells, leases, disposes of, or otherwise transfers property theretofore owned by it and the tax-exempt entity subsequently uses it. For example, if a tax-exempt entity contributes a building to a partnership and leases back a portion of the building, the transaction will be treated as a sale-leaseback for purposes of the bill. As a further example, if property is owned by a corporation that is owned by a tax-exempt entity, a sale or other disposition of the stock of that corporation will be treated as a sale or other disposition of the property. Finally, property owned by a tax-exempt entity (or a related party) which is subsequently leased to the tax-exempt entity pursuant to one overall arrangement will be tax-exempt use property regardless of from whom the lessor obtained the property. For example, assume that a tax-exempt entity sells a building to a taxable entity. The taxable entity sells or contributes the building to a partnership which, pursuant to one overall plan, leases it to the tax-exempt entity. The building is tax-exempt use property.

If a tax-exempt entity (or a related party) disposes of its ownership interest in a property and then leases it back within three months after it was placed in service by the tax-exempt entity (or a related party), the tax-exempt entity will not be treated as using the property in a sale-leaseback.

Improvements

The bill provides that improvements to property (other than land) will not be treated as separate property, but only for purposes of determining whether there is tax-exempt use of property not owned by a tax-exempt entity under the tax-exempt financing rule or the use after transfer rule. For example, if a governmental unit issues tax-exempt obligations, the proceeds of such issue are used by a taxpayer to acquire a building shell from a third party, and the taxpayer improves the building shell using other funds and leases the improved building to the governmental unit, the governmental unit will be treated as having participated in the tax-exempt financing of the entire property. Similarly, if a tax-exempt entity sells a building shell to a taxpayer and the taxpayer rehabilitates the building shell and leases the rehabilitated building back to the tax-exempt entity, the tax-exempt entity will be treated as using one property after a sale-leaseback.

On the other hand, if unimproved land is disposed of by a tax-exempt entity, a building is constructed on the land by the new owner, and the improved land is leased to the tax-exempt entity, the building will not be treated as having been the subject of a sale-leaseback.

Tax-exempt use property does not include improvements constructed by a taxable entity on underlying land or other property leased from a tax-exempt entity merely because the tax-exempt entity is the owner of the land or other property. For example, assume that a tax-exempt university leases land to a taxable entity for 45 years. The taxable entity constructs a building, which has an economic useful life of 40 years, on the land and leases it to a third-party taxpayer (or the university) for not more than 20 years. The building is not tax-exempt use property. Similarly, assume that a municipality leases a certified historic structure to a taxable entity for 20 years. The taxable entity rehabilitates the structure in one year, using industrial revenue bonds, in a rehabilitation qualifying under section 48(g), converting it into a shopping mall. The rehabilitated mall is leased, piece-by-piece, to a variety of taxable merchants. No leasehold improvement is tax-exempt use property. However, the municipality is the tax owner of the building shell.

Other rules

A determination that there is a tax-exempt use of property does not require that the ultimate user of the property be a tax-exempt entity. A disqualified use at any point in a chain of use subjects the property to the bill. A similar rule applies with respect to the nontaxable use restriction of present law. For example, assume that a corporation constructs a new convention center and leases it to a city under an arrangement in which the city has a fixed price option to buy after 20 years. The city subleases or licenses the property to a variety of taxable entities that use it. The entire structure is tax-exempt use property.

Similarly, if a U.S. corporation leases equipment (e.g., a drilling rig) to a foreign corporation not subject to U.S. tax and the foreign corporation subleases the equipment to a branch of a U.S. corporation, the property is tax-exempt use property even though all income earned by the U.S. branch with respect to the use of the property is subject to U.S. tax. (This result would not occur if, in view of the economic substance of the arrangement, the lease to and sublease by the foreign corporation are disregarded for U.S. tax purposes.) This result occurs without regard to the business reasons for the initial lease between the U.S. corporation and the foreign corporation.

Nor can a tax-exempt entity avoid the provisions of the bill merely by being a sublessee. Thus, if corporation A leases 15-year real property to corporation B under a lease with a fixed price option and corporation B subleases the property to a tax-exempt entity, assigning its fixed price option to the tax-exempt entity, the property will be tax-exempt use property.

Whether the tax-exempt entity is the tax owner of the property will be determined under present law. For example, a tax-exempt entity may hold legal title to property, used by a taxable entity, as a security device in connection with an industrial revenue bond. If the tax-exempt entity is not the tax owner of the property, the mere fact that it has legal title will not cause the property to be treated as tax-exempt use property. *See* Rev. Rul. 68-590, 1968-2 C.B. 66.

Tax-exempt use property does not include any property or portion thereof predominantly used by a tax-exempt entity in an unrelated trade or business the income of which is subject to tax under section 511.

4. Depreciation

General recovery period and method

In the case of tax-exempt use property, cost recovery deductions and any other deductions for depreciation or amortization are to be computed in determining taxable income by using the straight-line method and disregarding salvage value. The recovery period for tax-exempt use property in the 15-year or 20-year real property class is 40 years or 125 percent of the term of the lease, whichever is greater. The recovery period for all other tax-exempt use property is the mid-point life of the property as of January 1, 1981, under the ADR system, or 125 percent of the term of the lease, whichever is greater. Personal property that has no ADR life will be treated as having a mid-point life of 12 years.

However, the depreciation provisions of the bill do not apply to tax-exempt use property used by a foreign person or entity if such property is placed in service before January 1, 1984, and is used by such foreign person or entity pursuant to a lease entered into before January 1, 1984. Nor do the depreciation provisions of the bill apply to any such property which is subleased to another foreign person or entity after 1983. In the case of tax-exempt use property placed in service during 1984 and used by a foreign person or entity during 1984, depreciation will be allowed (1) on the 175 declining balance method, switching to the straight-line method, over the recovery period provided by the bill or (2) under present law, whichever is the lesser. All other tax-exempt use property used by a foreign person or entity will be allowed depreciation on the 150-percent declining balance method, switching to the straight-line method, over the recovery period provided by the bill, determined without regard to the lease term.

The committee does not intend the special depreciation rules which apply to property used by a foreign person or entity to apply to property that would in any case be tax-exempt entity use property by reason of use by a tax-exempt entity which is not a foreign person or entity.

Property treated as leased under the bill's provisions for distinguishing service contracts and other arrangements from leases (see below) will be treated as leased for purposes of all Federal income tax provisions, including the depreciation provisions.

Short-lived property

The depreciation provisions of the bill do not apply to short-lived property used by a tax-exempt entity pursuant to a lease with a term equal to 75 percent or less of the property's ADR mid-point life (5 years in the case of property with an ADR mid-point life of 6 years).

As with other property, whether short-lived property purportedly leased to a tax-exempt entity is to be treated as owned for tax purposes by the tax-exempt entity will be determined under present law. For example, if short-lived property with an economic useful life of 3 years is purportedly leased for 3 years, the nominal lessee may be treated as the tax owner of the equipment.

For purposes of the bill, short-lived property consists only of property with an ADR mid-point life of 6 years or less. However, high technology medical equipment will be deemed to have an ADR mid-point life of 6 years. High technology medical equipment includes only electronic, electromechanical, or computer-based high technology equipment used in the screening, monitoring, observation, diagnosis, or treatment of human patients in a laboratory, medical, or hospital environment. High technology medical equipment can include C.A.T. scanners, nuclear magnetic resonance equipment, clinical chemistry analyzers, drug monitors, diagnostic ultrasound scanners, nuclear cameras, radiographic and fluoroscopic systems, Holter monitors, and bedside monitors. Incidental use of any such equipment for other purposes, e.g., research, will not prevent it from qualifying as high technology medical equipment. High technology medical equipment consists only of equipment which, because of a high technology content, can reasonably be expected to become obsolete before the expiration of its physical useful life.

High technology medical equipment will not include any property determined under final regulations to have an ADR mid-point life of more than 6 years. However, no such regulations are to apply to property placed in service prior to the date such final regulations are published in the Federal Register.

Operating rules

If a taxpayer elects under ACRS to recover the cost of property over an optional recovery period that exceeds the recovery period prescribed by the bill, then the cost of the property is to be recovered over the longer period. Property which would be 15-year or 20-year real property if it were recovery property is treated as 15-year or 20-year real property for purposes of the bill. For 15-year or 20-year real property, first-year deductions are to be determined on the basis of the number of months in the year in which the property is in service. For other property, the half-year convention used under present law applies. For example, if the recovery period under the bill is 10 years, the cost recovery percentage will be 5 percent for the taxable year the property is placed in service by the taxpayer, 10 percent for each of the next 9 taxable years, and 5 percent for the eleventh taxable year.

Section 168(f)(12) (relating to depreciation of certain property financed with industrial development bonds) is not to apply to property subject to one of the depreciation provisions of the bill.

The committee intends that regulations be promulgated under section 168(f)(13) (relating to changes in use of depreciable property) of present law to apply to property the tax ownership of which has not changed which either becomes or ceases to be tax-exempt use property some time after having been placed in service by the taxpayer.

5. Investment Tax Credit

As under present law, the investment credit (including the investment credit for energy property but not, except as noted below, the rehabilitation tax credit) [13] generally will be denied for property (including short-lived property) leased to or otherwise used by tax-exempt entities. However, the investment credit provisions of the bill do not apply to tax-exempt use property used by a foreign person or entity (and not by a tax-exempt entity which is not a foreign person or entity), if such property is placed in service before January 1, 1984, and is used by such foreign person or entity pursuant to a lease entered into before January 1, 1984. Nor do the investment credit provisions of the bili apply to any such property which is subleased to another foreign person or entity after 1984. In the case of tax-exempt use property placed in service during 1984 and used by a foreign person or entity during 1984 (and not by a tax-exempt entity which is not a foreign person or entity), the investment credit allowed will be one-half of the investment credit available under present law (unless such property would in any case be tax-exempt use property by reason of use by a tax-exempt entity other than a foreign person or entity).

A special rule applies with respect to certain property held by certain international organizations.[14]

[13] New.

[14] New.

The bill expands the category of tax-exempt entities subject to the nontaxable use restriction and provides statutory guidelines for distinguishing a service contract or other arrangement from a lease (see below). Property which becomes tax-exempt use property some time after having been placed in service will cease to be section 38 property at the time it becomes tax-exempt use property with the result that all or part of the investment credit may be recaptured. The present-law exception to the nontaxable use restriction for short-term or casual leases is replaced by an objective short-term lease exception.

Expenditures attributable to the rehabilitation of any portion of a building that is (or is reasonably expected to be) tax-exempt use property will not qualify for the rehabilitation credit. However, the excluded expenditures will be taken into account under section 48(g)(1)(C) in determining whether there has been a substantial rehabilitation of the building. If all or a portion of a substantially rehabilitated building becomes tax-exempt use property for the first time within 5 years, rehabilitation credits will be recaptured at that time as if that portion of the building which becomes tax-exempt use property had then been disposed of.

For example, assume that a taxpayer acquires a building for $25,000 and spends $30,000 rehabilitating it. Two-thirds of the rehabilitated building is then leased to a tax-exempt entity under circumstances which make the two-thirds tax-exempt use property. No rehabilitation credit will be allowed on the $20,000 in rehabilitation expenditures attributable to that part of the building which is tax-exempt use property. However, a rehabilitation credit will be allowed on the other $10,000 in rehabilitation expenditures. If the other one third of the building becomes tax-exempt use property within 5 years, rehabilitation credits on the $10,000 will be recaptured.

Section 46(e)(2)(A) of present law in effect limits thrift institutions to 50 percent of the investment credit that would otherwise be available with respect to property they own. Under the bill, a lessor of property to a thrift institution will be unable to claim investment credit in excess of that which the thrift institution could have claimed had it acquired the property as owner.

6. Property Used Under Certain Service Contracts

The committee bill provides that a purported service contract arrangement with a tax-exempt entity or other person will not be treated as a service contract if the arrangement is more properly characterized as a lease. This provision of the bill applies to contracts under which property is used to provide services to or for the benefit of a tax-exempt entity. The bill creates no inferences regarding the treatment of service contracts under present law. Nor does the bill affect the present-law rules for determining the treatment of management contracts under which a tax-exempt entity or other property performs services with respect to property owned by a taxpayer.

The service contract provision applies for all purposes of the income tax provisions of the Internal Revenue Code, including the depreciation provisions of the bill and the nontaxable use restriction on the investment credit (as modified by the bill). This provision applies to service contracts involving personal property or real property, regardless of whether the so-called service provider is the tax owner or the lessee of the property.

Factors to be considered

In determining whether a transaction structured as a service contract is more properly treated as a lease, the committee bill requires that all relevant factors be taken into account, including, but not limited to, whether (1) the tax-exempt entity or other purported service recipient is in physical possession of the property, (2) such recipient controls the property, (3) such recipient has a significant possessory or economic interest in the property, (4) the service provider bears any risk of substantially diminished receipts or substantially increased expenditures if there is nonperformance under the contract, (5) the service provider uses the property concurrently to provide services to other entities unrelated to such recipient, and (6) the total contract price substantially exceeds the rental value of the property for the contract period.

Physical possession

Physical possession of property is indicative of a lease. Under the bill, property that is located on the premises of a service recipient, or located off the premises but operated by employees of such recipient, is viewed as in the physical possession of the recipient. However, property is not in the physical possession of the recipient merely because the property is located on land leased to the service provider by the tax-exempt entity.

Control of the property

The fact that the service recipient controls the property is indicative of a lease. Under the bill, a service recipient is viewed as controlling the property to the extent such recipient dictates or has a right to dictate the manner in which the property is operated, maintained, or improved. Control is not established merely by reason of contractual provisions designed to enable the recipient to monitor or ensure the service provider's compliance with performance, safety, pollution control, or other general standards.

Possessory or economic interest

A contract that conveys a significant possessory or economic interest to a service recipient resembles a lease. Under the bill, the existence of a possessory or economic interest in property is established by facts that show (1) the property's use is likely to be dedicated to the service recipient for a substantial portion of the useful life of the property, (2) the recipient shares the risk that the property will decline in value, (3) the recipient shares in any appreciation in the value of the property, (4) the recipient shares in savings in the property's operating costs, or (5) the recipient bears the risk of damage to or loss of the property.

Substantial risk of nonperformance

Under a service contract arrangement, the service provider bears the risk of substantially diminished receipts or substantially increased expenditures if there is nonperformance by the service provider or the property. Under the bill, facts that establish that the service provider does not bear any significant risk of nonperformance are indicative of a lease.

Concurrent use of property

The concurrent use of the property to provide significant services to entities unrelated to the service recipient is indicative of a service contract.

Rental value of property relative to total contract price

The fact that the total contract price (including expenses to be reimbursed by the service recipient) substantially exceeds the rental value of the property for the contract period is indicative of a service contract. If the total contract price reflects substantial costs that are attributable to items other than the use of the property subject to the contract, then the contract more closely resembles a service contract. Conversely, the fact that the total contract price is based principally on recovery of the cost of the property is indicative of a lease. A contract that states charges for services separately from charges for use of property is indicative of a lease.

Other rules

A contract will be treated as a lease rather than a service contract if the contract more nearly resembles a lease. Although each of the factors in the bill must be considered, a particular factor or factors may be insignificant in the context of any given case. Similarly, because the test for determining whether a service contract should be treated as a lease is inherently factual, the presence or absence of any single factor may not be dispositive in every case. For example, even if a tax-exempt entity or other service recipient does not have physical possession of property, the arrangement could still be treated as a lease after taking all other relevant factors into account.

Examples

The following examples illustrate the application of the service contract provision of the committee bill. In each of these examples, T is a taxpayer and E is a tax-exempt entity.

Example (1)

E, an agency of the Federal government, desires to obtain the use of a built-to-purpose vessel. A contractor arranges for the construction of the vessel and for the sale of the vessel to T. The contractor then leases the vessel from T, the shipowner, under a long-term bareboat charter. E and the contractor enter into a time charter with respect to the vessel. The time charter provides for the transportation of equipment, cargo, and personnel. Under the time charter, E has the right to designate the port of call and the cargo to be carried. The master, officers, and crew of the vessel are hired by the contractor, subject to E's approval. All officers of the vessel must qualify for a government "confidential" security clearance. In addition, the master, chief officer, and radio officer must qualify for a government "secret" security clearance. E reserves the right to station 28 permanent government personnel aboard the vessel and to assign up to 100 additional military personnel to the vessel. However, the master of the vessel is under the direction of the contractor as regards navigation and care of the cargo. E also has the right to cause alterations to be made to the vessel. E must make separate payments for "Capital Hire" (computed by reference to the amount required to repay, with interest or a guaranteed return, the debt financing and equity investment of T) and "Operating Hire" (which covers the cost of operating the vessel and the contractor's profit). Payments of Operating Hire are suspended or reduced when the vessel is not fully available for service. However, E must continue to pay Capital Hire during such period.

The time charter has an initial term of 5 years. E has the option to extend the basic term for one to four successive renewal periods, on similar terms, for a total of 25 years. The useful life of the vessel is in excess of 30 years. E can terminate the time charter for convenience at any time during the renewal periods. Upon a termination for convenience or if E fails to exercise a renewal option, E is required to pay any difference between the proceeds of the sale of the vessel and the "Termination Value" set forth in the time charter. The "Termination Value" is an amount approximating T's unrecovered equity, remaining debt service, and tax liability generated by the vessel's sale. E has the option to purchase the vessel at any time after the end of the basic 5-year term for the greater of fair market value or Termination Value at the time of purchase. If E purchases the vessel, E can require that the contractor continue to operate the vessel under the same terms as set forth in the time charter. If the vessel is damaged, destroyed, or otherwise lost due to causes beyond the contractor's control, E must pay any difference between Termination Value and any insurance proceeds. Thus, E also bears the risk of damage to or loss of the vessel.

E may be considered the owner of the vessel under the general principles for determining ownership for Federal income tax purposes. If, however, T were considered the owner, under the bill E would be treated as having a leasehold interest in the property (and the vessel would be tax-exempt use property). In the latter case, the following facts would serve as the basis for the conclusion that E is treated as having a leasehold interest: (a) E has some control over the vessel because E can direct that alterations be made, (b) E has a significant possessory interest because the time charter contemplates that the vessel's use will be dedicated to E for a substantial portion of its useful life, the requirement that Termination Value be paid shifts the risk that the vessel will decline in value to E, and E bears the risk of damage to or loss of the vessel, (c) T does not bear a substantial risk of nonperformance within the meaning of the bill because payments of Capital Hire continue even if the vessel is unavailable for service, (d) regarding the rental value of the property relative to the total contract price, the test for a service contract is not satisfied since the Capital Hire represents payments for the cost of the vessel and the Operating Hire represents separate payments for services, and (e) all other relevant facts and circumstances, including the facts that the vessel was built-to-purpose and the terms of E's purchase option. The fact that the contractor (and not E) has physical possession of the vessel is insignificant in the context of this case.

Example (2)

The facts are the same as in example (1) except that (a) E has no right to make alterations to the vessel, (b) E's obligation to pay charter hire is set at a rate per deadweight ton and is subject to the condition that the vessel be in full working order, (c) the time charter has an initial term of 5 years, with an option to renew for one to five one-year periods, for a total of 10 years, (d) T bears the risk of damage to or loss of the vessel, and (e) E has no option to purchase the vessel. In addition, E is not required to pay Termination Value (or any other penalty) if it fails to exercise a renewal option.

On these facts, the time charter will be respected as a service contract under the bill (and the vessel will not be tax-exempt use property). The following facts provide the basis for that conclusion: (a) E has no control over the vessel; (b) E has no possessory or economic interest in the vessel; (c) the contractor bears a substantial risk of nonperformance, since the contractor will receive no revenues if the vessel is unavailable for service; and (d) the facts do not indicate that any portion of the charter hire is based on the cost of the vessel.

Example (3)

E, a municipal housing authority, owns Section-8-assisted low-income housing projects. E sells the property to T, a partnership of taxable persons. In order to ensure that the purposes of the Section-8 housing program are fulfilled, T retains E to manage the property under a long-term management contract. Under the management contract, E performs many of the same managerial and administrative functions that it performed before the sale. However, T exercises a degree of control over E's activities by virtue of provisions in the management contract that require E to keep adequate records of its operations, to use its best efforts to lease the housing units, and to pay net earnings to T within a reasonable time period. For these services, E is compensated by a fee determined on an arm's-length basis. T bears the risk that the property will decline in value and that the property will be damaged or lost. E does not have an option to repurchase the property.

The mere fact that E continues to control the maintenance and operation of the property under a management contract does not provide a basis for treating the contract as a lease under the service contract provision of the bill. However, the bill leaves open the possibility that an arrangement structured as a management contract could be treated as a lease (under which the tax-exempt entity provides services to third parties for its own benefit) under present law rules. *See McNabb* v. *Commissioner*, 81-1 USTC 9143 (W.D. Wash. 1980) (where an arrangement structured as a management contract was characterized as a lease because the taxpayer did not adequately control the venture and did not bear the risk of loss); and *Meagher* v. *Commissioner*, 36 T.C.M. 1091 (1977) (where the court held that an agreement was a management contract and not a lease, applying the same tests discussed in the *McNabb* case).

Example (4)

E, a municipal agency, acquires an industrial park and then leases the facility to T, a taxable person, for a term in excess of 15 years. T substantially rehabilitates the building and then subleases the improved property to other taxable persons. T retains E to manage the property under a management contract.

T owns the improved portion of the building. The mere fact that E performs services with respect to the entire property under a management contract does not provide a basis for treating the improvements as tax-exempt use property under the service contract provision of the bill. Rather, the status of the management contract, as it relates to the leasehold improvements, is determined under present-law rules.

Example (5)

E, a municipality, and T, a private company, enter into a long-term agreement under which E will be the primary but not the only customer of a local district heating system (the System) that will be constructed, owned, operated, and maintained by T. The agreement between E and T does not qualify for the exception for qualified energy contracts (see below). A local district heating system consists of a pipeline or network which includes or is connected to a central heating source (such as a cogeneration facility or a solid waste resource recovery facility) that furnishes energy for heating through hot water or steam to two or more users for residential, commercial, or industrial heating or processing of steam. The System requires periodic maintenance and repair. The agreement between E and T provides for the distribution of BTUs to buildings owned by E. Forty to 75 percent of T's investment in the System will be allocable to the cost of pipeline, and the balance will be allocable to the cost of building or retrofitting a heating source. Approximately 97 percent of the pipeline included in the System is located off of E's premises. The only part of the System located on E's premises are pipes (for delivering the energy), meters (to measure E's usage), and heat exchangers. The in-building investment (attributable to pipes, meters, and heat-exchangers) may, in the case of some of the buildings owned by E, be made by E. In many cases, the only in-building investment made by T will be the cost of a meter. E will make monthly payments to T, determined by the amount of energy E consumes. T will also use much of the System to distribute BTUs to buildings owned by taxable persons in T's service area, under similar contracts.

On these facts, the agreement between E and T will not be treated as a lease. The following facts provide the basis for that conclusion: (a) E has physical possession of, at most, only a nominal part of the System; (b) E does not control the System; (c) T bears a substantial risk of nonperformance in that T will derive revenue from E based solely on the amount of energy E consumes; (d) T concurrently uses the System to distribute BTUs to others; and (e) T will be required to perform significant services. The fact that E has an economic or possessory interest in the property is, under the circumstances, outweighed by the other factors.

Example (6)

E, a school district, and T, a privately owned school bus company, enter into a multi-year agreement (up to 4 years) under which T will provide transportation for all enrolled school children within the district. T was awarded the contract under competitive bid and is paid, so long as it performs under the contract, at a fixed monthly rate. Under the agreement, T has the exclusive authority to designate bus stops and establish pickup and delivery schedules although it does consult with E. E designates the children to be transported and the time they are to be at school.

T has sole title to the buses, which generally have an economic useful life of 9.5 years, and has total discretion regarding the number and type of vehicles to be used. The agreement requires that all vehicles, equipment, and drivers must comply with applicable State and Federal safety regulations. Under the terms of the contract, T is responsible, subject to State requirements, for maintaining insurance coverage within specified limits. T is also responsible for the training and employing of drivers, and for the storage, repair, and maintenance, which is significant, of all vehicles. In addition, T decides when a bus should be replaced, determines what models should be purchased and what features they should have, and exercises discretion over substitution. It is unlikely the buses will be used for other purposes during the school year.

Absent other factors to the contrary, the agreement is a service contract under the bill. The following facts provide the basis for that conclusion: (a) T has physical possession of the buses; (b) T has control of the buses; (c) T bears a substantial risk of nonperformance in that, among other things, it will not get paid unless it performs; and (d) the monthly rate substantially exceeds the rental value of the property. The facts that the buses likely will not be used for other purposes during the school year, that the agreement is for up to 4 years (which is not a substantial portion of their useful lives), and that T must comply with applicable regulations do not, by themselves, support a conclusion that the agreement is a lease.

Exception for qualified solid waste disposal facilities

The bill provides an exception to the service contract provisions for qualified solid waste disposal facilities. The exception for qualified solid waste disposal facilities creates no inferences regarding the treatment of property subject to the general service contract provision.

The term "qualified solid waste disposal facility" is defined as any facility that provides solid waste disposal services for residents of part or all of one or more governmental units, if substantially all of the solid waste processed at such facility is collected from the general public. For purposes of this rule, the general public includes commercial businesses, but only if the waste collected from such businesses is collected from them in their capacities as members of the general public (and not as members of a limited group such as a group that generates waste not processable by normal waste facilities serving the public).

Exception not to apply in certain cases

The exception for qualified solid waste disposal facilities does not apply, and the facilities will be treated as leased, if the tax-exempt entity or other purported service recipient (or a related entity) (1) operates the facility, (2) bears any significant financial burden if there is nonperformance under the contract (other than for reasons beyond the control of the service provider), (3) receives any significant financial benefit if operating costs of the facility are reduced as the result of technological changes or other efficiencies introduced by the service provider, or (4) has an option to purchase, or may be required to purchase, all or a part of the facility at a fixed and determinable price (other than at fair market value). An option or put that would not be treated as an option or a put at a fixed or determinable price under the rules regarding tax-exempt use of 15-year or 20-year real property will not be treated as an option or a put at a fixed or determinable price for this purpose.

In general, for purposes of determining whether a facility is eligible for the exception to the general service contract provision, a tax-exempt entity's or other recipient's right to inspect the facility, exercise its sovereign power (in the case of a governmental unit), and to act in the event of a breach of contract by the service provider are not to be taken into account. Similarly, the allocation of the benefits and burdens of change in law are not taken into account.

For purposes of determining whether a recipient bears a significant financial burden, the following factors are to be disregarded: (1) temporary shut-downs of the facility for repairs, maintenance, or capital improvements and (2) financial burdens resulting from the bankruptcy or other financial difficulty of the service provider. The determination of whether the recipient receives a significant financial benefit as the result of certain reductions in operating costs is to be made without regard to (1) adjustments or payments based on the quantity of solid waste processed at the facility or (2) financial benefits generated by the production of energy or other recoveries.

Example (7)

E, a municipality, and T, a private company, enter into a solid waste disposal agreement under which T will construct, own, and operate a solid waste resource recovery facility (the Facility) on land leased from E. The Facility will process solid waste (of the type that is currently collected and disposed of as a part of normal municipal collections), generate steam, convert the steam to electricity, and recover ferrous metals from residual ash. T will invest 25 percent of the construction costs, and the balance will be financed with the proceeds of an issue of tax-exempt industrial development bonds to be issued by E. T will construct the project over a 3-year period and operate it for 20 years. E has the option to purchase the Facility at the end of the 20-year term, at the then fair market value of the Facility. Pursuant to a related energy purchase agreement, U, a utility, will be required to purchase a minimum amount of steam during each year of the same 20-year period. Absent default by T, E will pay an annual fee based on the greater of 400,000 tons of solid waste, regardless of whether such amount is actually delivered, or the number of tons of solid waste actually delivered. The fee is subject to a downward adjustment to reflect increases in T's energy revenues. T bears the primary risks of cost overruns and construction delays. E is entitled to receive 80 percent of all interest-cost savings resulting from a financing or refinancing of the tax-exempt bonds at a reduced interest rate.

E can terminate the agreement on performance grounds. In that event, E might obtain possession of the Facility until a new operator is found. In addition, E's employees will be present at the Facility to perform tasks such as delivering the solid waste, carrying away the residue or ash, or monitoring T's compliance with contractual performance standards.

If the Facility is shut down, E remains obligated to make payments equal to 10 percent of the minimum annual fee. Also in the case of a shut-down, E will incur costs for trucking and alternate disposal, which costs may approximate 150 percent of the fee that would otherwise be payable to T. If a shut-down is caused by the delivery of hazardous waste or other unsuitable materials, or by the imposition of Federal regulations prohibiting operation of the Facility, E will remain obligated to pay the minimum annual fee.

The Facility qualifies for the exception to the service contract provision because (a) the solid waste disposed of is collected from the general public, (b) E is not viewed as operating the property, notwithstanding the ability of E's employees to ensure that T complies with general performance standards or the tasks performed by such employees at the Facility, (c) E does not bear any significant burden if there is nonperformance under the contract (other than for reasons beyond T's control), (d) E will not benefit from a reduction in operating costs attributable to efficiencies introduced by T, and (e) E's purchase option is at fair market value.

Example (8)

E, a municipality, enters into a long-term solid waste disposal service contract with T, the operator. The contract obligates T to design, construct, and operate a 2,000 ton per day solid waste disposal resource recovery facility for an annual charge (computed as the cost of debt service on bonds issued to finance the facility, plus a fixed annual operation fee escalated for inflation, minus T's 90% share of the revenues derived from the sale of electricity produced by the facility). T has the option to purchase the facility at the expiration of the contract term at the then fair market value. T concurrently enters into a facility loan agreement with P, a public authority, providing for a loan to T of the proceeds of tax-exempt industrial development bonds issued by P to finance a portion of the cost of the facility and the construction of the facility by T to performance standards. The facility loan agreement provides that if T fails to construct a solid waste disposal facility capable of processing at least 1,500 tons per day of solid waste within 5 years, T must, as liquidated damages, pay or provide for the payment of P's bonds, and thereupon will have no further obligation. Neither the service contract nor the facility loan agreement entitles E to any damages in the event of T's nonperformance. Should T fail to perform its obligation to build a plant with a waste throughput capacity of at least 1,500 tons per day, E will suffer costs and expenses associated with having planned, developed, and negotiated for service from an inoperable plant, costs of developing a replacement disposal arrangement, and costs of transporting and landfilling waste that was expected to be disposed of at the original facility. Although the financial burdens to E from T's nonperformance may be significant, they arise from the continuing duty of E to dispose of waste and are not directly caused by T's nonperformance. The facility therefore does not constitute property leased to E.

Exception for qualified energy contracts

The bill also provides an exception to the service contract provision for property used under a qualified energy contract. The term "qualified energy contract" is defined as a contract between a tax-exempt entity or other service recipient and a service provider under which (1) electrical or thermal energy is produced at a cogeneration or alternative energy facility and sold to the recipient or (2) energy conservation or energy management services or water works treatment facilities, as defined for purposes of section 212(2) of the Federal Water Pollution Control Act, are provided to the service recipient.

A cogeneration facility is a facility that uses the same source of energy for the sequential generation of electrical or mechanical power in combination with steam, heat, or other forms of useful energy. The term "alternative energy facility" is defined as a facility for producing electrical or thermal energy, the primary energy source of which is not oil, natural gas, coal, or nuclear power.

In general, a contract for energy conservation or energy management services involves one or more of the following services: (a) an energy audit to identify opportunities to save energy in a building; (b) engineering design and specifications for energy management; (c) retrofitting of existing equipment or the installation of a renewable energy system; (d) training of personnel; (e) complete maintenance and operation of any equipment installed; and (f) continued monitoring by the service provider's employees who have access to the equipment installed on the premises of the service recipient, including the preparation of periodic reports to the recipient. The service provider's compensation may be based on a percentage of the savings resulting from the service provider's services. Alternatively, the contract may provide for a guaranteed saving to the recipient. The term of those types of contracts usually approximate ten years, at the end of which the recipient may have the option to purchase the equipment installed on its premises at fair market value. During the term of the contract, the service provider generally has the right to replace or alter equipment installed on the recipient's premises in order to further reduce energy consumption.

Exception not to apply in certain cases

The exception for qualified energy contracts does not apply, and any property involved will be treated as leased, if the tax-exempt entity or other purported service recipient (or a related entity) (1) operates the property, (2) bears any significant financial burden if there is nonperformance under the contract (other than for reasons beyond the control of the service provider), (3) receives any significant financial benefit if operating costs of property of the service provider are reduced as the result of efficiencies introduced by the service provider, or (4) has an option to purchase, or may be required to purchase, all or a part of the facility at a fixed and determinable price (other than at fair market value). In applying those rules, the rules applicable under the exception for qualified solid waste disposal facilities are to be used.

Example (9)

T, a private company, and E, a Federal governmental agency, enter into a contract under which T will construct and operate a solar energy system (the System). The System will be owned by a group of private investors. The System will be constructed on the roof of a building owned by E. All of the hot water and steam produced by the System will be sold to E under a long-term contract. E must pay a significant penalty if it defaults on the contract. However, T will receive no revenues under the contract unless the System produces energy. T is solely responsible for the operation and maintenance of the System. However, because the System is substantially maintenance free, the total contract price exceeds the rental value of the System by only 5 to 10 percent. Upon expiration of the contract, E has the option to purchase the System at fair market value.

The agreement between E and T is a qualified energy contract because (a) the contract provides for the sale of energy to E and the energy is produced by an alternative energy facility, (b) E does not operate the System, (c) E does not bear any significant financial burden if there is nonperformance under the contract, (d) E does not receive any financial benefit if T's operating costs are reduced, and (e) E's purchase option is at fair market value.

Treatment of partnerships and other pass-through entities and other arrangements

The committee is concerned that taxpayers may attempt to structure transactions to avoid the restrictions of the bill. Transactions of this character might include the use of partnerships or other pass-through entities. To deal with those transactions, the bill contains two anti-abuse provisions.

First, where property is held by a partnership of which a tax-exempt entity is a member, and where the allocation to the tax-exempt entity is not a qualified allocation, such entity's proportionate share of the property is to be treated as tax-exempt use property of the partnership. Solely for purposes of this rule, if a tax-exempt entity which has an unrelated trade or business is a partner, and if its share of income or loss of the partnership would be treated as income or loss from an unrelated trade or business, then it will not be treated as a tax-exempt entity.

A qualified allocation is an allocation under which (1) the tax-exempt entity is allocated the same percentage share of each item of partnership income, gain, loss, deduction, credit, and basis (excluding allocations with respect to contributed property), (2) such share remains the same during the entire period that the entity is a partner, and (3) such allocation has a substantial economic effect, as defined under the rules applicable to partnership allocations generally (sec. 704(b)(2)). A tax-exempt entity's proportionate share of property is such entity's share of partnership distributions or items of income or gain (excluding certain built-in gain with respect to contributed property), whichever results in the largest proportionate share. If a tax-exempt entity's share may vary during the period such entity is a partner, the entity's proportionate share is the highest share the entity may receive. However, a tax-exempt entity's share is not to be considered as varying merely because the tax-exempt entity may sell part of its interest or new partners may be admitted. The application of these rules is not to result in more than 100 percent of any partnership property being treated as tax-exempt use property. The bill provides for the application of similar rules to other pass-through entities (such as a trust).

The committee bill does not affect the present-law rule for determining the tax status of property that is co-owned by a tax-exempt entity under an arrangement that is not classified as a partnership for Federal tax purposes. Thus, a tax-exempt entity will continue to be viewed as owning a separate undivided interest in property held by a joint venture that is classified as a co-tenancy under Federal tax law. *See* Rev. Rul. 78-268, 1978-2 C.B. 10 (which addresses this issue in the context of applying the present law nontaxable use restriction on the investment credit).

Second, the committee bill provides that an arrangement other than a service contract (including but not limited to a partnership or other pass-through entity) that purports not to be a lease is to be treated as a lease if such arrangement is more properly treated as a lease. In determining whether any given arrangement is more properly treated as a lease, all relevant factors are taken into account, including factors similar to those set forth in the general service contract provisions. This provision is applicable to any arrangement, other than a service contract, under which a tax-exempt entity directly or indirectly obtains the use or benefits of property.

The Secretary is to prescribe such regulations as may be necessary or appropriate to carry out the purposes of the bill rules relating to service contracts and other arrangements.

Example (10)

E, a not-for-profit hospital, and T, a partnership composed of individuals who are active members of E's medical staff, enter into a joint venture to acquire and operate a computer axial tomography (or "C.A.T.") scanner. The C.A.T. scanner will be used solely to aid in the diagnosis of diseases of E's patients. Each joint venturer will contribute equal amounts of debt and cash towards the purchase price of the property, and will share equally in net profits and losses and net cash flows, and other partnership items. It is assumed that these allocations have substantial economic effect. The C.A.T. scanner, which will be located on the premises of E, will be operated by members of T. The day-to-day business of the joint venture will be managed by a representative of each joint venturer. Under the joint venture agreement, T will be responsible for the billing of all technical charges and will receive two percent of gross charges for costs associated with preparing, mailing, and collecting charges. E will bill the joint venture and be reimbursed for occupancy costs (including utilities, housekeeping services, building depreciation, and interest) relating to the location of the C.A.T. scanner on its premises. The joint venturers will be separately responsible for interest, taxes, and insurance relating to participation in the joint venture. However, as between E and T, E is ultimately liable for the debt service obligations with respect to the entire property. The joint venture will terminate at the end of seven years. The useful life of the C.A.T. scanner is approximately nine years. Within six months of termination, T can require that E purchase T's interest in the joint venture at fair market value, adjusted upward if fair market value is less than a price specified in the contract (which price is computed by reference to the amount required to repay T's equity investment with a guaranteed return, less the net profits received by T during the term of the joint venture).

Assuming that the joint venture is properly classified as a partnership rather than a co-tenancy for Federal tax purposes, there is, absent other factors, a qualified allocation. Accordingly, none of the property is tax-exempt use property under the first of the two anti-abuse provisions.

However, the joint venture agreement is also subject to the provision of the bill relating to arrangements other than service contracts that purport not to be leases. The property, by being used for E's patients, is being used for the benefit of E. Nor is it being used in an unrelated trade or business. Under the bill, taking into account factors similar to those numerated in the general service contract provision, the arrangement is treated as conveying to E a leasehold interest in T's interest in the property. Thus, it is tax-exempt use property under the second anti-abuse provision. The following facts provide the basis for this conclusion: (a) although no payments are required to be made by E to T, T will be compensated through payments made by E's patients and by the terms of the put; (b) E has control of T's interest in the property because E has an equal voice in the operation and maintenance of the entire property; (c) E has a possessory interest in T's interest because the property will be used under the agreement for a substantial portion of the property's useful life and E bears the risk that the property will decline in value by virtue of the put held by T; (d) T does not have the right to use the property to provide services to anyone other than a patient of E; and (e) all other relevant facts, including the facts that the use of the property is integrally related to E's tax-exempt function, that E has guaranteed the repayment of the total acquisition indebtedness, and that the property will be operated only by E's employees. Given the totality of the facts and circumstances, the fact that T bears a risk of substantially diminished receipts is mitigated by E's obligation to fulfill T's debt service requirements and does not provide a basis for a contrary conclusion.

The C.A.T. scanner does not qualify for the special rule for short-lived property because the term of the agreement exceeds five years. Thus, the entire C.A.T. scanner is subject to reduced depreciation and is ineligible for the investment credit.

Scope of service contract provisions

As indicated above, the provisions of the bill describing factors to be used to distinguish service contracts and other arrangements from leases are to apply for all Federal income tax purposes, even if no tax-exempt entity is involved. For example, assume a taxpayer and a public utility enter into a purported service agreement pursuant to which the taxpayer is to provide electrical energy to the public utility for resale by the public utility. If the arrangement would be characterized as a lease of property to the public utility under the appropriate set of service contract criteria discussed above, the property would be treated as used by the public utility for purposes of, e.g., section 46(c)(3)(B) and section 167(l)(3)(A). Similarly, a so-called service contract will generate rents under section 543(a)(2) if, after application of the appropriate services contract criteria, the arrangement more nearly resembles a lease of property.

7. Short-Term Lease Exception

Property subject to a short-term lease to a tax-exempt entity will not be subject to the bill. For purposes of this rule, the term of a lease begins when property is first used under it.

Different short-term lease rules apply for the depreciation provisions of the bill and for the investment credit provisions of the bill. Under the bill's depreciation provisions, in the case of property other than 15-year or 20-year real property, a lease of not greater than one year or 30 percent of the property's ADR mid-point life (but not greater than 3 years), will qualify as a short-term lease. In applying the bill's depreciation provisions with respect to 15-year or 20-year real property, a lease of not greater than 3 years will qualify as a short-term lease.

Under the bill's investment credit provisions, property leased to a tax-exempt entity (or a related tax-exempt entity) for less than 6 months in the lessor's taxable year will be treated as leased for a short term, unless the lease has a term of more than 6 months.[15] However, property described in ADR cla{s 13.0 (relating to assets used in the offshore drilling for oil and gas), and containers described in section 48(a)(2)(B)(v) (determined without regard to place of use) and related container chassis and container trailers having an ADR mid-point life of not more than 6 years,[16] will be treated as leased for a short term if the term of the lease does not exceed the greater of one year or 30 percent of the property's ADR mid-point life.

8. Lease Term

For all purposes of the bill, the term of a lease includes all periods for which the lessee (or a related party) has a legally enforceable option to renew, or the lessor has a legally enforceable option to compel renewal, whether the lease is in fact renewed and regardless of the terms at which the lease is renewable. However, in the case of 15-year or 20-year real property, an option to renew by

[15] New.

[16] New.

the lessee at fair rental value, as determined at the time of renewal, will not be treated as an option to renew.

The bill leaves open the possibility, as under present law, that the term of a subsequent lease could be included in the term of the original lease if the circumstances indicate that the parties, upon executing the original lease, had informally agreed that there would be an extension of the original lease. An extension at a rental rate differing materially from the market rental rate at the time of the extension would suggest that the parties had such an informal agreement. Similarly, the committee intends that rules similar to those applied under section 46(e)(3) (relating to investment credits for non-corporate lessors) be applied in determining the term of a lease. See, e.g., *Hokanson* v. *Commissioner*, 84-1 USTC Par. 9217 (9th Cir. 1984) (which applies a reasonable expectations test). Also, the bill measures the lease term by counting successive leases as one lease. This rule applies if the original lease and one or more successive leases are entered into contemporaneously. The successive lease rule will not apply (nor the term of the original lease treated as extended) merely because the parties enter into a new lease at fair rental value (or the lessee buys the property at its fair market value) at the end of the primary lease term.

Under the bill, if a tax-exempt entity (or a related party) at substantially the same time or as part of one arrangement enters into several leases covering the same or substantially similar property, each having a different term, the original lease term will be treated as running through the term of the lease which has the latest expiration date of the several leases. That rule will not apply merely because the parties enter into a new lease at fair rental value at the end of the primary lease term.

9. Certain International Organizations

Property owned or used by the International Telecommunications Satellite Organization or the International Maritime Satellite Organization, or any successor of either, is not tax-exempt use property to the extent of the share of such property of any taxable domestic corporation which is a member of such organization. Such member's share is determined after the application to each member which is a tax-exempt entity of the bill's special rules for partnerships (sec. 168(j)(9)). Furthermore, to the extent such property is not tax-exempt use property, it may qualify as section 38 property.

10. Definition of Related Party

The following related party rules apply under the bill:

Each governmental unit and each agency or instrumentality of a governmental unit is related to each other such unit, agency, or instrumentality the rights, powers, and duties of which derive in whole or in part, directly or indirectly, from the same sovereign authority. Therefore, a multi-State commission is related to each of its member States, since the commission will be deriving its authority from those States. For purposes of this rule, the United States, each State (including the District of Columbia), each possession of the United States (including Puerto Rico), and each foreign country is a separate sovereign authority. Therefore, a city in one State will not be related to a city in another State under the rule. However, each city in a foreign country will be treated as related to every other governmental unit, agency, or instrumentality in that foreign country.

Any entity (other than a governmental unit or an agency or instrumentality of such a unit) is related to any other person if the two have (a) significant common purposes and substantial common membership or (b) directly or indirectly, substantial common direction. For example, the local chapter of a national fraternity or of the Red Cross is related to its national organization.

Any tax-exempt entity is related to any other entity if either owns 50 percent or more of the capital interests or the profit interests in the other. For example, a foreign person is related to its wholly-owned subsidiary and any corporation that owns 50 percent or more of the value of its stock, and a section 501(c)(3) organization is related to any corporation 50 percent or more of the stock of which it owns. For purposes of this rule, an entity treated as related to any other entity under either of the two foregoing rules will be treated as the one entity. For example, assume that each of 10 cities within 1 State own 10 percent of a corporation. The State, each city, and the corporation are related parties.

Any tax-exempt entity is related to any other tax-exempt entity with respect to a particular transaction if such transaction is part of an attempt to avoid the application of section 46(f), section 48(a)(4), section 48(a)(5), section 48(g)(2)(B)(vi), or section 168(j).

11. Exceptions

The bill does not apply to mass commuting vehicles exempted from most of TEFRA's amendments to the safe harbor lease provisions. See section 208(d)(5) of P.L. 97-248. Furthermore, the bill does not apply to property described in section 208(d)(3)(E) of P.L. 97-248, as amended by P.L. 97-448 (relating to certain boilers and turbines of rural electric cooperatives). Nor does the bill apply to property described in section 168(f)(12)(C)(ii) (relating to certain sewage or solid waste disposal facilities) of present law if a ruling request relating to the tax consequences of the use of such property by a tax-exempt entity was filed on or before May 23, 1983.

The committee bill does not apply to any motion picture film or video tape described in section 48(k)(1)(B) (relating to motion picture films and video tapes created primarily for public entertainment or educational purposes) or any sound recording described in section 48(r) (as added by the bill) used by any foreign person or entity.[17] However, no inference is intended as to whether motion picture films, video tapes, or sound recordings can qualify under present law as recovery property.

[17] New.

Effective Date

General

The bill applies to property placed in service by the taxpayer after May 23, 1983, except to the extent acquired by the taxpayer subject to a lease in effect on May 23, 1983. The bill also applies to property placed in service by the taxpayer before May 24, 1983, and used pursuant to a lease entered into or renewed after May 23, 1983. For purposes of the preceding sentence, a lease will not be treated as entered into or renewed after May 23, 1983, merely by reason of the exercise by a lessee of a written option, or performance under a contract, enforceable against the lessor on May 23, 1983, and at all times thereafter. Furthermore, property will not become tax-exempt use property merely because a lessee under a lease entered into before May 24, 1983, subleases the property after May 23, 1983. The bill does not apply to property leased to the United States Postal Service pursuant to a lease entered into on or before October 31, 1983, if the taxpayer placed such property in service on or before such date.

Property qualifying under this transitional rule will not become tax-exempt use property merely by reason of a transfer of the property subject to the lease by the lessor (or a transfer of the contract to acquire, construct, reconstruct, or rehabilitate the property), so long as the lessee (or the party obligated to lease) does not change.

Transitional rule

General

The bill does not apply to property used by a tax-exempt entity pursuant to one or more written contracts binding on May 23, 1983, and at all times thereafter, which required the taxpayer (or a predecessor in interest under the contract) to acquire, construct, reconstruct, or rehabilitate the property and the tax-exempt entity (or a tax-exempt predecessor in interest under the contract) ~~to~~ use the property.

For example, assume that on February 1, 1983, a tax-exempt entity enters into a binding contract to have a building constructed. Construction is to be completed on January 15, 1984. On May 1, 1983, the tax-exempt entity assigns its interest in the construction contract to corporation X and enters into a binding contract to lease the building back from corporation X upon its completion. The transitional rule applies. However, the transitional rule would not apply if the assignment and entering into of the binding contract to lease did not occur until after May 23, 1983.

As a further example, assume that a tax-exempt entity has owned and occupied all of a building for years. On May 1, 1983, the tax-exempt entity enters into a binding contract with corporation Y pursuant to which the tax-exempt entity, on July 1, 1983, will sell the building to corporation Y and lease it back. The transitional rule applies. The result would be the same even if corporation Y assigns its entire interest in the contract to corporation Z, or contributes it to a partnership of which it is a member, on June 1, 1983. And the result would be the same if the tax-exempt entity assigned its interest in the lease to another tax-exempt entity on June 15, 1983.

A contract is binding only if it is enforceable under State law against the taxpayer (or a predecessor) and does not limit damages to a specified amount as, for example, by a liquidated damages provision. A contract that limits damages to an amount equal to at least 5.0 percent of the total contract price will not be treated as limiting damages⁄ A contract is binding even if subjekt to a condition, so long as the condition is not within the control of either party (or a predecessor). A contract will not be treated as ceasing to be binding merely because the parties make insubstantial changes in its terms or if any term is to be determined by a standard beyond the control of either party. Finally, a contract which imposes significant obligations on the taxpayer (or a predecessor) will not be treated as non-binding merely because some terms remain to be negotiated. For example, if a corporation and a tax-exempt entity enter into a legally enforceable contract on May 1, 1983, pursuant to which the corporation agrees to buy a building from the tax-exempt entity and then lease it back, the contract will be treated as a binding contract to use notwithstanding the fact that some terms of the lease have not yet been set.

On the other hand, a binding contract to acquire a component part for a larger piece of property will not be treated as a binding contract to acquire the larger piece of property. For example, if a tax-exempt entity entered into a binding contract on May 1, 1983, to acquire a new aircraft engine, there would be a binding contract to acquire only the engine, not the entire aircraft.

Nor does the bill apply to personal property leased to the United States (or an agency or instrumentality thereof) if prior to May 24, 1983, an express appropriation for the fiscal year 1983 was made for rentals under the lease (whether payable in fiscal year 1983 or subsequent fiscal years) in respect of property delivered in fiscal 1983 (or subsequent fiscal years), but only if neither the United States nor any agency or instrumentality thereof has provided any indemnification against loss of any tax benefits under the lease.

Specific projects

The bill identifies several projects that will not be subject to the bill. Those projects are identified, in part, by reference to particular actions taken. This transitional rule is to apply to property included in a project only to the extent that the project is completed substantially as contemplated at the time of and in the specified action.

Partnerships

The provisions of section 168(j)(9) (relating to partnerships which have tax-exempt as well as taxable partners) are not applicable to certain partnerships which were organized before October 21, 1983, and which conclude marketing of partnership interests within specified periods of time. This rule applies only with respect to property acquired, directly or indirectly, by such partnerships prior to 1985. For this purpose, property held before 1985 by a partnership an interest in which is acquired by another partnership before 1985, will be treated as property acquired by such other partnership.

Service contracts and other arrangements

The bill provides rules for distinguishing between services contracts or other arrangements, on the one hand, and leases, on the other, whether or not a tax-exempt entity is a party. In any case where a tax-exempt entity is not a party, those rules are not applicable with respect to service contracts or other arrangements pursuant to binding contracts in place on November 4, 1983.[18]

Revenue Effect

These provisions will increase fiscal year budget receipts by $492 million in 1984, $998 million in 1985, $1,811 million in 1986, $3,127 million in 1987, $5,008 million in 1988, and $7,089 million in 1989.

[18] New.

C. Treatment of Bonds and Other Debt Instruments

1. Market Discount (secs. 25 and 27 of the bill and new secs. 1276, 1277, and 1278 of the Code)

Present Law

Market discount arises when the value of a debt obligation declines after issuance (typically, because of an increase in prevailing interest rates). Capital gain treatment is accorded to the appreciation in value attributable to market discount on an obligation that was issued by a corporation or governmental unit and held for more than one year (sec. 1232). In many cases, interest on indebtedness incurred to purchase or carry a market discount bond is deductible currently against ordinary income, even though the income eventually generated by the investment is not taxed until disposition (and then only at capital gain rates).

Reasons for Change

The committee recognizes that, from the standpoint of the holder of a bond, market discount is indistinguishable from original issue discount (OID). In each case the discount is a substitute for stated interest, and the holder of the obligation receives some of his return in the form of price appreciation when the bond is redeemed at par upon maturity. When a taxpayer makes a leveraged purchase of a market discount bond, the taxpayer effectively converts the ordinary income that is offset by current interest deductions to capital gain that is taxed on a deferred basis.

It has come to the committee's attention that tax-shelter transactions have arisen in which taxpayers acquire market discount bonds, using borrowed funds, to take advantage of the opportunities under present law to defer tax liability on ordinary income and to convert ordinary income to capital gain. The committee appreciates that the theoretically correct treatment of market discount, which would require current inclusion in the income of the holder over the life of the obligation, would involve administrative complexity. However, the committee believes that the present-law rules should be modified to prevent the use of market discount bonds as a basis for tax-shelter transactions, under an approach that would be more easily administered and complied with by taxpayers. The committee is also of the view that it is appropriate to provide tax treatment for market discount on bonds that is generally comparable to the tax treatment of OID, without regard to whether market discount bonds are held in a tax-shelter context.

Explanation of Provisions

Overview

The bill generally requires that gain on disposition of a market discount bond be recognized as interest income, to the extent of accrued market discount (computed under a linear formula). However, accrued market discount is not treated as interest for purposes of withholding at source or information reporting requirements under the Code. The bill also limits a taxpayer's ability to take current interest deductions on indebtedness incurred to purchase or carry a market discount bond. The bill provides an election to include accrued market discount in income currently. Neither the rule requiring ordinary income treatment on disposition nor the rule limiting interest deductions would apply to bonds with respect to which the election is made. The committee intends no inference that tax-shelter transactions involving market discount bonds cannot be successfully challenged under present law.

Accrued market discount treated as ordinary income

Except as otherwise provided by the bill, gain on the disposition of any market discount bond is generally treated as interest income to the extent of accrued market discount, for all purposes of Federal income taxation (including, for example, the statutory provision that limits the deductibility of investment interest). However, accrued market discount is not treated as interest for purposes of information reporting or withholding at source required under sections 871(a), 881, 1441, 1442, and 6049 of the Code (and such other provisions as the Secretary may specify in regulations). Characterization of the market discount as interest would not affect the issuer of the bond.

For purposes of this rule, a taxpayer who disposes of a bond in a transaction other than a sale, exchange, or involuntary conversion (*e.g.*, by making a gift) is treated as realizing an amount equal to the fair market value of the bond, with the result that accrued market discount is recognized at that time. Under regulations to be prescribed by the Secretary, certain transfers will be excepted from the provisions of the bill. The bill provides that regulations will include rules similar to those of section 1245(b), relating to transfers excepted from the depreciation recapture rules, with certain modifications (including that no exception will be provided for gifts, and that market discount will not be included in income if a bond is transferred in the course of certain tax-free reorganizations). Appropriate adjustments will be made to the basis of any property to reflect gain recognized under the provisions of the bill.

Definition of market discount bond

The bill defines a bond as any bond, debenture, note, certificate, or other evidence of indebtedness. Except as provided by the bill, the term "market discount bond" means any bond having market discount. Exceptions are provided for obligations (i) with a fixed maturity not exceeding one year from date of issue, (ii) the interest on which is not includible in the gross income of the holder under section 103 of the Code (relating to certain governmental obligations), or any other provision of law that provides for tax exemption without regard to the identity of the holder, or (iii) which is a U.S. savings bond.

Definition of market discount

Market discount is generally defined as the excess of the stated redemption price of a bond over the adjusted basis of such bond immediately after its acquisition by the taxpayer. No market discount arises with respect to an installment obligation subject to the rules of section 453. However, when a market discount bond is exchanged for an installment obligation, accrued market discount will be characterized as ordinary income when payments are received pursuant to the rules of section 453. For OID bonds acquired at a market discount, the stated redemption price is treated as equal to its "revised issue price" (defined as the sum of the issue price of the bond and the aggregate amount of the OID includible in the gross income of all holders for periods before the bond was acquired by the taxpayer). Under a de minimis rule, market discount is considered to be zero if the market discount is less than .25 of 1 percent of the stated redemption price at maturity, multiplied by the number of complete years to maturity after the taxpayer acquires the bond.

Linear computation of accrued market discount

Accrued market discount is computed by determining the amount that bears the same ratio to the market discount on the bond as (i) the number of days that the taxpayer held the bond, bears to (ii) the number of days after the date the taxpayer acquired the bond up to (and including) the date of maturity. Thus, the market discount is treated as accruing in equal daily installments during the period the bond is held by the taxpayer.

Accrued market discount on substituted basis property

With respect to a market discount bond that is "transferred basis property" (property received in a nonrecognition transaction excepted from the bill the basis of which is determined by reference to its basis in the hands of the transferor), the transferee is treated as having acquired the bond on the date when it was acquired by the transferor for an amount equal to the adjusted basis (increased for gain recognized by the transferor on the transfer). For purposes of this rule, a market discount bond the basis of which is determined under section 732(a), 732(b), or 334(c) is treated as transferred basis property.

The amount of accrued market discount with respect to "exchanged basis property" (property received in a nonrecognition transaction the basis of which is determined in whole or in part by reference to the basis of property that was transferred in the transaction) includes any accrued market discount to the extent such amount was not previously treated as interest income under the provisions of the bill. For example, on the disposition of stock received upon the conversion of a convertible bond or in a recapitalization gain is treated as interest income to the extent of the amount of accrued market discount as of the date of conversion.

Election to accrue market discount under an economic accrual formula

At the election of the taxpayer, accrued market discount can be computed by using the constant interest method that is provided by present law for the amortization of OID on bonds issued after July 1, 1982. The constant interest method parallels the manner in which interest would accrue through borrowing with interest-paying nondiscount bonds.

Deferral of interest deduction allocable to accrued market discount

The bill limits a taxpayer's ability to take current deductions for interest on indebtedness incurred to purchase or carry a market discount bond. The taxpayer's net direct interest expense is allowed as a deduction only to the extent that the expense exceeds the amount of market discount allocable to the days during the taxable year on which the bond was held by the taxpayer. The term "net direct interest expense" is defined as the excess of the interest paid or accrued by the taxpayer over the interest (including OID) includible in gross income for the taxable year with respect to such bond. In the case of a financial institution to which section 585 or 593 applies, unless the taxpayer otherwise establishes an appropriate allocation, an amount of interest that bears the same ratio to the total interest otherwise allowable as a deduction as the taxpayer's average adjusted basis (within the meaning of section 1016 of the Code) of market discount bonds bears to the average adjusted basis for all assets of the taxpayer shall be treated as interest paid or accrued on indebtedness incurred to purchase or carry such market discount bonds.

For example, in the case of a financial institution subject to the special rule, the amount of interest otherwise allowable as a deduction would be multiplied by a fraction, the numerator of which is the average basis of all market discount bonds held by the taxpayer and the denominator of which is the average basis of all assets held by the taxpayer. The product, which would be treated as interest paid or accrued on indebtedness incurred to purchase such bonds, would be reduced by any interest includible in gross income with respect to the bonds for the taxable year to obtain the taxpayer's net direct interest expense.

Interest that is deferred under this rule is allowed as a deduction for the taxable year when the taxpayer disposes of the market discount bond. If the bond is disposed of in a transaction in which gain is not recognized in whole or in part, the deferred interest is allowed as a deduction at that time to the extent of recognized gain.

To the extent deferred interest is not allowed as a deduction upon the disposition of a bond in a nonrecognition transaction, the disallowed interest expense will be treated as disallowed interest expense with respect to transferred-basis or exchanged-basis property received in the transaction. Thus, in the case of a market discount bond that is transferred-basis property, the transferee will be entitled to deduct the disallowed interest expense upon disposition of the bond.

For bonds that are subject to the interest-deferral rule but not the rule requiring the recognition of interest income upon disposition of the bond (because the bond was issued before the effective date of the interest-characterization rule), gain on disposition is recognized as interest income to the extent of the disallowed interest expense allowed as an ordinary deduction at the time of disposition.

If such a bond is disposed of in a nonrecognition transaction, a similar interest-characterization rule will apply at the time gain is recognized and the disallowed interest expense is allowed as a deduction.

Election to include accrued market discount in income currently

The bill provides an election to include accrued market discount in gross income for the taxable years to which it is attributable. Under this provision, market discount can be accrued under the economic accrual formula or the linear formula at the election of the taxpayer. If the taxpayer makes an election to include market discount in income currently, neither the rule requiring ordinary income treatment upon disposition nor the interest-deferral rule would apply to bonds acquired during the period the election is in effect. The bill contemplates that where the election is made the taxpayer's basis in the bond will be increased by the amount of market discount included in income with respect to the bond. The election to accrue market discount currently cannot be revoked without the consent of the Secretary.

Effective Date

The provision requiring the recognition of interest income on disposition of a market discount bond will apply to obligations issued after the date of enactment of the bill. The provision that defers interest deductions on indebtedness incurred to purchase or carry market discount bonds will apply to obligations acquired after the date of enactment of the bill.

Revenue Effect

The revenue effects of this provision are included in the estimates of the revenue effects of the provision relating to discount on short-term obligations.

2. Discount on Short-term Obligations (secs. 25 and 27 of the biil and new secs. 1281, 1282, and 1283 of the Code)

Present Law

In general, periodic inclusion of original issue discount (OID) is required of the holders of debt obligations (sec. 1232A). However, a special rule is provided by statute for governmental obligations that are issued at a discount and payable without interest at a fixed maturity not exceeding one year (Treasury bills). For Treasury bills, discount is not considered to accrue until the obligation is paid at maturity or otherwise disposed of (sec. 454(b)). This rule applies regardless of the character of the obligation in the hands of the holder (*e.g.*, as inventory or a capital asset). Furthermore, on disposition of the instrument, the taxpayer's capital gain or loss is computed with reference to accrual of the acquisition discount, not OID. Under Treasury regulations, there is no accrual of OID on certain short-term obligations (*e.g.*, certificates of deposit) held by cash-basis taxpayers (Treas. reg. sec. 1.1232-3(b)(1)(iii)).

In many cases, interest on indebtedness incurred to purchase obligations eligible for the special rules can be deducted currently against unrelated income, thereby generating a one-year tax deferral.

Reasons for Change

The special rules that permit deferral of acquisition discount on Treasury bills and original issue discount on short-term discount obligations are commonly used to defer tax liability on ordinary income through leveraged purchases of such obligations. The committee believes that such activities should not be encouraged by the tax laws.

Explanation of Provision

Overview

The bill limits the ability to use leveraged purchases of short-term discount obligations within the special rules to defer tax on ordinary income. An election is provided under which taxpayers can avoid application of the interest-deferral rule by electing to include discount in income as it accrues. The committee intends no inference that year-to-year deferral of tax liability involving leveraged purchases of short-term discount obligations cannot be successfully challenged under present law.

Deferral of interest deduction allocable to accrued discount

The bill limits the ability to make leveraged purchases of short-term obligations as a device to defer tax on ordinary income. The net direct interest expense with respect to a short-term obligation (as defined for purposes of applying the bill) is allowed as a deduction only to the extent of the daily portions of the acquisition discount for each day on which the taxpayer held the obligation during the taxable year. The term "net direct interest expense" is defined in the same manner as that term is used for purposes of the provision that defers interest deductions allocable to accrued market discount (generally, the excess of interest paid or accrued—determined with regard to the special rule for financial institutions—over interest includible in gross income with respect to the obligation).

For purposes of the interest-deferral rule, rules similar to the rules applicable to market discount bonds will apply (including the allowance of deductions for deferred interest upon disposition of the bond and the treatment of substituted-basis property).

Definition of short-term obligation

The bill generally defines "short-term obligation" to mean any bond, debenture, note, certificate, or other evidence of indebtedness that has a fixed maturity date not exceeding one year from the date of issue. Exceptions are provided for obligations the interest on which is not includible in gross income under section 103 (relating to interest on certain governmental obligations), or any other provision of law that provides for tax-exemption without regard to the identity of the holder.

Definition of acquisition discount

Acquisition discount is defined as the excess of the stated redemption price at maturity (as defined for purposes of the rules requiring the periodic inclusion of OID), over the taxpayer's basis for the obligation.

Computation of daily portions of acquisition discount

The bill generally provides that the daily portion of the acquisition discount is equal to (i) the amount of such discount, divided by (ii) the number of days after the day on which the taxpayer acquired the obligation and up to (and including) the day of its maturity. The application of this provision results in the linear accrual of the acquisition discount. However, under regulations prescribed by the Secretary, taxpayers may elect to accrue acquisition discount under an economic accrual formula, pursuant to which the daily portion of the discount is computed on the basis of the taxpayer's yield to maturity based on the cost of acquiring the obligation, compounded daily. The election to account for acquisition discount under an economic-accrual formula is irrevocable without the consent of the Secretary.

Election to include acquisition-discount in income currently

The interest-deferral rule does not apply to a taxpayer who elects to include acquisition discount in income currently. If the election is made, the provision for current inclusion will apply to all short-term obligations acquired by the taxpayer on or after the first day of the first taxable year to which the election applies. The electicn cannot be revoked for subsequent taxable years without the consent of the Secretary.

Short-term obligations other than governmental obligations

The rules described above apply to short-term obligations other than governmental obligations, taking OID into account rather than acquisition discount. Taxpayers who acquire obligations other than governmental obligations after original issue can elect to apply these rules with respect to acquisition discount on such obligations rather than OID. The election, if made, applies to all short-term obligations acquired by the taxpayer after the first day of the first taxable year to which the election applies. This election cannot be revoked without the consent of the Secretary.

Effective Date

General

The provision relating to the treatment of acquisition and original issue discount will be effective for obligations acquired after the date of enactment.

Election

The interest-deferral rule (including the election to include discount in gross income currently) may be applied to short-term obligations acquired before the effective date under an election.

Taxpayers can elect to apply the interest-deferral rule to all short-term obligations held during the taxable year that includes the date of enactment (the "transition year"). If this election is made, taxpayers can also elect a five-year "pay in." Under this rule, a taxpayer would first compute the additional taxable income that would arise in the taxable year preceding the transition year if the interest-deferral rule were applied with respect to all short-term obligations held during that year. Then, the taxpayer would compute the increase in tax liability for the transition year that would result if the additional taxable income (referred to in the preceding sentence) were included in the transition year. This amount can be paid in two to five equal annual installments. Interest is charged on any unpaid installments of tax that are still outstanding after the due date for the first installment.

Revenue Effect

The revenue gain from these changes, and the changes involving market discount bonds, is expected to be $154 million in fiscal year 1984, $663 million in 1985, $93 million in 1986, $92 million in 1987, $90 million in 1988, and $72 million in 1989.

3. Original Issue Discount on Tax-Exempt Bonds (sec. 25 of the bill and new sec. 1288 of the Code)

Present Law

In general, interest on obligations issued by any political subdivision of a State is exempt from Federal income taxation (sec. 103(a)). On the basis of long-standing administrative practice, the Internal Revenue Service ruled that original issue discount (OID) on an obligation issued by a municipality is similarly exempt from tax. (Rev. Rul. 73-112, 1973-1 C.B. 47, restating G.C.M. 10452, X-1 C.B. 18 (1932)). The Internal Revenue Service further ruled that tax-exempt OID is apportioned on a straight-line basis over the term of the obligation among the original holder and subsequent purchasers.

Prior to 1982, holders of OID bonds issued by corporations were also required to apportion OID on a straight-line basis over the term of the obligation. The Tax Equity and Fiscal Responsibility Act of 1982 included a provision that requires the economic accrual of OID on bonds issued by corporations and other entities.

Reasons for Change

The application of a straight-line interest computation to discount municipal obligations may permit the holder of a deep-discount municipal bond to generate an artificial loss by disposing of the bond prior to maturity. This result could occur because the holder's amount realized on disposition, for purposes of determining gain or loss, is reduced by the amount treated as accrued tax-exempt OID, even though the market price of the bond is likely to reflect the (slower) economic accrual of interest.

Recently, there has been a significant increase in the issuance of zero coupon tax-exempt bonds. The committee is concerned that taxpayers may acquire these obligations to generate tax losses to shelter income. Although it appears to be the position of the Internal Revenue Service that no loss is allowable based on the accrual of tax-exempt OID, some taxpayers have claimed that such losses are allowable. The committee believes that OID on municipal bonds should be accrued in the same manner as that provided for OID on obligations issued by corporations and other juridical entities. The committee intends no inference regarding the proper treatment of obligations acquired before the effective date of the bill.

Explanation of Provision

The bill requires the holders of discount obligations to accrue tax-exempt OID by using the constant interest method provided by present law for the holders of obligations issued by corporations and other entities. Under the bill, the basis of an obligation is increased by the amount of accrued tax-exempt OID. Thus, the holder of a zero coupon municipal bond will be entitled to claim economic losses realized on disposition of the bond. The bill also adopts a simplifying assumption for the determination of the issue price of tax-exempt OID bonds. Under this rule, in the case of an issue of bonds sold to the public, the issue price is considered to be the initial offering price to the public (other than bond houses and brokers) at which price a substantial number of the bonds were sold. This rule, which applies under current law where taxable bonds are sold for cash in a public offering, has the effect of insuring that all bonds in an issue have a single issue price.

Effective Date

This provision is effective for obligations issued after September 3, 1982 (the date of enactment of the Tax Equity and Fiscal Responsibility Act) and acquired after March 1, 1984.

Revenue Effect

This provision is estimated to increase fiscal year receipts by $3 million in 1984, $5 million in 1985, $7 million in 1986, $8 million in 1987, $10 million in 1988, and $13 million in 1989.

D. Tax Treatment of Corporations and Their Shareholders

1. Debt-financed Portfolio Stock (sec. 31 of the bill and sec. 246A of the Code)

Present Law

In general, a corporate shareholder can deduct 85 percent of dividends received from other corporations. Because the maximum rate of tax on corporate ordinary income is 46 percent, the maximum effective rate of tax on dividends received by a corporation is only 6.9 percent. When a corporation borrows the funds used to purchase dividend-paying stock, interest on the acquisition indebtedness generally is deductible against ordinary income. In some cases, these rules may permit corporations to make debt-financed portfolio stock investments which, but for the tax laws, would be uneconomic.

Reasons for Change

The purpose of the dividends received deduction is to prevent multiple taxation of income as it flows from the corporation that earns it to the ultimate noncorporate shareholder. When a corporation borrows money to finance purchases of portfolio stock, the conjunction of a dividends received deduction and an interest deduction can result in avoidance of substantial corporate-level taxes on corporate earnings. The problem is aggravated to the extent the distributing corporation is not paying full corporate taxes owing to the use of various tax preferences.

Explanation of Provision

The bill reduces the allowable dividends received deduction for dividends with respect to debt-financed portfolio stock (defined below).

Debt-financed portfolio stock

With respect to any dividend distribution, the term "debt-financed portfolio stock" is defined as any stock of a corporation if (i) as of the beginning of the ex-dividend date, the taxpayer does not own at least 50 percent of the total combined voting power of all classes of stock and at least 50 percent of the total number of all other classes of stock of the distributing corporation, and (ii) at some time during the base period there is portfolio indebtedness with respect to such stock. For purposes of this definition, the term base period means, with respect to any dividend distribution, the shorter of (i) the period beginning on the ex-dividend date for the most recent previous dividend on the stock and ending on the day before the ex-dividend date for such dividend, or (ii) the one-year period ending on the day before the ex-dividend date for such dividend.

The bill defines the term portfolio indebtedness to mean any indebtedness that is directly attributable to an investment in stock with respect to which a dividend is received. The bill contemplates that the directly attributable requirement will be satisfied if there is a direct relationship between the debt and an investment in stock. The bill does not contemplate the use of any allocation or apportionment formula or fungibility concept. Thus, for example, the bill does not apply merely as a result of (i) the existence of outstanding commercial paper that is issued by a corporation as part of an ongoing cash management program, or (ii) deposits received by a depositary institution as a part of the ordinary course of its business. However, if indebtedness is clearly incurred for the purpose of acquiring dividend-paying stock or otherwise is directly traceable to such an acquisition, the indebtedness would constitute portfolio indebtedness. Thus, for example, if stock is held in a margin account with a securities broker, the margin borrowing constitutes portfolio indebtedness. The same result would follow with respect to any nonrecourse loan secured, in whole or in part, by dividend-paying stock. This rule also applies when a taxpayer, close to an ex-dividend date, buys one stock and sells a similar stock short, closing out both positions just after the 16-day holding period. In any such a case, the short sale would be considered as borrowing directly attributable to the purchase of the long position.

Certain amounts attributable to a short sale treated as indebtedness.—For purposes of the definition of portfolio indebtedness, any proceeds attributable to a short sale are treated as indebtedness of the taxpayer for the period beginning on the day on which such amount is received and ending on the day the short sale is closed. This rule does not apply if no deduction is allowed to the short seller under section 263(h) (as added by the bill) for payments in lieu of dividends.

Controlled group of corporations.—The portfolio indebtedness is not required to be that of the holder of the dividend-paying stock to satisfy the directly attributable test of the bill. Thus, for example, the bill could apply to a case where one member of an affiliated group of corporations incurs the portfolio indebtedness and another member of the group acquires the dividend-paying stock.

Computation of allowable deduction

In lieu of the 85-percent deduction that is generally available (sec. 243(a)(1), sec. 244(a)(3), and sec. 245), the bill limits the deduction to a percentage determined by computing the product of 85 percent and 100 percent minus the average indebtedness percentage. This provision is not intended to provide any dividends received deduction in any case where no such deduction would otherwise be allowed. Under regulations prescribed by the Secretary, the average indebtedness percentage is obtained by dividing (i) the average amount of the portfolio indebtedness with respect to the stock during the base period, by (ii) the average amount of the adjusted basis of the stock during the base period. However, under regulations prescribed by the Secretary, any reduction in the amount allowable as a dividends received deduction under the rule is to be limited to the amount of the interest deduction allocable to the related dividend (including any short sale expenses related to short positions treated as debt for purposes of determining the average indebtedness percentage).

Special rule where stock is not held throughout the base period

For any stock that is not held by the taxpayer throughout the base period, the rules are applied by (i) taking into account only the portion of the base period during which the stock was held, and (ii) adjusting the average indebtedness percentage by multiplying the figure obtained under the general rule by a fraction the numerator of which is the number of days during the base period on which the taxpayer held the stock and the denominator of which is the number of days during the base period.

Exceptions

The bill provides exceptions for dividends eligible for the 100-percent dividends received deduction (generally determined under section 243(b)), and for dividends received by a small business investment company operating under the Small Business Investment Act of 1958.

Effective Date

The provision applies to stock the holding period for which begins after the date of enactment, in taxable years ending after such date. For this purpose, the holding period is to be deemed to begin notwithstanding that it may be suspended under section 246(c).

Revenue Effect

The revenue gain is estimated to be less than $10 million per year.

2. Certain Dividends from Regulated Investment Companies (sec. 32 of the bill and sec. 854(b) of the Code)

Present Law

Domestic corporations are generally entitled to a dividends received deduction with respect to dividends includible in their gross income. No similar deduction is available with respect to interest income. Individuals are generally entitled to exclude from gross income up to $100 of dividend income under present law, but no similar rule is available with respect to interest.

Mutual funds, or regulated investment companies ("RICs"), are generally not subject to Federal income taxes if they distribute their income to shareholders. If less than 75 percent of a RIC's gross income consists of dividends from domestic corporations, then the distributions to the RIC's shareholders are treated as part dividends, part other income, on a pro rata basis. However, if at least 75 percent of a RIC's gross income consists of dividends from domestic corporations, then all the amounts distributed by the RIC are treated as dividend income to such shareholders even though up to 25 percent of the RIC's gross income may consist of, say, interest income (sec. 854(b)).

The foregoing rules permit taxpayers to convert interest income into dividend income. Taxpayers have organized RICs to take advantage of this conversion opportunity.

Reasons for Change

The committee believes that present law provides an opportunity for the conversion into dividend income of interest income and other kinds of income which is unwarranted.

Explanation of Provision

The bill requires that 95 percent, rather than 75 percent, of a RIC's gross income constitute dividend income in order for all its distributions to be treated as dividend income eligible for the 85 percent dividends received deduction for corporate shareholders or the $100 dividend exclusion for individual shareholders. If less than 95 percent of a RIC's gross income constitutes dividend income, then only a portion of such distributions are to be treated as dividend income for purposes of computing the dividends received deduction and the $100 dividend exclusion.

In addition, the bill provides that, for this purpose, no payment to a RIC is to be treated as dividend income to it unless, had it not been a RIC, it would have been allowed a dividends received deduction under section 243 with respect to the payment. Thus, for example, if a RIC holds a share of stock for less than 16 days, no payment with respect to it will be treated as a dividend. Under section

246(c)(1)(A), no dividends received deduction would have been allowable had the RIC not been a RIC.

Effective Date

The provision is effective for all taxable years of a RIC beginning after the date of enactment of the bill.

Revenue Effect

This provision will increase fiscal year budget receipts by $19 million in 1985, $34 million in 1986, $36 million in 1987, $39 million in 1988, and $42 million in 1989.

3. Corporate Shareholder's Basis in Stock Reduced by Reason of Extraordinary Dividends (sec. 35 of the bill and secs. 246(c), 301(e), and 1059 of the Code)

Present Law

General

A corporation owning stock of another corporation generally is allowed a deduction equal to 85 percent of the amount of any dividends received with respect to that stock. However, the deduction is disallowed unless the stock is held for more than 15 days (more than 90 days in the case of preference dividends attributable to a period or periods aggregating more than 366 days). In determining whether the holding period requirement is satisfied, any period during which the taxpayer has an option to sell, is contractually obligated to sell, or has made (and not closed) a short sale of substantially identical stock or securities is excluded. The deduction is also disallowed if the taxpayer is under an obligation, pursuant to a short sale or otherwise, to make a payment corresponding to the dividend with respect to substantially identical stock or securities.

Gains and losses from the sale of capital assets are generally long-term if the assets have been held by the taxpayer for over 1 year, and short-term if held for 1 year or less. Net short-term gain (short-term gains exceeding short-term losses) is taxed at the maximum corporate rate of up to 46 percent to the extent it exceeds any net long-term loss.

Under present law, the receipt of a dividend by a corporate shareholder generally has no effect on the shareholder's basis in the stock with respect to which the dividend was received. As a result, a domestic corporation, for example, can buy shares of stock in another corporation in anticipation of receiving an extraordinary dividend that will be eligible for the dividends received deduction and that will reduce the value of the stock. After receiving the dividend, the corporation can sell the stock and claim the loss resulting from the decline in value of the stock as a short-term capital loss. The short-term loss will offset unrelated short-term gain which may otherwise be taxable at the maximum corporate tax rate of 46 percent. The transaction results in counterbalancing such gain with dividend income taxable at an effective rate of 6.9 percent. Thus, although the transaction may result in little or no economic cost or loss, a tax benefit of up to $0.391 per dollar of dividend income may be available.

Holding period

The 85-percent dividends received deduction is disallowed unless the taxpayer satisfies a 16-day holding period with respect to the dividend-paying stock (91 days in the case of dividends on certain preferred stock). The 16-day and 91-day holding periods do not include periods during which the taxpayer reduces or eliminates the risk of loss on the underlying stock by entering into a short sale of, acquiring an option to sell, or entering into a binding contract to sell substantially identical stock or securities. Under Treasury regulations, where preferred stock or bonds are convertible into common stock, the relative values, price changes, and other circumstances may be such that the bonds or preferred stock are treated as the common-stock-equivalent. Under the common-stock-equivalent standard, the Internal Revenue Service ruled that convertible preferred stock and common stock of the same issuer are substantially identical where there are no restrictions on conversion, the instruments have the same voting and dividend rights, for a substantial period the instruments sell at prices that do not vary significantly from the conversion ratio, and the price of the convertible preferred stock adjusts to any fluctuation in price of the common stock. Rev. Rul. 77-201, 1977-1 C.B. 250.

Basis

If the dividend consists of appreciated property, the amount of the dividend and the basis of the distributed property in the hands of the corporate shareholder will be its basis in the hands of the distributing corporation (adjusted for any gain recognized to the distributing corporation on the distribution). Furthermore, because the property has a carryover basis in the hands of the distributee, the period the property was held by the distributing corporation is tacked onto the distributee shareholder's holding period in determining whether gain realized on a subsequent disposition is long-term or short-term (sec. 1223(2)). Thus, if the distributed property has a low basis relative to its value and had been held by the distributing corporation for over a year, its sale by the corporate shareholder would result in long-term capital gain, subject to the alternative corporate capital gain tax rate of 28 percent, while a sale of the stock would result in a short-term loss. Alternatively, the corporate shareholder could contribute the distributed property to charity and be allowed a deduction for its full fair market value (sec. 170(e)(1)(A)).

Results

In recent years, publicly-held oil companies have transferred royalty interests carved out of long-held working interests in oil and gas leases to trusts and distributed units of interest in the trusts to their shareholders. The distribution of the units of interest generally is regarded as a dividend fully taxable to noncorporate shareholders but, for a corporate shareholder, the dividend is generally regarded as subject to the beneficial treatment applicable to dividends of property outlined above. When a dividend distribution of interests in a royalty trust is announced, a domestic corporate taxpayer can obtain such beneficial treatment by purchasing the stock before the dividend is paid and, after receiving the dividend and after satisfying the holding period requirement applicable with respect to the dividends received deduction (generally more than 15 days), sell the stock and dispose of the distributed property. To the extent the property has a low or zero basis in the hands of the distributing corporation, the need to satisfy the holding period requirement diminishes or disappears.

Similarly, if the distribution is of long-held property with a low basis relative to its value, it does not matter if the distribution does not qualify as a dividend. To the extent of the appreciation, a corporate shareholder would be in a position to convert short-term capital gain into long-term capital gain. To the extent of the property's basis, such a conversion would not be possible because present law already provides for a reduction in the stock basis in such a case (sec. 301(c)(2)).

Reasons for Change

Present law has generated several types of tax-motivated transactions which the committee believes should be discouraged. First, in the case of large dividends, corporations are buying stock shortly before the ex-dividend date and selling shortly after. They deduct a short-term capital loss on the stock and 85-percent of the dividend. For a corporation with a short-term capital gain, this transaction, in effect, converts that gain into 85-percent exempt income.

Second, when the distribution consists of appreciated property, corporations can convert short-term capital gain to long-term gain by selling the distributed property along with the stock. They get a short-term capital loss on the stock and a long-term capital gain on the distributed property.

Third, some corporations are engaging in straddle-like transactions by buying a dividend-paying stock and selling short similar securities (like convertible bonds). If the property sold short is not substantially identical, the dividends received deduction can be claimed and the short-sale expenses deducted in full against ordinary income. In effect, these transactions convert ordinary income into 85-percent exempt income.

When a stock pays an extraordinary dividend, the acquisition of the stock often may be viewed as the acquisition of two assets: the right to the distribution to be made with respect to the stock and the underlying stock itself. In instances in which the acquisition of stock is the acquisition of two assets, the committee concludes that it is appropriate to reduce the basis of the underlying stock to reflect the value of the distribution not taxed to a corporate distributee. In the committee's view, the failure of present law to apply a two asset analysis in cases of extraordinary distributions when the taxpayer's holding period in the stock is short leads to tax arbitrage opportunities of the type described above.

Also, present law denies the dividends received deduction in cases in which the taxpayer has entered into another position that significantly reduces, or eliminates, his risk of loss with respect to the stock. However, these rules are not comprehensive, and the committee believes they should be tightened. In the view of the committee, the holding of substantially similar positions that, in fact, reduce the taxpayer's risk of loss should result in a tolling of the holding period of dividend-paying stock, without regard to whether the stringent common-stock-equivalent standard is satisfied.

Explanation of Provision

Basis

The bill provides for a reduction in the basis of a share of stock held by a corporate shareholder by the non-taxed portion of any non-liquidating extraordinary dividend received with respect to such share if the share is sold or exchanged before it has been held by the taxpayer for more than 1 year. Extraordinary dividends are those which, in amount, equal or exceed 5 percent, in the case of a share of stock preferred as to dividends, and 10 percent, in the case of any other share of stock, of the corporate shareholder's adjusted basis in such share (determined without regard to this rule). All dividends received with respect to a share of stock which have ex-dividend dates within a period of 85 consecutive days are to be aggregated and treated as one dividend in determining whether the 5 percent or 10 percent test is met. Furthermore, all dividends received with respect to a share of stock which have ex-dividend dates during a period of 365 consecutive days are to be treated as extraordinary if their amounts total more than 20 percent of the corporate shareholder's adjusted basis in such share. The basis reduction resulting from any extraordinary dividend is to occur at the beginning of the ex-dividend date for such dividend. Special rules are provided for dividends received with respect to shares of stock having a substituted basis.

For purposes of the new rules, the amount of any distribution is, in the case of a distribution of property other than cash, the net fair market value of the distributed property at the time of the distribution. The non-taxed portion of any dividend is the amount of the dividend, as so determined, less any portion thereof includible in gross income and not offset by a dividends received deduction. However, for purposes of measuring the amount of a distribution for purposes of section 301(b)(1)(B)(ii) and section 301(d)(2), present law is not changed.

Holding period

The bill provides that the holding period of stock is reduced by any period during which the taxpayer (i) has an option to sell, is under a contractual obligation to sell, or has made (and not closed) a short sale of substantially identical stock or securities, (ii) is the grantor of an option to buy substantially identical stock or securities, or (iii) under regulations prescribed by the Secretary (subject to an exception for broker-dealers on their ordinary income or loss property) has otherwise reduced the risk of loss from holding the stock by reason of holding one or more positions in substantially similar property. An exception to this rule is provided for nondeep-in-the-money covered calls, as defined for purposes of the tax straddle rules (without regard to the requirement in those rules that the positions constitute capital assets in the hands of the taxpayer). This rule applies for purposes of the 16-day or 91-day holding period requirement of the dividends-received deductions under present law, as well as the more-than-one-year requirement under the provision of the bill relating to extraordinary dividends.

The committee intends the concept of "positions in substantially similar property" to be broader than the present law concept of "substantially identical stock or securities," but not as broad as the present law concept of "offsetting positions" in the anti-straddle loss deferral rules. The following transactions are examples of the types of transactions that are within the scope of the risk reduction rule for substantially similar positions: (i) a short sale of common stock when the taxpayer holds convertible preferred stock of the same issuer, and the price changes of the convertible preferred stock and the common stock are related (the same result would obtain in the case of a short sale of a convertible debenture while holding convertible preferred stock or common stock, or a short sale of convertible preferred stock while holding common stock); and (ii) the acquisition of a short position in a regulated futures contract ("RFC") on a stock index (or, alternatively, the acquisition of an option to sell the RFC or the stock index itself, or the grant of a deep-in-the-money option to buy the RFC or the stock index itself) while holding the stock of an investment company whose principal holdings are designed to mimic the performance of the stocks included in the stock index (or, alternatively, a portfolio composed of all but a *de minimis* number of the stocks included in the stock index). The bill contemplates that regulations setting forth the application of the risk reduction rule to the transactions identified above generally will be effective as of the date of enactment of the bill, but that such regulations will be applied prospectively to other risk reduction transactions. The committee intends no inference regarding the circumstances under which the dividends received deduction is disallowed under present law in cases where taxpayers enter into short sales of stock or securities of the same issuer.

Ordinarily, stock in one corporation would not be substantially similar to stock in another corporation. In addition, the risk reduction rule does not apply where the taxpayer (i) holds a single instrument that is designed to insulate the holder from market risks (*e.g.*, adjustable rate preferred stock that is indexed to the Treasury bill rate), or (ii) is an investor with diversified stock holdings and acquires an RFC or option on a stock index merely to hedge general market risks.

Other rules

For purposes of the new rules, a distribution which, had it qualified as a dividend, would have been an extraordinary dividend is to be treated as an extraordinary dividend even though the distributing corporation has no current or accumulated earnings and profits. In such a case, the amount of the distribution is to be reduced by the amount of any reduction in basis resulting from the application of section 301(c)(2). The new rules will apply whether or not the distribution is part of a redemption of stock.

In the case of any distribution of appreciated property with respect to a share of stock, whether or not a dividend and whether or not extraordinary, the distributee corporate shareholder shall not be treated as acquiring the property before the date on which it acquired such share if its basis in the property is determined with reference to its basis in the hands of the distributing corporation under section 301(d)(2).

To the extent a taxpayer is obligated to make a dividend-substitute or corresponding payment with respect to a position in substantially similar property, the dividend received deduction will not be allowed.

The Secretary is authorized to prescribe such regulations as may be appropriate to carry out the purposes of the new rules, including regulations governing their applicability in the case of stock dividends, stock splits, reorganizations, and other similar transactions. The committee contemplates that the regulations will provide, in the case of a transfer of stock in which the transferee's basis is determined with reference to the transferor's, that the transfer will not ordinarily constitute a disposition and that the transferor's holding period will be tacked on to the transferee's.

Effective Date

Except for the holding period rules, the foregoing provisions apply to distributions after the date of enactment. The holding period provisions are generally applicable with respect to stock acquired after the date of enactment.

Revenue Effect

These provisions will increase fiscal year budget receipts by $140 million in 1985, $100 million in 1986, $100 million in 1987, $100 million in 1988, and $100 million in 1989.

4. Distributions of Appreciated Property by Corporations (sec. 36 of the bill and sec. 311(d) of the Code)

Present Law

Under present law, a corporation generally does not recognize income on the distribution, with respect to its stock, of property. There are several exceptions to this rule. First, such a distribution will generally trigger recapture, as under section 1245 (relating to depreciable personal property). Second, the distribution of inventory accounted for on a LIFO basis will give rise to ordinary income to the extent of the difference between what the inventory amount of such inventory would have been had it been accounted for on a FIFO basis and what the inventory amount of such inventory is on the LIFO basis (sec. 311(b)). Third, if a corporation distributes property which is subject to a liability, or the shareholder assumes a liability of the corporation in connection with the distribution, gain is generally recognized to the corporation to the extent such liability exceeds the adjusted basis of the distributed property as if the property had been sold (sec. 311(c)). Fourth, if a corporation distributes property in a redemption to which sections 301 through 307 apply and the fair market value of such property exceeds its adjusted basis, gain in an amount equal to the excess is recognized to the corporation as if the property had been sold.

There are several exceptions to the rule requiring recognition of gain with respect to distributions of property in a redemption to which sections 301 through 307 apply. First, gain is not recognized with respect to distributions in a redemption of stock of certain corporate shareholders if the basis of the distributed property to the distributee is determined with reference to its adjusted basis in the hands of the distributing corporation (sec. 311(d)(2)(A)). Second, gain is not recognized with respect to certain distributions in redemption of stock of noncorporate shareholders if the distribution qualifies as a partial liquidation (sec. 311(d)(2)(B)). Third, gain is not recognized with respect to distributions in a redemption of stock qualifying under section 311(e)(2) (relating to distributions of stock or securities of certain controlled corporations to persons holding qualified stock, as defined in section 311(e)) or section 303(a) (relating to distributions to pay death taxes), certain distributions to private foundations, and certain distributions by regulated investment companies.

Reasons for Change

In many situations, present law permits a corporation to distribute appreciated property to its shareholders without recognizing the gain. In such a case, if the distributee is an individual, the basis of the property will be stepped up without any corporate-level tax having been paid (although the individual shareholder will often have dividend income in an amount equal to the fair market value of the property). The committee believes that under a double-tax system, the distributing corporation generally should be taxed on any appreciation in value of any property distributed in a non-liquidating distribution. For example, had the corporation sold the property and distributed the proceeds, it would have been taxed. The result should not be different if the corporation distributes the property to its shareholders and the shareholders then sell it. Furthermore, if the shareholder is a corporation, present law generally permits gain on distributed property to be deferred, until the shareholder sells it. The committee generally believes that deferral to be inappropriate.

Explanation of Provisions

Under the bill, gain (but not loss) is generally recognized to the distributing corporation on any ordinary, non-liquidating distribution, whether or not it qualifies as a dividend, of property to which subpart A (secs. 301 through 307) applies as if such property had been sold by the distributing corporation for its fair market value rather than distributed. The general rule applies whether or not there is a redemption of stock.

If the distribution is in redemption of stock, the present-law exceptions to the recognition of gain generally remain, with 2 exceptions. First, gain is to be recognized if the distribution in redemption is to a domestic corporate shareholder unless such shareholder is then an 80 percent or more shareholder, that is, unless it owns, at the time of the distribution, stock possessing at least 80 percent of the total combined voting power of all classes of stock of the distributing corporation and at least 80 percent of the total number of all other classes of stock of the distributing corporation (not including nonvoting stock which is limited and preferred as to dividends). Furthermore, the distributee is not to be treated as an 80 percent or more shareholder unless the distributee's basis in the distributed property is determined with reference to its basis to the distributing corporation (determined without regard to this section). Second, gain is not to be recognized if the distribution (i) qualifies as a partial liquidation under section 302(b)(4), or (ii) is a qualified dividend (described below).

If the distribution is not in redemption of stock, gain is to be recognized in full unless (1) the distribution is to a corporation that at the time of the distribution is an 80 percent or more shareholder (as determined above), or (2) section 311(d)(2)(C) (relating to distributions of stock or obligations of certain controlled corporations) applies.

In addition, if the distribution is not in redemption of stock, gain is not to be recognized to the distributing corporation with respect to property distributed to a shareholder other than a corporation to the extent the distribution is a qualified dividend. A qualified dividend is a distribution of property which is a dividend, is of property used by the distributing corporation immediately before the distribution in the active conduct of a trade or business, and is not property described in section 1221(1) relating to inventory or certain other assets) or section 1221(4) (relating to certain accounts and notes receivables). Furthermore, the dividend must be with respect to qualified stock, as defined in section 311(e). The committee intends that the distribution of property described in either section 1221(1) or section 1221(4) is to be treated as made out of earnings and profits to the extent thereof.

The bill also provides that section 311(b) (relating to distributions of LIFO inventory) and section 311(c) (relating to liabilities in excess of adjusted basis) are to be applied before any of the other provisions. Thus, for example, assume that a corporation distributes LIFO inventory to an individual shareholder not in a redemption of stock. Assume further that the LIFO inventory amount is $100, its FIFO inventory amount is $125, and the inventory is worth $120. The distribution corporation would have ordinary income of $25. If the inventory is worth $130, the distributing corporation would have ordinary income of $30.

The committee intends no change in the applicability of the recapture rules of present law, except as indicated.

Effective Date

The provisions are effective with respect to distributions declared after March 15, 1984. However, the provisions do not apply to distributions made before February 1, 1986, of property held by certain corporations acquired by a common parent during the 1-year period ending February 1, 1984. Nor do the provisions apply to certain distributions made before February 1, 1986, of interests in a publicly traded partnership more than 80 percent of which was owned by the distributing corporation (or any member of an affiliated group of which the distributing corporation was a member) on March 7, 1984.

Revenue Effect

This provision will increase fiscal year budget receipts by $3 million in 1984, $18 million in 1985, $64 million in 1986, $114 million in 1987, $169 million in 1988, and $227 million in 1989.

5. Capital Gains Distributions from Regulated Investment Companies and Real Estate Investment Trusts (sec. 37 of the bill and secs. 852(b)(4) and 857(b)(7) of the Code)

Present Law

Generally, regulated investment companies ("RICs") that distribute their income are not subject to Federal income taxes. Rather, that income is taxed directly to their shareholders.

RICs frequently realize long-term capital gain income. That income is generally treated as long-term capital gain income to the shareholders. Under these rules, a person can buy stock of a RIC immediately before the ex-dividend date for a distribution of long-term capital gain income by the RIC and sell the stock shortly thereafter. The distribution will reduce the value of the stock so that the shareholder will have a loss when he sells it. Under present law, if the stock is held for less than 31 days, the loss, to the extent of any long-term capital gain resulting from the distribution, is treated as long-term capital loss. However, if the shareholder holds the stock for 32 days but not more than 1 year, the loss, if capital in character, is short-term. Similar rules apply with respect to real estate investment trusts ("REITs")

Under these rules, a person can convert short-term capital gain into lower-taxed long-term capital gain by buying RIC or REIT stock immediately before the ex-dividend date of a long-term capital gain distribution, waiting 32 days, and then selling the stock.

Reason for Change

The committee believes that present law offers too much of an opportunity to convert short-term capital gain into long-term capital gain. The committee believes that the 31-day holding period requirement should be lengthened to discourage taxpayers from making tax-motivated purchases of RIC or REIT stock shortly before ex-dividend dates for capital gains distributions.

Explanation of Provision

If a shareholder of a RIC or REIT holds its stock for 6 months or less, any loss recognized on the sale of such stock is to be treated as long-term capital loss to the extent of any distribution to him with respect to such stock which is treated as long-term capital gain. There is an exception for dispositions of stock pursuant to a periodic redemption plan. In determining how long a shareholder has held stock of a RIC or REIT for this purpose, rules similar to those of section 246(c), as amended by the bill, are to apply.

Effective Date

The provisions are applicable to losses incurred on stock with respect to which the taxpayer's holding period begins after the date of enactment of the bill.

Revenue Effect

This provision will increase fiscal year budget receipts by less than $5 million in 1985, $83 million in 1986, $89 million in 1987, $96 million in 1988, and $103 million in 1989.

6. Denial of Deductions for Certain Expenses Incurred In Connection with Short Sales (sec. 41 of the bill and secs. 163(d), 263, and 265 of the Code)

Present Law

If a distribution becomes payable on stock with respect to which the taxpayer has made a short sale, the taxpayer is generally required to pay an amount equal to the fair market value of the distribution to the lender of the stock sold short. The Internal Revenue Service has ruled that this payment in lieu of a dividend is fully deductible. Rev. Rul. 72-521, 1972-2 C.B. 178; and Rev. Rul. 62-42, 1962-1 C.B. 133. In general, the stock may be expected to decline in value by an amount equivalent to the fair market value of the distribution, and the taxpayer can close out the short sale and realize a short-term capital gain approximately equal to the dividend-substitute payment. Net capital loss from other transactions, the deductibility of which would otherwise be limited, may be deducted against the short-term gain from the short sale and be replaced by a current deduction against ordinary income.

Present law limits the deduction of investment interest generally to an amount equal to net investment income plus $10,000. Investment interest is defined as interest paid or accrued on indebtedness incurred or continued to purchase or carry investment property but does not specifically include any amount to carry personal property used in a short sale. Present law also disallows a deduction for interest relating to tax-exempt interest but does not specifically extend the disallowance to costs to purchase or carry property used in a short sale.

Reasons for Change

The short sale transaction described above provides a means to avoid the limitations on the deductibility of capital losses through a scheme lacking substantial economic substance. A taxpayer may sell stock short just before the ex-dividend date, deduct his payment in lieu of the dividend against ordinary income, and realize an offsetting short-term capital gain upon closing the short sale. Capital losses, whose deductibility against ordinary income is limited, may be deducted against the short-term capital gain. For a taxpayer with both long-term capital gain and short-term capital loss, the transaction is also attractive, because it, in effect, converts ordinary income into long-term capital gain.

In the case of large dividends, these short sale transactions prior to ex-dividend dates are widely used to avoid tax. For example, Chrysler Corp. recently paid a large dividend on 10 million shares of preferred stock. At the time of the ex-dividend date, short sales of the preferred stock exceeded 6 million shares.

Under the two-asset analysis discussed above in relation to the dividends received deduction for extraordinary dividends, there should be capitalization of the present value of the dividend-substitute payment at the time of the short sale. The committee decided that a present-value adjustment would add too much complexity to the proposal and, therefore, agreed to require capitalization of the full amount of the dividend-substitute payment.

Furthermore, costs incurred in a short sale for the use of property to produce investment income or exempt interest have the same function relative to such investment income or exempt interest as interest, the deduction of which is limited or disallowed under present law. The committee believes that the tax treatment of interest and short sale expenses should be conformed.

Explanation of Provision

The bill disallows the deduction of any amount paid by reason of the payment of a distribution (whether or not a dividend) on stock used by the taxpayer in a short sale if the short sale is closed on or before 15 days after the date of the short sale (on or before the day one year after the date of the short sale in the case of any amount paid by reason of an extraordinary dividend, generally as defined in sec. 35 of the bill). The amount disallowed as a deduction is charged to capital account and added to the basis of the stock used to close the short sale.

In determining how long a short sale is kept open, there is not to be included any period during which the taxpayer holds, has an option to buy, or is under a contractual obligation to buy, substantially identical stock or securities or is otherwise substantially protected from the risk of loss from the short sale by reason of the holding of one or more positions in substantially similar property. The concept of "subtantially similar property" is described above in the explanation of the provision relating to extraordinary dividends.

The provisions restricting the deduction of investment interest and disallowing interest relating to tax-exempt interest are extended to costs incurred to carry property used in a short sale which are not required to be capitalized as described above. This rule is applicable regardless of whether the property sold short is equity or debt.

Effective Date

The above provisions are applicable with respect to short sales after the date of enactment, in taxable years ending after such date.

Revenue Effect

This provision will increase fiscal year budget receipts by $22 million in 1984, $32 million in 1985, $38 million in 1986, $43 million in 1987, $48 million in 1988, and $54 million in 1989.

7. Corporate Stock Warrants (sec. 42 of the bill and sec. 1032 of the Code)

Present Law

Prior to the Tax Reform Act of 1976, gain to the grantor of an option to buy property arising from the failure of the holder to exercise it generally resulted in ordinary income to the grantor. In Rev. Rul. 72-198, 1972-1 C.B. 223, the Internal Revenue Service stated its position that the general rule applied with respect to warrants issued by a corporation to acquire its own stock, reasoning that warrants are a kind of option. Under the Service's position, a corporation would have $2 of ordinary income if a warrant it issued for $2 lapsed without being exercised. Similarly, the Service has allowed a corporation to deduct a loss if it bought back warrants to acquire its own stock for more than it received upon their issuance.

The Service's position is arguably inconsistent with some old case law. For example, *Illinois Rural Credit Association*, 3 B.T.A. 1178 (1926), held that subscription payments made to a corporation as a down payment on the purchase of stock of the corporation were not includible in the corporation's income when they were forfeited to the corporation. The transaction was viewed as capital in character.

The Tax Reform Act of 1976 changed the rules applicable to options to buy property (sec. 1234). Under those rules, gain or loss to the grantor of an option from any closing transaction with respect to, and gain on the lapse of, such an option is treated as short-term capital gain or loss. However, the legislative history of the new rules indicated that Congress was aware of, and taking no position on, the question whether a corporation realizes income when warrants to purchase its stock from it expire unexercised, or lapse. The Service continues to adhere to its position that warrants should be treated like other options.

Section 1032 provides that a corporation recognizes no gain or loss on the receipt of money or other property in exchange for its stock. Furthermore, a corporation does not recognize gain or loss when it redeems its stock, with cash, for less or more than it received when the stock was issued.

Present law treats the issuance of notes and warrants together as coming within the investment unit rules of the original issue discount rules.

Reasons for Change

Present law may put the Service into an unacceptable position. If a corporation issues a warrant for $2 and buys it back for $1, it may argue that, notwithstanding Rev. Rul. 72-198, it recognizes no income, citing *Illinois Rural Credit Association* and other authorities. If the corporation's stock goes up in value and the corporation buys the warrant back for $3, it is likely to claim a loss, citing Rev. Rul. 72-198. The committee desires to end this possible discontinuity and provide clear rules for the treatment of gain or loss to a corporation on any lapse or repurchase by the corporation of a warrant it issued to acquire its stock. The committee believes that the repurchase of a warrant by the issuing corporation should not produce different tax consequences to the corporation than an exercise of the warrant followed by a repurchase by the corporation of the newly-issued stock.

Explanation of Provision

Under the bill, a corporation does not recognize gain or loss on any lapse or repurchase of a warrant it issued to acquire its stock. The committee does not intend to change present-law treatment of nonqualified employee stock options.

Effective Date

The provision is applicable to warrants acquired or lapsing after the date of enactment of the bill, in taxable years ending after such date.

Revenue Effect

This provision will increase fiscal year budget receipts by less than $5 million annually.

8. Accumulated Earnings Tax (sec. 43 of the bill and secs. 532 and 535(b) of the Code)

Present Law

Section 531 *et seq.* impose an accumulated earnings tax on a corporation that is formed or availed of for the purpose of avoiding the income tax with respect to shareholders by permitting earnings and profits to accumulate instead of being distributed. The fact that a corporation is a mere holding or investment company is *prima facie* evidence of a tax avoidance motive. In the case of other corporations, an accumulation of earnings and profits beyond the reasonable needs of the business is determinative of a tax avoidance purpose unless the corporation proves to the contrary.

Where applicable, the accumulated earnings tax is imposed at a rate of 27½ percent of the first $100,000 of accumulated taxable income and at a rate of 38½ percent of accumulated taxable income in excess of $100,000. The term "accumulated taxable income" means taxable income, with certain adjustments, reduced by a deduction for any dividends paid. In determining accumulated taxable income, a corporation is permitted to deduct any net capital loss during the year in question. However, a net capital loss is not allowed as a deduction against taxable income (but can be carried back or forward as a deduction against capital gain). A corporation is also permitted to deduct from accumulated taxable income its net capital gain, determined without regard to capital loss carrybacks or carryovers, less taxes attributable to such capital gain.

Reasons for Change

The deduction from accumulated taxable income for net capital losses was introduced in 1936. Presumably, its purpose was to permit a corporation to accumulate income in order to restore losses sustained in the course of its business. While there may have been ample justification for the deduction in 1936, there is little justification today. As a result of a series of provisions enacted beginning in 1939, business losses are now very seldom treated as capital losses.

The special deduction for net capital losses is particularly difficult to justify in the case of a mere holding or investment company. Allowing such a company to deduct net capital losses is inconsistent with the treatment of qualified regulated investment companies and real estate investment trusts. These entities are required to distribute a high percentage of their income annually and, for this purpose, net capital losses are not allowed as a deduction in determining their income.

A rather elaborate scheme has been utilized by a number of investment companies to exploit the special deduction from accumulated taxable income for net capital losses. Under this scheme, an investment company that does not elect to be taxed as a regulated investment company is formed to accumulate dividend income, with the intention that neither the shareholders nor the corporation itself will pay more than a minimal amount in current taxes. Its stock is widely-held.

The corporation's assets are invested primarily in dividend-paying stock so that, for the most part, the corporation's income will be dividends eligible for the 85-percent dividends received deduction. To the extent of slightly more than the remaining 15 percent of income, the corporation will have deductible expenses consisting of management fees, brokerage fees, interest, and other items. Consequently, the corporation will have no regular taxable income. The 85 percent dividends received deduction will not shield the corporation from the accumulated earnings tax, however, because the dividends received deduction is added back to taxable income in computing accumulated taxable income.

Initially, the corporation may contend that because its shares are publicly-held, it is not subject to the accumulated earnings tax. However, if the corporation is nominally subject to the accumulated earnings tax, it may avoid actual liability for the tax almost completely by carefully structuring the timing of its capital gains and losses. For example, the corporation might for several years arrange to realize an annual capital loss equal to the amount of dividends received during the year (less operating expenses). Because net capital losses are allowed as a deduction from accumulated taxable income, the corporation would not be subject to the accumulated earnings tax in these years.

The corporation then might take all of its capital gains in one year. These capital gains would not be subject to regular income tax to the extent that they are offset by the capital losses sustained in earlier years. Moreover, these capital gains for the most part would not be subject to the accumulated earnings taxes. The allowance of a deduction for net capital losses as well as a deduction for net capital gains realized in subsequent years (not reduced by capital loss carryovers), less taxes attributable thereto, in determining accumulated taxable income effectively permits the capital losses to be taken into account twice.

The committee knows of no reason why widely-held companies should be automatically exempt from the accumulated earnings tax. Nor can it justify the deductions from accumulated taxable income of both net capital losses and net capital gains, as permitted under present law.

Explanation of Provisions

The bill provides that the mere fact that the stock of a corporation is widely-held does not exempt it from imposition of the accumulated earnings tax. No inference is intended as to the applicability of the tax in such circumstances under present law. This rule applies to operating companies as well as mere holding or investment companies. However, although the requisite tax avoidance purpose may be inferred in an appropriate case, the committee acknowledges that, as a practical matter, it may be difficult to establish such a purpose in the case of a widely-held operating company where no individual or small group of shareholders has legal or effective control of the corporation.

Under the bill, the deduction from accumulated taxable income for net capital gain, less taxes attributable thereto, remains. Nor is any change made in the method of determining the taxes attributable to the net capital gain. However, in determining net capital gain for this purpose, net capital loss for any taxable year shall be treated as short-term capital loss during the next taxable year. Furthermore, the deduction from accumulated taxable income for net capital loss sustained during the taxable year generally remains. However, that latter deduction is subject to reduction.

In general, the reduction is equal to any deduction from accumulated taxable income, for preceding taxable years beginning after the date of enactment, for net capital gain, less regular taxes attributable thereto. However, in no event is the same net capital gain, less taxes attributable thereto, to be used to reduce the deduction for net capital loss more than once. Furthermore, if the corporation's accumulated earnings and profits as of the close of the preceding taxable year are less than the reduction that would otherwise be made for a taxable year, the reduction for that taxable year is to be limited to the amount of such accumulated earnings and profits.

The rule of present law that capital loss carrybacks and carryforwards do not reduce accumulated taxable income remains.

Three special rules are provided for mere holding or investment companies, as that term is applied under the accumulated earnings tax provisions. First, they are allowed no deduction from accumulated taxable income for net capital loss. Second, no net capital loss is to be allowed as a carryover in determining accumulated taxable income. Third, for all purposes of subchapter C (sec. 301 through sec. 385), accumulated earnings and profits shall not be less than they would have been had section 535(b), as amended by the bill, applied to all taxable years beginning after the date of enactment.

Effective Date

The provisions apply to all taxable years beginning after the date of enactment of the bill.

Revenue Effect

This provision will increase fiscal year budget receipts by $62 million in 1985, $78 million in 1986, $33 million in 1987, $35 million in 1988, and $36 million in 1989.

9. Distributions By a Corporation of Debt Obligations Having a Fair Market Value Less Than Par (sec. 47 of the bill and sec. 312 of the Code)

Present Law

A distribution by a corporation constitutes a dividend only if out of current or accumulated earnings and profits. The fair market value of property distributed as a dividend is includible in the gross income of an individual shareholder.

A corporation can distribute as a dividend its own debt obligations. Those obligations may have a fair market value less than their face amount. That is, they may carry a stated interest rate which is below the prevailing market rate. In such a case, an individual shareholder would have dividend income in an amount equal to the value of the obligations distributed to him. But the corporation may contend that, under present law, it can reduce its earnings and profits by the principal amount of such obligations (sec. 312(a)). The result could be to eliminate earnings and profits at the cost of a relatively small dividend tax. Distributions made by a corporation with no earnings and profits are not dividends but a return of capital.

Furthermore, taxpayers may argue that, under present law, such an obligation is not subject to the original issue discount rules. If that is correct, a shareholder on the cash basis may report no income with respect to the discount until it is paid, and the income may qualify as capital gain. Similarly, an accrual basis obligor may claim interest deductions currently on a straight-line or ratable rather than a constant rate basis, thereby accelerating deduction of the discount.

Reasons for Change

The committee does not believe that a dividend distribution should reduce earnings and profits by more than the amount includible as a dividend in the gross income of an individual recipient of such a distribution. Furthermore, the committee believes that obligations distributed by a corporation that bear economic discount should be subject to the general original issue discount rules.

Explanation of Provisions

In the case of a dividend distribution by a corporation of its own debt securities at a discount, the corporation's earnings and profits are to be reduced by the issue price of the securities at the time of the distribution (determined under the original issue discount rules). Furthermore, any such securities are to be subject to the original issue discount rules. These provisions apply, however, only if the instruments distributed in fact represent indebtedness of the distributing corporation rather than equity. The provisions are not intended to create any inference that purported debt obligations distributed by a corporation should be treated as debt. The characterization of such instruments is governed by generally applicable provisions of present law. Furthermore, no inference is intended as to the proper treatment with respect to discount instruments distributed as dividends under present law.

Effective Date

These provisions apply to distributions declared after March 15, 1984.

Revenue Effect

This provision will increase fiscal year budget receipts by less than $10 million annually.

10. Phaseout of Graduated Rate for Large Corporations*

(Sec. 44 of the bill and sec. 11 of the Code)

Present Law

Corporate taxable income is subject to tax under a five-step graduated tax rate structure. The top corporate tax rate is 46 percent on taxable income over $100,000.

The corporate taxable income brackets and tax rates are presented in the following table:

Taxable income:	*Tax rate*
0-$25,000	15
$25,000-$50,000	18
$50,000-$75,000	30
$75,000-$100,000	40
Over $100,000	46

For corporations whose income is $100,000, the corporate tax is $20,250 less than would be the case under a 46-percent flat rate.

Reasons for Change

The graduated corporate tax rates were added in 1978 to ease the tax burden on small business. However, large corporations, as well as small corporations, are entitled to these benefits. The committee believes that large corporations should not be able to take advantage of this small business provision. Therefore the benefits of the graduated tax rates are generally eliminated for any corporation with large income.

Explanation of Provision

An additional 5-percent corporate tax will be imposed on a corporation's taxable income in excess of $1 million. However, the maximum additional tax will be $20,000. Thus, all but $250 of the benefit of the graduated rates will be eliminated for corporations with income in excess of $1.4 million.

For purposes of applying these rules, the component members of a controlled group of corporations (under section 1561) will be treated as one corporation.

Effective Date

The provision will apply to taxable years beginning after December 31, 1983.

*This provision was contained in S. 2062 reported by the Senate Committee on the Budget on November 4, 1983.

Revenue Effect

This provision will increase fiscal year budget receipts by $70 million in 1984, $212 million in 1985, $185 million in 1986, $190 million in 1987, $192 million in 1988, and $194 million in 1989.

11. Corporate Tax Preferences (sec. 45 of the bill and sec. 291 of the Code)

Present Law

Under present law, corporations pay a minimum tax on certain tax preferences. The tax is in addition to the corporation's regular tax. The amount of the minimum tax is 15 percent of the corporation's tax preferences in excess of the greater of the regular income tax paid or $10,000.

The tax preference items included in the base for the minimum tax for corporations are:

(1) Accelerated depreciated on real property in excess of straight-line depreciation over the useful life or recovery period (in the case of property eligible for ACRS, 15 years);

(2) Amortization of certified pollution control facilities (the excess of 60-month amortization over depreciation otherwise allowable);

(3) In the case of certain financial institutions, the excess of the bad debt deductions over the amount of those deductions computed on the basis of actual experience;

(4) Percentage depletion in excess of the adjusted basis of the property; and

(5) 18/46 of the corporation's net capital gain.

In addition, present law provides for a 15-percent cutback in certain corporate tax preferences. Adjustments are made to the corporate minimum tax to prevent the combination of that tax and the cutback provision from unduly reducing the tax benefit from a preference.

The cutback applies to the following items as described below:

(1) Depletion for coal and iron ore.—The excess of percentage depletion otherwise allowable for iron ore and coal (including lignite) over the adjusted basis of the property is reduced by 15 percent. However, only 71.6 percent [1] of the excess of the allowable depletion allowances for these minerals over the adjusted basis of the

[1] The 71.6 percent figure is what is needed to prevent the combination of the add-on minimum tax and the 15-percent preference cutback from reducing the tax benefit from the taxpayer's marginal dollar of preference by more than it is currently cut back by the minimum tax for a taxpayer who has a 46-percent marginal regular tax rate, paid more than $10,000 of regular tax and had tax preferences in excess of regular tax liability.

Consider, for example, a taxpayer with $100 of percentage depletion. He received a regular tax benefit of $46 from the preference under prior law. However, the preference led to a direct minimum tax of $15 (the 15-percent minimum tax rate times the $100 preference), as well as an indirect minimum tax of $6.90 through the reduction in the deduction for regular taxes under the minimum tax ($46 times 15 percent). Thus, the net tax benefit from the preference, at the margin, was $24.10.

Under the preference cutback, the depletion deduction is reduced to $85, reducing its regular tax benefit to $39.10 (46 percent times $85). Including only 71.6 percent of the preference ($60.86) in the minimum tax reduces the direct minimum tax to $9.13 (15 percent times $60.86). Together with the indirect minimum tax through the reduction in the deduction for regular taxes (15 percent times $39.10, or $5.87), this reduces the total tax benefit from the preference to $24.10 ($39.10 minus $9.13 minus $5.87). Thus, the tax benefit from this taxpayer's marginal dollar of percentage depletion is the same as it was prior to the enactment of section 291.

property is treated as a corporate tax preference under the minimum tax (under section 57(a)(8)).

(2) Bad debt reserves.—The bad debt reserve deduction (under sec. 585 or 593) is reduced by 15 percent of the amount by which the otherwise allowable deduction exceeds the amount which would have been allowable on the basis of actual experience. Only 71.6 percent of the excess of the allowable deduction over what would be allowable based on actual experience is treated as an item of tax preference under the mimimum tax (under sec. 57(a)(7)).

(3) Tax exempt interest.—In the case of a financial institution, 15 percent of the otherwise allowable interest deduction allocable to debt incurred or continued to purchase tax-exempt obligations acquired after 1982 is disallowed.

(4) DISC.—The deemed dividend distribution by a domestic international sales corporation (DISC) to a corporate shareholder (under sec. 995(b)(1)(F)(i)) is increased by 15 percent, to 57½ percent of certain taxable income. This change has the effect of reducing the tax benefit from DISC by 15 percent.

(5) Section 1250 property.—The amount treated as ordinary income on the sale or other disposition (including certain nonrecognition transactions) of section 1250 property (real estate) by a corporation is increased by 15 percent of the additional amount which would be treated as ordinary income if the property were subject to recapture under section 1245 (the rule applicable to personal property). The minimum tax preference for the remaining 85 percent of the capital gain which would have been ordinary income under section 1245 is reduced by 28.4 percent (i.e., will equal 71.6 percent of $^{18}/_{46}$ of the gain, or approximately 28 percent of the gain).

(6) Pollution control facilities.—Fifteen percent of the basis of pollution control facilities to which an election under section 169 applies is treated as if the election did not apply. The minimum tax preference for the remaining property for which 5-year amortization is elected will be reduced by 28.4 percent.

(7) Intangible drilling costs.—In the case of an integrated oil company, 15 percent of the amount otherwise allowable as a deduction for intangible drilling costs under section 263(c) is capitalized to the oil, gas or geothermal property and deducted ratably over a 36-month period beginning with the month the costs are paid or incurred.

(8) Mineral exploration and development costs.—Fifteen percent of the amounts otherwise allowable as deductions under section 616 and 617 to a corporation are capitalized and treated as if they were used to acquire recovery property assigned to the 5-year class. ACRS deductions are allowed beginning with the year the expenses are paid or incurred, and the investment tax credit is available in the year the expenses are paid or incurred.

Reasons for Change

The committee believes that some of the tax preferences enacted over the years should be scaled back further in light of the large budget deficits. For this reason, the present 15-percent cutback is increased to 20 percent.

Explanation of Provision

The bill will increase the 15-percent preference cutback to 20 percent. The benefits of the new FSC legislation in the bill will be reduced by 5/85 in the case of a corporate FSC shareholder. The 71.6 percent preference inclusion rule for the add-on minimum tax will be decreased to 59 5/6 percent.[2]

Effective Dates

The provisions generally apply to taxable years beginning after December 31, 1984. However, the provision relating to deductions under secs. 263(c), 616 and 617 applies to expenditures made after that date; the provision relating to pollution control facilities applies to property placed in service after that date; and the provision relating to section 1250 property applies to dispositions after that date.

Revenue Effect

The provision will increase fiscal year budget receipts by $260 million in 1985, $367 million in 1986, $410 million in 1987, $460 million in 1988, and by $524 million in 1989.

[2] The 59 5/6 percent figure is derived as follows: A taxpayer with $100 of percentage depletion received a tax benefit, at the margin, of $24.10 as explained in the previous footnote. Under a 20-percent preference cutback, the depletion deduction is reduced to $80, reducing its regular tax benefit to $36.80 (46 percent times $80). Including only 59 5/6 percent of the preference ($47.87) in the minimum tax reduces the direct minimum tax to $7.18 (15 percent times $47.87). Together with the indirect minimum tax through the reduction in the deduction for regular taxes (15 percent times $36.80, or $5.52), this reduces the total tax benefit of the preference to $24.10 ($36.80 minus $7.18 minus $5.52). Thus the tax benefit from this taxpayer's marginal dollar of percentage depletion will be the same as under pre-1982 law.

12. Golden Parachutes (sec. 46 of the bill and secs. 280F and 4999 of the Code)

Present Law

Present law generally allows corporations a deduction for all the ordinary and necessary expenses paid or incurred during the taxable year in carrying on a trade or business. For this purpose, reasonable allowances for salaries or other compensation for personal services actually rendered qualify as ordinary and necessary trade or business expenses.

Reasons for Change

The committee understands that corporations anticipating the possibility of a hostile takeover attempt frequently, as a defensive tactic, enter into "golden parachute" contracts with key personnel. Golden parachute contracts come in several forms. Under a typical golden parachute contract, the corporation agrees to make special payments to a key officer in the event that the corporation is successfully taken over. Frequently, those payments are greatly in excess of the individual's historic compensation.

Corporations using golden parachute contracts often defend them on the ground that they encourage key personnel, who might otherwise resign for fear of losing their positions in the event of a takeover, to stay with the corporation. They also sometimes argue that it is in the best interest of the corporation and its shareholders, employees, and customers, etc. that the corporation not be taken over and that golden parachute contracts reduce the likelihood of that happening. In either event, they argue, payments under golden parachute contracts are ordinary and necessary trade or business expenses.

The committee, on the other hand, is concerned that in many instances golden parachute contracts do little but assist an entrenched management team to remain in control. They also may provide corporate funds to subsidize officers or other highly compensated individuals. The committee is unwilling to permit the tax law to be used as a subsidy in such situations. In fact, the committee believes that a tax penalty should be exacted in those situations.

Explanation of Provisions

In general, it is to be presumed that all payments under golden parachute contracts are in excess of a reasonable allowance for salaries or other compensation for personal services actually rendered and, therefore, are not deductible. Furthermore, a nondeductible excise tax of 20 percent of such payments is to be imposed on the recipient, in addition to regular income taxes.

The presumption is rebuttable. However, the presumption may be rebutted only by a showing that the payments are reasonable allowances for salaries or other compensation for personal services actually rendered. It may not be rebutted by a showing that the payments otherwise qualified as an ordinary and necessary trade or business expense. If the presumption is not rebutted, none of the payments under the contract will be deductible and all will be subject to the 20-percent excise tax.

A golden parachute contract generally is any contract entered into by a corporation with any officer, shareholder, or highly compensated individual (including any independent contractor) providing, at the time of execution, for contingent payments of cash (or property) which are to be paid in event of a change (or threatened change) in ownership or control of the corporation (or of a significant portion of its assets). Furthermore, the present value of the contingent payments (determined as of the time the contingency occurs) must exceed 200 percent of the highest annual compensation income of the individual from the corporation includible in gross income during the 5-taxable year period ending with the end of the individual's taxable year immediately preceding the execution of the contract. The present value of the contingent payments is to be determined under section 1274 (as added by the bill). The rules are applicable whether or not an individual is terminated.

The bill also provides that payments under golden parachute contracts, like termination pay, are to be subject to FICA taxes when paid.

To the extent provided by regulations, any contracts which the Securities and Exchange Commission classifies as unreasonable in situations involving the threatened takeover of a corporation will also constitute golden parachutes contracts for purposes of these provisions.

Effective Date

The provisions are applicable to payments under contracts entered into after March 15, 1984.

Revenue Effect

This provision will increase budget receipts less than $5 million per year.

13. Earnings and Profits (sec. 47 of the bill and sec. 312 of the Code)

Present Law

Under present law, distributions by corporations to shareholders are treated by the shareholders as dividends (and taxed at ordinary income rates) only to the extent such distributions are out of current or accumulated earnings and profits. Distributions in excess of earnings and profits are treated as a return of capital and reduce the shareholder's basis in his or her share of stock. Distributions in excess of basis are treated as gain from the sale or exchange of the stock. In general, a corporation's earnings and profits are intended to be a measure of the earnings of the corporation, which are treated as available for distribution to its shareholders. However, in many instances earnings and profits are substantially less than the corporation's economic income.

The effect on the earnings and profits of a corporation of a distribution by the corporation in redemption of shares of its own stock is determined by reference to section 312(e). That section provides that the part of a distribution that is "properly chargeable" to capital account does not reduce earnings and profits. Some cases have held, and the IRS has now ruled, that a corporation's capital account is an amount equal to the par value of its stock plus the amount, if any, of paid-in surplus, and that this amount is reduced in proportion to the amount of the corporation's stock that is redeemed. Under this approach, earnings and profits are reduced by an amount equal to the amount of the distribution over the amount charged against capital account. *See,* e.g. *Jarvis* v. *Commissioner,* 43 B.T.A. 439, aff'd 123 F.2d 742 (4th Cir. 1941); and Rev. Rul. 79-376, 1979-2 C.B. 133.

For example, assume that X corporation has 1,000 shares of $10 par value stock outstanding, and that A and B each acquired 500 of the shares upon their issuance at a price of $20 per share. Assume further that X corporation, which has operated a profitable services business since its inception, holds net assests worth $100,000 consisting of cash ($50,000) and appreciated improved real property ($50,000), and has current and accumulated earnings and profits of $50,000. If X corporation distributes $50,000 in cash to A in complete redemption of A's shares in X corporation, the distribution, under *Jarvis* v. *Commissioner,* would be charged first aganist X corporation's capital account, reducing it by $10,000. The remaining $40,000 would reduce earnings and profits. After the transaction, X corporation would have $10,000 of earnings and profits. A would generally have no dividend income from the redemption.

Reasons for Change

The committee is aware that, under present law, a corporation's earnings and profits may not reflect its economic income. For example, an oil and gas corporation reduces its earnings and profits each year by the amount which it deducts from taxable income as intangible drilling costs even though the expenditure may lead to the creation of an asset which will last many years. Such a corporation may, as a result, have economic earnings available for distribution to its shareholders but no earnings and profits for tax purposes. Another corporation might sell an appreciated asset, realizing substantial amounts of gain. If the corporation reports the gain on the installment method, it will increase its earnings and profits in the year of sale and in subsequent years by an amount equal only to the portion of the realized gain that is recognized in such year. In either case, a distribution by the corporation to its shareholders that is treated as a dividend under State law might constitute a return of capital for tax purposes. When this occurs, a corporate tax preference or other benefit is, in effect, being passed through to shareholders and providing shareholders with an unintended tax benefit.

Also, in the case of a distribution in redemption of the distributing corporation's stock, that capital is reduced in proportion to the amount of stock redeemed, with earnings and profits reduced by the excess of the amount of the distribution over the amount charged against capital. As a result, a distribution in redemption of the distributing corporation's stock (taxable to the shareholder as capital gain) can offset more than a proportionate share of the earnings and profits of the distributing corporation. The committee believes that this is an inappropriate result and that earnings and profits should be reduced in proportion to the shares of stock that are redeemed.

Accordingly, the committee bill contains a number of provisions designed to ensure that a corporation's earnings and profits more closely conform to its economic income. In addition, the committee bill contains rules that apply in the case of a distribution by a corporation in redemption of its own stock and provide that in such event the distributing corporation's earnings and profits are generally reduced in proportion to the outstanding stock redeemed.

Explanation of Provision

The committee bill requires that a number of changes be made in the way in which a corporation's earnings and profits are calculated. However, no change is intended in the calculation of accumulated earnings and profits (except as they are affected by current earnings and profits). Except as otherwise provided, the committee intends that these changes apply for all purposes of the Internal Revenue Code. Although sections 446 and 481 will not apply to these changes, no inference is created as to whether the way in which a corporation computes its earnings and profits constitutes a separate method of accounting.

The committee anticipates that regulations will provide such adjustments as may be necessary to prevent amounts from being duplicated or omitted. For example, deferred gain on an installment sale included in earnings and profits under this provision is not to be included in earnings and profits a second time, i.e., when recognized.[1]

Construction period interest, taxes, and carrying charges

Construction period interest, taxes, and carrying charges are required to be capitalized as a part of the asset to which they relate for purposes of computing a corporation's earnings and profits. This rule applies to all corporations. Further, it applies with respect to both residential and nonresidential real property, and to personal property. That capitalized amount is to be written off for earnings and profits purpose as is the asset itself.

Construction period interest and taxes include property taxes (real and personal), interest paid or accrued on debt incurred or continued to acquire, construct, or carry property, and other carrying charges, but only to the extent such taxes, interest, and other carrying charges are attributable to the construction period for such property. The committee anticipates that the Secretary will issue regulations allocating expenditures to the construction period and among different properties. The committee expects that these regulations generally will adopt rules similar to those contained in Financial Accounting Standards Board Statement Number 34, as amended. For example, under those rules, the amount of interest to be capitalized is the portion of the total interest expense incurred during the construction period that could have been avoided if funds had not been expended for construction. Interest expense that could have been avoided includes interest costs incurred by reason of additional borrowings to finance construction and interest costs incurred by reason of borrowings that otherwise could have been repaid with funds expended for construction.

The term "construction period" generally means the period beginning on the date on which construction or acquisition begins and ending on the date on which the item of property is ready to be placed in service or held for sale by the taxpayer. In the case of real property, the construction period commences with the date on which the construction or acquisition of a building or other improvement begins and ends on the date that the building or improvement is ready to be placed in service or is ready to be held for sale.

This provision is applicable to the effect on earnings and profits of amounts paid or accrued in taxable years beginning after the date of enactment.

Intangible drilling costs and mine development costs

Intangible drilling costs allowable as a deduction for any taxable year under section 263(c), and mineral exploration and development costs allowable as a deduction under sections 616(a) or 617, are required to be capitalized for purposes of computing earnings and profits, but only if the expenditures give rise to the creation of

[1] The committee also anticipates that the Internal Revenue Service will review the effect of these changes on the consolidated return regulations in general, and on Treas. reg. sec. 1.1502-32 in particular, to determine whether changes in such regulations are appropriate as a result of this provision.

an asset having an anticipated economic life of more than one year. Intangible drilling costs capitalized under the provision are to be amortized on a straight-line basis over 5 years. The amortization period for mineral exploration and development expenses is 10 years. No amortization is to occur, however, prior to the date the asset is placed in service.

Unamortized intangible drilling expenses incurred in connection with the drilling of a well (or a group of related wells) are to be deducted in computing earnings and profits when it has been determined that the well is dry (or the wells are dry). Unamortized mineral exploration and development expenses incurred in connection with a mineral property are to be deducted in computing earnings and profits when the property is abandoned. The committee intends that, in general, a mineral property will be treated as abandoned when the taxpayer would be treated as having suffered a deductible loss under section 165.

This provision is applicable to the effect on earnings and profits of amounts paid or accrued in taxable years beginning after the date of enactment.

Certain trademark, trade name, and other expenditures

Amounts amortized under sections 173 (relating to circulation expenditures), 177 (relating to trademark and trade name expenditures), and 248 (relating to organizational expenditures) are to be capitalized and treated as part of the basis of the asset to which they relate. Expenditures made in connection with property having a reasonably determinable useful life are to be recovered for earnings and profits purposes over such useful life. There will be no amortization for expenditures made in connection with property which does not have a reasonably determinable limited useful life. This provision is applicable to the effect on earnings and profits of amounts paid or accrued in taxable years beginning after the date of enactment.

Certain distributions of appreciated property

In the case of a distribution of appreciated property by a corporation to a shareholder with respect to stock, earnings and profits of the distributing corporation are to be increased by the amount of gain on the distributed property that is realized by the distributing corporation on the distribution whether or not such gain is recognized. The provision does not apply to a distribution in complete liquidation of the distributing corporation. It also does not apply to any distribution to which sections 301 through 307 are not applicable or to a distribution to corporate shareholders described in section 311(d)(2)(A) (as amended by the bill).

With certain exceptions, the provision is applicable to the effect on earnings and profits of distributions after the date of enactment.

Changes in LIFO reserves

A corporation's earnings and profits are to be increased by the amount of any increase in the corporation's LIFO reserve for a taxable year. In addition, any decrease in the amount of a corporation's LIFO reserve will generally decrease earnings and profits. However, decreases in reserve amounts below the LIFO reserve as of the beginning of the taxable year beginning after the date of enactment will not, except as provided by regulations, reduce earnings and profits. For example, assume a calendar year taxpayer has a LIFO reserve of $100 at the end of 1984. Assume further that the reserve decreases to $95 at the end of 1985 and increases to $105 at the end of 1986. The committee anticipates that, under regulations, the change in the LIFO reserve for 1985 will not result in a change in earnings and profits but that at the end of 1986, the $10 increase in the taxpayer's LIFO reserve will result in a $10 increase in earnings and profits. For purposes of this provision, the term "LIFO reserve" has the same meaning as that given to the term "LIFO recapture amount" under section 336.

The provision is applicable to the effect on earnings and profits of changes in reserve amounts in taxable years beginning after the date of enactment.

Deferred gain from installment sales

A corporation's earnings and profits for a year in which the corporation sells property on the installment basis are to be increased by the amount of any deferred gain on the installment sale. This is accomplished by treating all principal payments as having been received in the year of the sale. The provisions are applicable to the effect on earnings and profits of sales occurring after March 15, 1984, other than sales pursuant to binding contracts entered into on or prior to such date.

Completed contract method of accounting

A corporation that accounts for income and expenses attributable to a long-term contract on the completed contract method of accounting generally recognizes income and expense in the year in which the contract is completed. Under the bill, corporations that account for income and expense on this method are required to compute earnings and profits as if it were accounting for income and expense attributable to long-term contracts on a percentage of completion basis. Under this method, income is generally recognized according to the percentage of the contract that is completed during each taxable year.

This provision is applicable to the effect on earnings and profits of contracts entered into after March 15, 1984.[2]

ACRS deductions for real property

The amount by which a corporation's earnings and profits are reduced for ACRS deductions with respect to 15-year and 20-year real property is the amount of the deduction that would be allowable if the straight-line method of depreciation had been used and the property had a 40 year recovery period. This provision does not apply in computing the earnings and profits of a foreign corporation for any taxable year for which less than 20 percent of the

[2] The committee anticipates that if a taxpayer subsequently changes to or from the percentage of completion method for purposes of computing taxable income, regulations will provide for adjustments for purposes of earnings and profits to prevent amounts from being duplicated or omitted.

gross income from all sources of such corporation is derived from sources within the United States.

This provision is applicable to the effect on earnings and profits of property placed in service in taxable years beginning after the date of enactment.

Redemptions

In the case of a distribution by a corporation in redemption of its own stock, earnings and profits are to be reduced in proportion to the amount of the corporation's outstanding stock that is redeemed. For example, assume that X corporation has 1,000 shares of $10 par value stock outstanding, and that A and B each acquired 500 of original issue shares at a price of $20 per share. Assume further that X corporation, which has operated a profitable services oriented business since its inception, holds net assets worth $100,000 consisting of cash ($50,000) and appreciated improved real property ($50,000), and has current and accumulated earnings and profits of $50,000. If X corporation distributes $50,000 in cash to A in redemption of A's share in X corporation, earnings, profits and capital account would each be reduced by $25,000. After the transaction, X corporation would have $25,000 of earnings and profits. However, the committee does not intend that earnings and profits be reduced by more than the amount of a redemption.

This provision is applicable with respect to the effect on earnings and profits of distributions in taxable years beginning after the date enactment.

Effective Dates

The effective date of each provision is included in the explanation of the provision.

Revenue Effect

The provision is estimated to increase fiscal year budget receipts by $108 million in 1985, $308 million in 1986, and $343 million in 1987, $389 million in 1988, and $430 million in 1989.

14. Continuation of Suspension of Effective Date for Certain NOL Carryover Rules (sec. 48 of the bill and secs. 382 and 383 of the Code)

Present Law

The Tax Reform Act of 1976 substantially revised Code sections 382 and 383, relating to the carryover of corporate net operating losses and other corporate tax attributes following acquisitions or reorganizations.

Under present law, the 1976 Act revisions relating to acquisitions other than reorganizations are generally effective with respect to taxable years beginning after June 30, 1984. Those relating to reorganizations are effective with respect to a reorganization pursuant to a plan of reorganization adopted on or after January 1, 1984.

Reasons for Change

Because of problems with the 1976 Act revisions that have been brought to the attention of the committee, the committee concluded that the present effective dates for these revisions should be postponed generally until 1986, in order to allow time for further study and analysis.

Explanation of Provision

The provision modifies subsection (g) of section 806 of the Tax Reform Act of 1976 by substituting "January 1, 1986" for "January 1, 1984" in paragraphs (2) and (3) of that subsection and by substituting "December 31, 1985" for "June 30, 1984" in paragraph (2) of that subsection.

Thus, the provision postpones until January 1, 1986, the effective date for the 1976 Act revisions to Code sections 382 and 383, both for acquisitions and reorganizations. Accordingly, the 1976 Act revisions relating to acquisitions other than reorganizations will become generally effective with respect to taxable years beginning on or after January 1, 1986. Those relating to reorganizations will become effective with respect to a reorganization pursuant to a plan of reorganization adopted by either party on or after January 1, 1986.

Effective Date

The provision is effective as of January 1, 1984.

Revenue Effect

The provision is estimated to decrease budget receipts by less than $10 million annually.

15. Distribution Requirement in the Case of a C Reorganization (sec. 49 of the bill and sec. 368 of the Code)

Present Law

A C reorganization, as defined by section 368(a)(1)(C), is an acquisition by one corporation (the "acquiring corporation") of substantially all of the properties of another corporation (the "transferor corporation") in exchange solely for voting stock of the acquiring corporation or its parent corporation, or in exchange for such voting stock and a limited amount of money or other property. In determining whether an exchange is solely for voting stock, the assumption by the acquiring corporation of a liability of the transferor corporation, or the fact that the property acquired is subject to a liability, is disregarded.

A transaction can qualify as a C reorganization even if the transferor corporation does not distribute to its shareholders any of the consideration received from the acquiring corporation or any retained assets. Further, the Service has ruled that a transaction qualified as a tax-free C reorganization where the transferor distributed a 25% stock interest in the acquiring corporation but retained liquid assets which it intended to use to engage in an active trade or business.[1]

Under present law, the acquiring corporation in a C reorganization succeeds to, and takes into account, the tax attributes of the transferor corporation described in section 381, subject to limitations contained in that section and section 382. For example, the acquiring corporation succeeds to the earnings and profits account of the transferor corporation.

Reasons for Change

Prior to 1934, Federal statutes provided for reorganization treatment only in the case of a transaction qualifying as a merger or consolidation under state law. The C reorganization provisions were added to the Code because uniform merger or consolidation statutes had not been enacted in all states, and the Congress believed that for Federal tax purposes substantially similar transactions should be treated consistently without regard to state law.[2] Thus, the provisions were intended to apply to transactions that are acquisitive in nature and resemble statutory mergers or consolidations.

Different provisions are intended to apply to divisive transactions. The committee is concerned that since a distribution by the transferor corporation of all its assets is not required in connection with a C reorganization, and after such a reorganization the trans-

[1] Rev. Rul. 73-552, 1973-2 C.B. 116.

[2] S. Rep. No. 558, 73d Cong., 2d Sess. 17 (1934).

feror may be able to engage in an active trade or business and not merely serve as a holding company for its shareholders' interests in the acquiring corporation, transactions that are somewhat divisive in nature can qualify as reorganizations without qualifying under the provisions generally applicable to divisive transactions.

In addition, as stated above, the C reorganization provisions were intended to apply to transactions that resemble, in substance, statutory mergers or consolidations. In the case of a statutory merger or consolidation, the transferor is liquidated by operation of law. The committee is concerned that substantially similar transactions should be treated consistently for Federal income tax purposes.

Also, under present law, there is an incongruity between the provisions of the Code that provide for the carryover of an acquired corporation's tax attributes and the C reorganization provisions which do not require the transfer of all the transferor corporation's assets. As a result, a transferor corporation can remain in existence and hold assets having substantial value (e.g., the stock of the acquiring corporation and any retained assets) and be treated for Federal tax purposes as a new corporation without tax attributes. The committee is concerned that opportunities for tax avoidance may result if a corporation that has been in existence can engage on a tax-free basis in a transaction that, in effect, erases its tax history and remain in existence. For example, it may be possible to avoid the rules requiring that amounts distributed to shareholders out of current or accumulated earnings and profits be treated by the shareholders as dividends taxable at ordinary income rates.[3]

Explanation of Provision

Except as otherwise provided by regulations, an acquisition by one corporation, in exchange solely for all or a part of its voting stock (or in exchange solely for all or a part of the voting stock of a corporation which is in control of the acquiring corporation), of substantially all of the properties of another corporation, is treated as a C reorganization only if the transferor corporation distributes all of its assets (less those retained to meet claims), including consideration received from the acquiring corporation and any retained assets, within 12 months of the acquisition.

Under the bill, the Secretary may prescribe regulations providing exceptions to the distribution requirement. The committee intends that the regulations will provide that a distribution will not be required if substantial hardship, such as the loss of a valuable nontransferable charter, will result. The committee anticipates that any such regulations will impose appropriate conditions so that the abuses intended to be corrected by the bill will not be present.

The Secretary is also directed to prescribe regulations under section 312 providing, among other things, for the allocation of earnings and profits between the acquiring corporation and the trans-

[3] If a transferor corporation that prior to the reorganization had substantial earnings and profits were to remain in existence, the corporation could make distributions to its shareholders out of the retained assets or cash received (either from the acquiring corporation or from lenders) and the amounts received would be treated by the shareholders as a return of capital. If the distribution were made prior to the reorganization, amounts received would constitute dividends.

feror corporation in situations in which one corporation owns 80 percent or more of the stock of the transferor corporation before the transaction.

Effective Date

The provisions are applicable to transactions pursuant to a plan adopted after the date of enactment.

Revenue Effect

The provision is estimated to increase revenues by less than $10 million per year.

16. Control Requirement in a D Reorganization (sec. 50 of the bill and sec. 368 of the Code)

Present Law

D reorganizations

Under section 368(a)(1)(D), a transfer by a corporation of all or a part of its assets to a corporation controlled immediately after the transfer by the transferor or one or more of its shareholders is generally treated as a D reorganization if, among other things, stock or securities of the controlled corporation are distributed pursuant to the plan of reorganization in a transaction qualifying under sections 354, 355, or 356. A D reorganization may involve the acquisition of substantially all of the assets of a corporation (an acquisitive or nondivisive transaction) or the division of an existing corporation (a divisive transaction). For purposes of a D reorganization, the term "control" is defined as the ownership of stock possessing at least 80 percent of the total combined voting power of all classes of stock entitled to vote and at least 80 percent of the total number of shares of all other classes of stock of the corporation. No attribution rules are explicitly made applicable.

If a nondivisive transaction qualifies as a D reorganization, generally no gain or loss is recognized by the transferor corporation or its shareholders. The acquiring corporation's basis in the assets acquired from the transferor corporation is generally the same as it was in the hands of the transferor corporation. If boot (i.e., money or other property other than stock or securities of the transferee corporation) is distributed to the shareholders of the transferor corporation, then any gain realized by such shareholders is recognized, but in an amount not in excess of the sum of such money and the fair market value of such other property. If the distribution of the boot has the effect of a dividend, it is treated by the shareholder as a dividend to the extent of his or her pro rata share of the corporation's undistributed earnings and profits.[1]

Liquidation and contribution to a related corporation

In general, under section 331, amounts distributed to a shareholder in complete liquidation of a corporation are treated as full payment in exchange for the shareholder's stock. If the stock is a capital asset in the hands of the shareholder, a complete liquidation will result in capital gain or loss. The shareholder's basis in the property received in the taxable liquidation is the fair market value of the property at the time of the distribution. With several

[1] The IRS takes the position that for purposes of determining dividend equivalency, a boot distribution is treated as having been made by the acquired corporation (i.e., the transferor) rather than by the acquiring corporation. Rev. Rul 75-83, 1975-1, C.B. 112. See also *Shimberg* v. *United States*, 577 F.2d 283 (5th Cir. 1978). But see *Wright* v. *United States*, 482 F.2d 600 (8th Cir. 1973).

exceptions, no gain or loss is recognized to the distributing corporation on a distribution in complete liquidation of such corporation or a liquidating sale by the corporation.

The Internal Revenue Service has taken the position, and a number of cases have held, that a liquidation followed by a contribution of a substantial part of the distributed properties to a corporation controlled by the shareholders of the liquidating corporation can constitute a D reorganization. In such cases, the transferee corporation's basis in acquired assets is the same as the basis in the transferor corporation's hands prior to the transfer. Further, the transferee corporation inherits tax attributes of the transferor corporation, which would generally disappear in the case of a liquidation. If money or property (other than stock or securities in the transferee corporation) is distributed to the shareholders of the transferor corporation, the shareholders may be treated as having received a dividend rather than a payment in exchange for stock.[2]

Sale of stock to commonly controlled corporation

Under present law, a sale of stock in one corporation by a shareholder to a commonly controlled corporation is generally treated under section 304 as a redemption rather than as a sale to an independent third party. A distribution in redemption of stock is generally treated by the shareholders as in part or full payment in exchange for the stock if (1) it is not essentially equivalent to a dividend, (2) it is substantially disproportionate with respect to the shareholder, (3) it is in complete termination of the shareholder's interest, or (4) certain other requirements are satisfied. Distributions in redemption of a shareholder's stock that are not treated as in part or full payment in exchange for the stock are treated as dividends to the extent of undistributed earnings of profits.

For purposes of section 304, the term control means the ownership of stock possessing at least 50 percent of the total combined voting power of all classes of stock entitled to vote, or at least 50 percent of the total value of shares of all classes of stock. Attribution rules apply for purposes of determining ownership of stock.

Reasons for Change

Liquidation-reincorporation transactions (i.e., transactions involving the liquidation of a corporation coupled with a transfer of its operating assets to a new corporation in which the shareholders of the transferor corporation have a substantial stock interest) that are not treated as reorganizations can be used to accomplish a bailout of earnings and profits at capital gains rates. Further, these transactions can be used by a shareholder (or group of shareholders) to obtain a step-up in the basis of assets that are held in corporate solution largely at the cost of a shareholder-level capital gains tax without a significant change in ownership.

The D reorganization provisions generally envision the continuation of the transferor corporation's business in a corporation in which the transferor corporation or its shareholders have a substantial interest. In many transactions, the liquidating corpora-

[2] See, e.g., *James Armour, Inc.*, 43 TC 295 (1965).

tion's business is being continued by a related corporation. However, the control requirement that applies in the case of a D reorganization has in some instances prevented the Service from successfully asserting that these transactions constitute D reorganizations.

Also, the D reorganization provisions and section 304 both operate to prevent the bail-out of earnings and profits at capital gains rates. Further, both apply to transactions in which property is transferred from one corporation to another corporation in a transaction in which money or other property is received by common shareholders. Nonetheless, the control requirement under section 304 is a 50-percent requirement. Further, attribution rules apply for purposes of determining stock ownership under section 304. The committee believes that the control test in the case of the D reorganization provisions should more closely conform to that of section 304.

The absence of explicit attribution rules to determine ownership of stock for purposes of the control requirement may enable taxpayers to bail-out earnings and profits at capital gains rates by transferring assets to a corporation controlled by a related person rather than to a corporation controlled by them.

Explanation of Provision

Under the bill, in the case of a transaction otherwise qualifying as a nondivisive D reorganization, the transferor corporation or its shareholders are treated as having control of the transferee corporation if the transferor corporation or its shareholders own stock possessing at least 50 percent of the total combined voting power of all classes of stock entitled to vote and at least 50 percent of the total number of shares of all other classes of stock of the corporation. Further, the constructive ownership of stock rules contained in section 318(a), modified, are applicable for purposes of determining whether the transferor corporation or its shareholders are in control of the transferee corporation.

Effective Date

This provision is applicable to transactions pursuant to a plan adopted after the date of enactment.

Revenue Effect

The provision is estimated to increase revenues by less than $10 million per year.

17. Collapsible Corporations (sec. 51 of the bill and sec. 341 of the Code)

Present Law

In general, a collapsible corporation is one formed or availed of principally for the manufacture, construction, production, or purchase of certain types of property with the view to the sale or exchange by the shareholders of their stock (or of the liquidation of the corporation) before the realization by the corporation of a "substantial" part of the taxable income to be derived from such property. If stock in a collapsible corporation is sold or exchanged or the corporation is liquidated in whole or in part (*i.e.*, collapsed), or if certain distributions are made, any gain recognized by any shareholder in any such sale, exchange, liquidation, or distribution which would otherwise be long-term capital gain is considered ordinary income.

In the case of *Commissioner v. Kelley,* 293 F.2d 904 (5th Cir. 1961), affirming, 32 TC 135 (1959), nonacq., 1962-1 C.B. 5, withdrawn and acq. substituted, Rev. Rul. 72-48, 1972-1 C.B. 102, the Fifth Circuit held that a corporation will have realized a "substantial" part of the taxable income to be derived from the property (thereby avoiding collapsible corporation status with respect to that property) if the corporation realizes as little as one-third of the taxable income to be derived from the property. In *Commissioner v. Kelley,* the court reasoned that the substantial part requirement related to the part of the taxable income realized and that a substantial part of such income could be realized even though an even greater part of the taxable income to be derived from the property was not realized. This view of the substantial part requirement must be compared with that announced in *Abbott v. Commissioner,* 258 F.2d 537 (3rd Cir. 1958), in which the Third Circuit held that the realized part could not be substantial unless only an insubstantial part of the taxable income to be derived from the property remained unrealized.

The statute provides an exception to collapsible corporation treatment under the "70/30" rule (sec. 341(d)(2)). In general, under this rule, a shareholder who realizes gain with respect to his stock in a collapsible corporation must determine the amount of the recognized gain attributable to collapsible assets in the corporation. If this amount is 70 percent or less of his total grain for the taxable year, then none of the recognized gain is treated as ordinary income under the collapsible corporation provisions of the Code.

Reasons for Change

The committee is concerned with the opportunities for avoidance of the collapsible corporation provision provided by the rule in the case of *Commissioner v. Kelley* and the existing regulations interpreting the 70/30 rule. The committee believes that property which is collapsible should continue to be so treated until less than a substantial portion of the taxable income to be realized from the property remains unrealized. Thus, in general, the committee intends to adopt the *Abbott v. Commissioner* view of the "substantial part" requirement.

With respect to the 70/30 rule, the committee is concerned with the possibilities for avoiding collapsible treatment with respect to gain on the various stock dispositions subject to the 70/30 rule where a collapsible corporation has two or more separate projects. For example, assume that a corporation builds or acquires two similar but separate inventory-type assets or projects with a view toward collapsing the corporation prior to the time it has realized a substantial part of the taxable income to be derived from either asset. Each asset is of equal value at all relevant times. The corporation is owned entirely by one shareholder. The corporation is liquidated. Under present law, if the selling shareholder caused the corporation to realize one-third of one of its assets prior to the date of the liquidation, that asset likely would be treated as non-collapsible for purposes of the 70/30 rule. Since less than 70 percent of the recognized gain on the stock sale would be attributable to a collapsible asset, the 70/30 rule would apply to except the sale proceeds from the collapsible corporation provisions of the Code, even though only one-sixth of the total potential income from the assets had been recognized.

Explanation of Provision

Under the bill, the collapsible corporation definition of present section 341(b)(1) would be amended. It would be explicitly stated that property otherwise collapsible will be collapsible unless at least two-thirds of the taxable income to be derived from the property has realized by the corporation. This would replace the "substantial part" standard of present law. The committee intends that no inference should be drawn from this amendment with respect to the meaning of the "substantial part" requirement of present law.

In addition, the Secretary of the Treasury would be authorized to prescribe regulations describing the extent to which all inventory, stock in trade, or property held primarily for sale to customers in the ordinary course of a trade or business (sec. 1221(l) property) would be treated as a single asset in applying the 70/30 rule. The committee intends that these regulations will insure that the two-thirds realization requirement cannot be avoided where the corporation's collapsible section 1221(l) properties are less than two-thirds realized in the aggregate but where some of its collapsible properties have been two-thirds or more realized. Thus, if the aggregate of the corporation's cellapsible section 1221(l) properties is less than two-thirds realized, all of the corporation's collapsible section 1221(l) properties, including any collapsible section 1221(l) property that has been two-thirds or more realized, will be treated as collapsible property for purposes of the 70/30 rule. The committee intends that, for purposes of applying this aggregation requirement under the "70/30" rule, all property with respect to which the taxpayer has, or at any time had, a collapsible view will be treated as collapsible property (*i.e.*, property described in section 341(b)(1)) even if it is two-thirds or more realized. Section 1221(l) property which is not collapsible property, and which never was collapsible property, need not be aggregated under this rule.

Effective Date

These amendments would be effective to sales, exchanges, and distributions made after December 31, 1984.

Revenue Effect

This provision will increase fiscal year budget receipts by $8 million in in 1985, $81 million in 1986, $256 million in 1987, $351 million in 1988, and $382 million in 1989.

E. Partnership Provisions

1. Partnership Allocations With Respect to Contributed Property (sec. 55 of the bill and sec. 704 of the Code)

Present Law

Partnership allocations generally.—A partner's distributive share of partnership income, gain, loss, deduction, or credit (or items thereof) is generally governed by the partnership agreement (sec. 704(b)). However, if the allocation provided by the agreement does not have substantial economic effect, these items are reallocated for tax purposes in accordance with the partner's interest in the partnership, determined by taking into account all facts and circumstances. Proposed Treasury regulations provide that, in general, an allocation has economic effect if (1) the allocation is reflected by an appropriate increase or decrease in the partner's capital account, (2) liquidation proceeds (if any) are to be distributed in accordance with the partners' capital account balances, and (3) any partner with a deficit in his capital account following the distribution of liquidation proceeds is required to restore the amount of such deficit to the partnership. The economic effect of the allocation must be substantial in relation to the tax effect for the allocation provided for in the agreement to have substantial economic effect.[1]

Property contributed to a partnership.—Under present law (sec. 704(c)), when property is contributed to a partnership, the partnership may (but is not required to) allocate depreciation, depletion, or gain or loss with respect to the contributed property so as to take account of the variation between the basis of the property to the partnership and its fair market value at the time of contribution. If the partnership does not make allocations on this basis, the allocations are made as if the property had been purchased by the partnership.

A shifting of income or losses among partners that does not reflect the economic burdens borne by the parties may occur if a partnership does not elect to allocate depreciation, depletion, and gain or loss with respect to contributed property so as to take account of the variation between the basis and the fair market value of the contributed property. For example, if partner A contributes property with a basis of $200 and a value of $100 while partner B contributes $100 in cash to a partnership, and the initial capital accounts of the partners are each set at $100 (the fair market value of their contributions), some taxpayers contend that absent specific allocations of the loss under the partnership agreement, a subsequent sale of the property for $100 would result in an allocation of

[1] Prop. Treas. Reg. sec. 1.704-1(b)(2)(ii), 48 Fed. Reg. 9871 (March 9, 1983).

$50 of loss to each partner, thereby shifting $50 of loss from A to B; The shifting of the loss could be effective so long as the partnership remained in existence however, the pre-contribution loss would be effectively reallocated to the contributing partner if the partnership were liquidated. Some taxpayers contend that a similar shifting of gain can be accomplished in the case of a contribution of appreciated property to a partnership.

Reasons for Change

Although the committee believes that the underlying theory of the present law partnership provisions that taxpayers should be able to pool their resources for productive uses without triggering gain or loss is appropriate, it believes that special rules are needed to prevent an artificial shifting of tax consequences between the partners with respect to pre-contribution gain or loss. This is particularly important since the various partners may have different tax positions. For example, a partner to whom gain could be shifted in the absence of the bill's provisions could be tax-exempt, could have a lower marginal rate than the contributing partner, or could have expiring net operating loss carryovers. The committee has not provided a similar rule when cash is contributed to an ongoing partnership which has property with a value more than, or less than, its adjusted basis because it believes that this issue may have been adequately dealt with in proposed Treas. Reg. sec. 1.704-1(b)(4)(i).

Explanation of Provision

The bill provides a new rule regarding allocations with respect to property contributed to a partnership. Under the new rule, depreciation, depletion, and gain or loss with respect to items of contributed property are to be shared among the partners, pursuant to Treasury regulations, so as to take account of the difference between the partnership's basis for the property and the fair market value of the property at the time of contribution. It is anticipated that the regulations under this provision generally will provide for the same result that is achieved under present law when a partnership elects with respect to all relevant items to provide for sharing of depreciation, depletion, and gain or loss among the partners so as to take into account fully the difference between the basis of the property to the partnership and its fair market value at the time of the contribution. Generally, the fair market value of contributed property will be determined by reference to the arm's-length dealings of the various partners as reflected in their capital accounts if the parties have sufficiently adverse interests and normally will not be upset by the Treasury except in cases of manipulation or abuse. The committee anticipates that the regulations may require a partnership to file a statement of the agreed fair market value of contributed property with the partnership return for the year in which the contribution is made. Under the provision a partnership will generally be required, rather than being permitted (as under present law), to allocate "built-in" gain or loss on contributed property to the contributing partner. It is anticipated that the regulations will permit partners to agree to a more rapid elimination of disparities between the value and adjusted basis of contributed property (determined at the time of contribution) among partners than required by the new rules by substituting items not described in section 704(c) for items described in section 704(c) and vice versa, provided that there is no tax avoidance potential.[2] Similarly, to limit the burden of recordkeeping requirements for small operating partnerships, if no tax avoidance potential exists, the regulations may permit (i) aggregation of properties with fair market values greater than their respective adjusted basis that are contributed by a single partner and aggregation of properties with fair market values less than their respective adjusted basis that are contributed by a single partner (ii) differences of less than 15% (but not exceeding $10,000) between the adjusted basis and the fair market value of any aggregated properties to be accounted for in a manner consistent with existing section 704(c)(1), and (iii) differences between the adjusted basis and the fair market value of contributed properties to be eliminated more slowly than required by the new rules through allocations solely of gain or loss on the disposition of such properties (without requiring special allocations of depreciation or depletion).

The bill also eliminates a present law rule for the treatment of contributions of undivided interests in property to a partnership by the various owners of the undivided interest. This rule, which allowed the partnership to treat the property as if it had not been contributed to the partnership, is made unnecessary by the provision of the bill requiring allocations of depreciation, depletion, and gain or loss to reflect the difference between the basis of property and its fair market value at the time of contribution.

The bill also makes two conforming amendments in sections 613A(c)(7)(D) (relating to percentage depletion) and 743(b) (relating to optional adjustment to basis).

The committee expects that regulations issued under this provision will provide that, with respect to contributions made before the regulations are issued, the partnership has complied with the requirements of the provision if allocations with respect to contributed property have been made in accordance with the existing regulations under section 704(c)(2) providing for sharing of depreciation, depletion, and gain or loss among the partners so as to take into account fully the variation between the adjusted basis of the property to the partnership and its fair market value at the time of the contribution.

Effective Date

The provision is effective with respect to property contributed to a partnership after March 31, 1984, in taxable years ending after that date.

[2] In addition, it may be appropriate to amend example (2) of Treas. Reg. sec. 1.704-1(c) to provide that if the property there is sold for a price exceeding $9,000, the gain represented by the first $200 of such excess would be allocated to partner C.

Revenue Effect

This provision will increase fiscal years budget receipts by $4 million in 1984, $61 million in 1985, $147 million in 1986, $178 million in 1987, $240 million in 1988, and $298 million in 1989.

2. Retroactive Allocations (sec. 56 of the bill and sec. 706 of the Code)

Present Law

General rules

The Tax Reform Act of 1976 amended the partnership provisions to preclude a partner who acquires his interest late in the taxable year from deducting partnership expenses incurred prior to his entry into the partnership (so-called "retroactive allocations" of partnership losses). The 1976 Act provided that when partners' interests change during the taxable year, each partner's share of various items of partnership income gain, loss, deduction and credit is to be determined by taking into account each partner's varying interest in the partnership during the taxable year.

Present law allows two basic methods for determining the amount of a partnership's income, gain, loss, deduction, and credit which may be allocated to a partner entering during the taxable year. The first method provides for an "interim closing" of the partnership books whenever a new partner enters the partnership. This method traces partnership income, gain, loss, deduction, and credit to the particular segment of the partnership taxable year during which it is incurred. For example, a partner admitted on December 1 to a partnership using a calendar taxable year could be allocated only his share of items incurred by the partnership during the month of December.

The second allocation method allowed by present law provides for a proration of partnership income, gain, loss, deduction, and credit for the entire taxable year. This proration generally is based on the number of days in the partnership taxable year during which the entering partner is a member of the partnership divided by the total number of days in the partnership taxable year. The entering partner's share of each partnership item for the taxable year is determined by multiplying this fraction by the amount of partnership income, gain, loss, deduction, and credit that the partner would have been allocated had he been a partner for the entire partnership taxable year. For example, a partner admitted on December 1 to a partnership having a calendar year taxable year would be allocated 1/12 of his hypothetical share of items for the entire partnership taxable year, regardless of the point during the year at which these expenses were incurred.

The legislative history of the 1976 Act provides that to avoid undue complexity, a partnership may use a convention (for both the interim closing and proration methods) under which partners are treated as entering on a semi-monthly basis. That is, partners entering in the first half of a month can all be treated as entering on the first day of the month and partners entering in the last half of the month can be treated as entering on the 16th day of the month.

Techniques for avoiding retroactive allocation rules

Tiered arrangements

Some taxpayers have attempted to avoid the retroactive allocation rules by use of tiered partnership arrangements combined with the interim closing method of allocations. For example, assume that Parent partnership owns a 90-percent interest in Subsidiary partnership and that both the Parent and the Subsidiary use a calendar year taxable year. Assume further that Subsidiary will have a $10,000 loss for the calendar year, and that Parent's distributive share will be $9,000. If Partner A makes a contribution to the partnership in exchange for an 80-percent interest in Parent at the close of business on December 30, Parent may make an interim closing of its books on December 30 to determine A's distributive share of partnership items. Parent may take the position that, for tax purposes, it incurs its entire $9,000 portion of Subsidiary's loss on December 31, i.e., at the close of Subsidiary's taxable year, regardless of when the loss was actually incurred by subsidiary. Partner A will, therefore, claim a $7,200 loss on his return (Parent's $9,000 loss multiplied by his 80-percent interest in the partnership on December 31) rather than the $19.73 that he would be entitled to under a proportioned share computation (i.e., $9,000 x 80% x 1/365 days).

The Internal Revenue Service has taken the position that, in the situation above, losses are sustained by the parent partnership in at the same time they are sustained by the subsidiary partnership and that the limitation against retroactive allocations is equally applicable. Rev. Rul. 77-311, 1977-2 C.B. 218. However, taxpayers may continue to take a contrary position on their returns.

Cash basis partnerships

In addition to tiered arrangements, partnerships may attempt to avoid the retroactive allocation rules by using the cash method of accounting and deferring actual payment of deductible items until near the close of the partnership's taxable year. For example, if a partnership defers the payment of an expense (e.g., interest) until December 31, and the partnership uses the interim closing method of allocations, a partner admitted on December 30 may be allowed a deduction for a full portion of the expense. This may be the case although the expense has economically accrued at an equal rate throughout the taxable year.

Reasons for Change

The 1976 rules were enacted to clarify that the law required the inclusion of income and loss according to a partner's varying interests during the taxable year. Legislative history indicates that Congress, in adding these rules, intended to prevent partners investing in a partnership toward the close of the taxable year from deducting expenses which were incurred prior to their entry into the partnership.[3] In adding these rules, Congress rejected the argument that retroactive allocations were proper because the funds invested by the new partners served to reimburse the original partners for their expenditures so that, as an economic matter, the new partners had incurred the costs for which they were claiming deductions. This argument was found unpersuasive when the new partner was compared with an investor directly purchasing property which had generated tax losses earlier in the taxable year; that investor would clearly not be entitled to deduct the losses incurred prior to his ownership of the property.

The committee believes that the policy of the 1976 act prohibiting retroactive allocations and the rationale for that policy remain equally applicable today. Taxpayers should not be able to attempt to avoid the 1976 rules through the use of tiered partnership or other arrangements.

The committee recognizes that the use of cash method partnerships raises issues distinct from tiered arrangements and that the cash method may be appropriate for partnerships in certain circumstances. However, the committee believes that the cash method should not be used to create deductions for late-entering partners. Accordingly, the bill requires that cash basis items generally be prorated over those days during the year to which they are economically attributable and that each partner take into account only that portion of each item attributable to that portion of the year for which he is a partner. This rule will prevent abuses associated with retroactive allocations without causing undue hardship or administrative burdens to cash basis partnership. To prevent undue burdens, the bill provides that any member entering the partnership during a month may be treated as a member for the entire month.

Explanation of Provision

General rule

The bill provides a general rule comparable to the present law rule that if any partner's interest in a partnership changes at any time during the partnership's taxable year, each partner's share of any item of partnership income, gain, loss, deduction, or credit is to be determined by using any method prescribed by Treasury regulations which takes into account the varying interests of the partners in the_partnership during the taxable year. It is anticipated that these regulations will apply the law in a manner consistent with the policies of the Tax Reform Act of 1976 and of the new provisions. The committee wishes to make clear that the varying interests rule is not intended to override the longstanding rule of section 761(c) with respect to interest shifts among partners who are members of the partnership for the entire taxable year, provided such shifts are not, in substance, attributable to the influx of new capital from such partners. *See Lipke* v. *Commissioner,* 81 T.C. 689 (1983).

[3] H. Rep. 94-658, accompanying H.R. 10612, 94th Cong. 1st Sess, P. 124 (November 12, 1975); S. Rep. 94-938, 94th Cong., 2d Sess. p. 97 (June 10, 1976).

Cash basis partnership

With respect to partnerships using the cash method of accounting, the bill provides new rules for the allocation of items among partners when there is a change in partnership interests. First, for specified cash basis items, the bill requires that the item be assigned to each day in the period to which it is attributable. The amounts so assigned are then apportioned among the partners in proportion to their interest in the partnership at the close of each day. These rules (which apply except when regulations otherwise provide) effectively require, for purposes of determining the partners' varying interests in a partnership taxable year, that certain items be allocated under the accrual method. The items to which the provision applies are (1) interest, (2) taxes, (3) payment for services or for the use of property, and (4) any other item of a kind specified in Treasury regulations with respect to which the rule is necessary to avoid retroactive allocations to the partners.

For example, if a new partner joins a calendar-year partnership on December 1, and if the partnership on December 31 pays an interest expense which has accrued over the course of the entire year, the partner would be entitled to 1/12 of his otherwise allocable share of deduction for that item. If the expense were attributable only to the final 6-months of the year, he would receive 1/6 of his otherwise allocable share of that item. The committee intends that the determination of the period to which an expense is attributable will be made in accordance with economic accrual principles.

The bill provides that when application of the economic accrual principles described above would result in allocating an item to periods before or after the current taxable year, those items are to be allocated entirely to the first day of the year in the case of items allocable to prior years and entirely to the last day of the year in the case of items allocable to future periods. This rule does not make any substantive change to the timing of any deduction under present law; rather, it merely describes the treatment of amounts that are currently deductible even though allocable to a past or future year in economic terms. For example, if a cash method partnership failed to pay for services provided to it in year 1 until the middle of year 2, the amount of the year 2 deduction would be allocated to the first day of year 2. Similarly, if the partnership was required to pay property taxes in year 1 for the last half of year 1 and the first half of year 2, the amount allocable to year 2 would be treated as paid on the last day of year 1. Of course, this latter rule will have limited application because of the general limitations on the deductibility of prepaid expenses.

Tiered partnerships

The bill provides that, if a parent partnership holds an interest in a subsidiary partnership, then (except to the extent provided by regulations) the parent partnership's share of any item of income, gain, loss, deduction, or credit of the subsidiary partnership is to be prorated equally over that portion of the taxable year during which the parent partnership had an interest in the subsidiary. For example, if a new partner who has a 25-percent interest in all partnership items enters on December 1, a parent partnership that is on a calendar taxable year and the parent has had a 50-percent interest in a calendar year subsidiary partnership for the subsidiary's entire year, then that partner would be allocated 1/96th of the subsidiary's items for the taxable year. (That is his 1/4th share of 1/12th of the parent's 1/2 of the items for the entire year.) If the parent had an interest in the subsidiary beginning July 1, the partner would be allocated 1/192nd of each of the subsidiary's items. (That is his 1/4 share of 1/12th of parent's 1/2 of the items for 1/2 of the year.) It is anticipated that the regulations will permit (and may require) that when a parent and subsidiary partnership use the same taxable year, the income, gain, loss, credit, and deductions of the subsidiary must be allocated to the relevant periods of the parent's taxable year in a manner consistent with the accrual of the items during the subsidiary's taxable year. Similarly, when the parent and subsidiary have different taxable years, the regulations may provide for an interim closing of the subsidiary's taxable year (with respect to the parent) at the time the parent's taxable year closes. These rules are intended to prevent the use of tiered partnership arrangements to avoid the retroactive allocation rules and generally are consistent with Rev. Rul. 77-311, 1977-2 C.B. 218.

Other rules

The bill provides for daily apportionment; however the committee recognizes that most partnerships do not account for the admission of new partners on a daily basis and that daily apportionment of partnership income and expenses would thus result in an undue administrative burden. Accordingly, to prevent undue complexity, the bill provides, that in any case where there is a disposition of less than an entire interest in the partnership by a partner (including the entry of a new partner), the partnership may elect (on an annual basis) to determine the varying interests of the partners by using a monthly convention that treats any changes in any partner's interest in the partnership during the taxable year as occuring on the first day of the month. Pending issuance of regulations, a partnership will be deemed to have elected to use the monthly convention if it uses that convention on its books or files its return foı the taxable year on that basis. If a partnership is treated as having made such an election, the monthly convention will also apply to partners entering during the entire taxable year.

The committee does not intend that any inference be drawn regarding the present law treatment of either the tiered partnership or cash methods arrangement for allowing retroactive allocations.

Effective Dates

The rule regarding tiered partnerships is effective for amounts paid or accrued after March 31, 1984. The rule regarding cash basis partnerships is effective for amounts attributable to periods after March 31, 1984.

Revenue Effect

This provision will increase fiscal year budget receipts by $50 million in 1985, $75 million in 1986, $100 million in 1987, $100 million in 1988, and $100 million in 1989.

3. Payments to Partners for Property or Certain Services (sec. 57 of the bill and sec. 707 of the Code)

Present Law

General background

The contribution of property to a partnership in return for a partnership interest is generally a tax-free transaction (sec. 721). If, instead of contributing property to a partnership, the taxpayer sells property to the partnership, the taxpayer realizes income to the extent of gain on the sale and the partnership is generally required to capitalize the amount of the purchase price, which may be deductible over the useful life of the property (or any applicable recovery period). When services are provided to a partnership, the partnership may generally deduct amounts paid or incurred for such services (unless such expenses are required to be capitalized) and the party providing services must include an equivalent amount in income. This rule also applies to services provided by a partner acting in a capacity other than that of a member of the partnership.

When a partnership allocates income from partnership operations among its partners, the partners generally include these amounts in income in the year taxable to the partnership. This is distinct from a distribution of partnership assets, which is generally tax-free to the extent that the amount distributed does not exceed the recipient partner's basis for his partnership interest. This tax-free treatment is based, in part, on the theory that a partner is entitled to withdraw his investment in a partnership (including partnership income on which he has paid tax) before recognizing gain on the investment.

Although amounts allocated to a partner are not deductible by the partnership, an allocation of taxable income to one partner may have the effect of a deduction for the remaining partners by reducing the amount of taxable income allocated to them.

Avoidance of capitalization and other requirements for payments for property or services

A partnership, like any taxpayer, is generally required to capitalize (rather than currently deduct) expenditures which relate to the improvement of property or which create an asset the useful life of which extends substantially beyond the end of the taxable year. Present law (sec. 709) provides specifically that a partnership may not currently deduct amounts paid or incurred to organize the partnership. Instead, the partnership is permitted an election to deduct these amounts ratably over a 5-year period. Alternatively, the partnership may capitalize these expenses. The denial of current deductions for organizational expenses was made explicit by the Tax Reform Act of 1976. In addition, neither the partnership nor any partner is ever permitted to deduct partnership syndication expenses.

If the organizer or syndicator of a partnership is also a general partner of the partnership, allocations of partnership gross or net income to the organizer and related distributions to him in payment for his services, if recognized, could have the effect of a current deduction for organizational and syndication fees despite the rules above. This results because the allocation (which in this case when coupled with an equivalent distribution is economically indistinguishable from a direct payment), reduces the taxable income allocated to the remaining partners in the year of the allocation. The capitalization requirement for other types of capital expenditures also can be avoided by this type of arrangement. Similarly, if a service-partner is allocated a portion of the partnership's capital gains in lieu of a fee, then the effect of the allocation/distribution will be to convert ordinary income (compensation for services) into capital gains.

Under present law, if amounts are paid or incurred to a partner who engages in a transaction with the partnership in a capacity other than as a member of the partnership, or if guaranteed payments are made to a partner for services or for the use of the partner's capital, capitalization is required to the same extent as with comparable payments to a non-partner. The courts, however, have held that payments to a partner based on a percentage partnership gross income generally are not to be regarded as guaranteed payments. *Pratt* v. *Commissioner,* 64 T.C. 203 (1975), *aff'd,* 550 F. 2d 1023 (5th Cir. 1977).

Disguised sales

Gain or loss generally is not recognized on the contribution of property to a partnership in return for a partnership interest (sec. 721). Additionally, distributions of money from a partnership to a partner are generally tax-free to the extent of the adjusted basis of the recipient partner's interest in the partnership (sec. 731). However, the partner is required to reduce the basis of his partnership interest by the amount of money received (thereby deferring tax until he disposes of the interest).

Treasury regulations provide that, if the transfer of property by a partner to a partnership results in the receipt by the partner of money or other consideration, including a promissory obligation fixed in amount and time for payment, the transaction will be treated as a sale or exchange rather than a contribution (Treas. Reg. sec. 1.721-1(a)). These regulations state that the substance of the transaction, rather than its form, will govern in such cases. Treasury regulations also provide that if a contribution of property is made to a partnership and (1) within a short time before or after such contribution other property is distributed to the contributing partner and the contributed property is retained by the partnership, or (2) within a short time after such contribution to the partnership, contributed property is distributed to another partner, tax-free distribution treatment may not apply. These regulations further state that tax-free treatment does not apply if a purported distribution was, in fact, made to effect an exchange of property between two or more of the partners or between the partnership and a partner (Treas. Reg. sec. 1.731-1(c)(3)). In addition, based on these regulations, the Internal Revenue Service has argued that a contribution of cash by one partner followed by a distribution of cash to another partner should be recharacterized as a sale of an interest in the partnership.

The rules above may not always prevent de facto sales of property to a partnership or another partner from being structured as a contribution to the partnership, followed (or preceded) by a tax-free distribution from, the partnership. For example, under the case law, partner A may contribute $50,000 in cash to a partnership and partner B may contribute property with a basis of $50,000 and a fair market value of $100,000 to the partnership as an equal partner. If the partnership then transfers $50,000 in cash to partner B, based on the case law, it would not be unreasonable for partner B to claim that this $50,000 represents a distribution not exceeding his basis in the partnership and for which he is therefore not subject to tax. (The basis for partner B's interest in the partnership would then be reduced from $50,000 to $0.) If this result is permitted, partner B has deferred or avoided tax on a transaction which closely resembles a sale of property to the partnership (or a partial sale to partner A followed by a joint contribution). Case law has permitted this result, despite the regulations described above, in cases which are economically indistinguishable from a sale of all or part of the property. *See Otey* v. *Commissioner*, 70 T.C. 312 (1978), *aff'd per curiam* 634 F. 2d 1046 (1980); *Communications Satellite Corp.* v. *United States*, 223 Ct. Cl. 253 (1980); *Jupiter Corp.* v. *United States*, No. 83-842 (Ct. Cl. 1983).

Reasons for Change

The committee is concerned that partnerships have been used to effectively circumvent the requirement to capitalize certain expenses and other rules and restrictions concerning various expenses by making allocations of income and corresponding distributions in place of direct payments for property or services. The committee believes that these transactions must be expressly prohibited if the integrity of the capitalization requirements of present law is to be preserved. For example, in *Ellison* v. *Commissioner*, 80 T.C. 391 (1983), the Tax Court rejected use of a similar technique to convert purchase price into the equivalent of a deductible expense and concluded that a retained income interest in the seller of property was in reality a disguised purchase price.

In the case of disguised sales, the committee is concerned that taxpayers have deferred or avoided tax on sales of property (including partnership interests) by characterizing sales as contributions of property (including money) followed (or preceded) by a related partnership distribution. Although Treasury regulations provide that the substance of the transaction should govern, court decisions have allowed tax-free treatment in cases which are economically indistinguishable from sales of property to a partnership or another partner. The committee believes that these transactions should be treated for tax purposes in a manner consistent with their underlying economic substance.

Explanation of Provisions

a. Characterization of payments for services or property

If a partner performs services for, or transfers property to, a partnership, and, in connection therewith, receives a related partnership allocation and distribution, the transaction will be treated as a transaction between the partnership and a person who is not a partner, if under all the facts and circumstances, the transaction is more properly characterized as a payment to a partner acting in his non-partner capacity. In such a case, the amount paid to the partner in consideration for the property or services will be treated as a payment for services or property provided to the partnership (as the case may be), and, where appropriate, the partnership will be required to capitalize these amounts (or otherwise treat such amounts in a manner consistent with the recharacterization). The partnership will treat the purported allocation to the partner performing services or transferring property to the partnership as a payment to a non-partner in determining the partners' shares of taxable income or loss.

The committee does not intend that this provision will apply in every instance in which a partner acquires an interest in a partnership and also performs services or transfers property to the partnership. In particular, the committee does not intend to repeal the general rule under which gain or loss is not recognized on a contribution of property in return for a partnership interest (sec. 721)[4] or to apply this new provision in cases in which a partner receives an allocation (or an increased allocation) for an extended period to reflect his contribution of property or services to the partnership provided the facts and circumstances indicate that the partner is receiving the allocation in his capacity as a partner. However, the committee does intend that the provision apply to allocations which are determined to be related to the performance of services for, or the transfer of property to, the partnership and which, when viewed together with distributions, have the substantive economic effect of direct payments for such property or services under the facts and circumstances of the case.

The bill authorizes the Treasury Department to prescribe such regulations as may be necessary or appropriate to carry out the purposes of the provision. In prescribing these regulations, the Treasury should be mindful that the committee is concerned with transactions that work to avoid capitalization requirements or other rules and restrictions governing direct payments and not with non-abusive allocations that reflect the various economic contributions of the partners. These regulations may apply the provision both to one-time transactions and to continuing arrangements which utilize purported partnership allocations and distributions in place of direct payments. The committee specifically intends that the provision will apply to allocations used to pay partnership organization or syndication fees subject to the general principles above.

[4] Of course, if a partner received an interest in a partnership in exchange for services, he may recognize income upon that receipt. *See* sections 61 and 83, and *Diamond* v. *Commissioner*, 492 F. 2d 286 (7th Cir. 1974).

These regulations will provide, when appropriate, that the purported partner performing services or transferring property is not a partner at all. Once it is determined that the service performer or property transferor is actually a partner, the committee believes the factors described below should be considered in determining whether the partner is receiving the putative allocation and distribution in his capacity as a partner.

The first, and generally the most important, factor is whether the payment is subject to an appreciable risk as to amount. Partners extract the profits of the partnership with reference to the business success of the venture while third parties generally receive payments which are not subject to this risk. An allocation and distribution provided for a service partner under the partnership agreement which subjects the partner to significant entrepreneurial risk as to both the amount and the fact of payment generally should be recognized as a distributive share and a partnership distribution, while an allocation and distribution provided for a service partner under the partnership agreement which involves limited risk as to amount and payment should generally be treated as a fee under sec. 707(a). For example, allocations that limit a partner's risk may be either "capped" allocations of partnership income (i.e., percentage or fixed dollar amount allocations subject to an annual maximum amount when the parties could reasonably expect the cap to apply in most years) or allocations for a fixed number of years under which the income that will go to the partner is reasonably certain. Similarly, continuing arrangements in which purported allocations and distributions (under a formula or otherwise) are fixed in amount or reasonably determinable under all the facts and circumstances and which arise in connection with services also shield the purported partner from enterpreneurial risk. Although short-lived gross income allocations are particularly suspect in this regard, gross income allocations may, in very limited instances, represent an entrepreneurial return, classifiable as a distributive share under sec. 704. Similarly, while net income allocations generally appear to constitute distributive shares, some net income allocations may be fixed as to amount and probability of payment and if coupled with a distribution or payment from the partnership, should be characterized as fees.

The second factor is whether the partner status of the recipient is transitory. Transitory partner status suggests that a payment is a fee or is in return for property. The fact that the partner status is continuing, however, is of no particular relevance.

The third factor is whether the distribution and allocation that are made to the partner are close in time to the partner's performance of services for or transfers of property to the partnership. In the case of continuing arrangements, the time at which income will be allocated to the partner may be a factor indicating that an allocation is, in fact, a disguised payment. For example, an allocation close in time to the performance of services, or the transfer of property, is more likely to be related to the services or property. Also, when the income subject to allocation arises over an extended period or is remote in time from the services or property contributed by a partner, the risk of not receiving payment (the first factor described above) may increase.

The fourth factor is whether, under all the facts and circumstances, it appears that the recipient became a partner primarily to obtain tax benefits for himself or the partnership which would not have been available if he had rendered services to the partnership in a third party capacity. The fact that a partner has significant non-tax motivations in becoming a partner is of no particular relevance.

The fifth factor, which relates to purported allocations/distributions for services, is whether the value of the recipient's interest in general and continuing partnership profits is small in relation to the allocation in question. This is especially significant if the allocation for services is for a limited period of time. The fact that the recipient's interest in general and continuing partnership profits is substantial does not, however, suggest that the purported partnership allocation/distribution arrangement should be recognized.

The sixth factor, which relates to purported allocations/distributions for property, is whether the requirement that capital accounts be respected under section 704(b) (and the proposed regulations thereunder) makes income allocations which are disguised payments for capital economically unfeasible and therefore unlikely to occur. This generally will be the case unless (i) the valuation of the property contributed by the partner to the partnership is below the fair market value of such property (thus improperly understating the amount in such partner's capital account), or (ii) the property is sold by the partner to the partnership at a stated price below the fair market value of such property, or (iii) the capital account will be respected at such a distant point in the future that its present value is small and there is to be no meaningful return on the capital account in the intervening period.

The committee anticipates that the Secretary may describe other factors that are relevant in evaluating whether a purported allocation and distribution should be respected. In applying these various factors, the Treasury and courts should be careful not to be misled by possibly self-serving assertions in the partnership agreement as to the duties of a partner in his partner capacity but should instead seek the substance of the transaction.

In the case of allocations which are only partly determined to be related to the performance of services for, or the transfer of property to, the partnership, the provision will apply to that portion of the allocation which is reasonably determined to be related to the property or services provided to the partnership. Finally, it is anticipated that Treasury regulations will provide for the coordination of this provision with the existing rules of section 707 and other provisions of subchapter K such as section 736.

The committee does not intend to create any inference regarding the tax treatment of the transactions described above under existing law.

The principles of this provision can be illustrated by the following examples.

Example 1

A commercial office building constructed by a partnership is projected to generate gross income of at least $100,000 per year indefinitely. Its architect, whose normal fee for such services is $40,000, contributes cash for a 25-percent interest in the partnership and receives both a 25-percent distributive share of net income for the life of the partnership, and an allocation of $20,000 of partnership gross income for the first two years partnership operations after leaseup. The partnership is expected to have sufficient cash available to distribute $20,000 to the architect in each of the first two years, and the agreement requires such a distribution. The purported gross income allocation and partnership distribution should be treated as a fee under sec. 707(a), rather than as a distributive share. Factors which contribute to this conclusion are (1) the special allocation to the architect is fixed in amount and there is a substantial probability that the partnership will have sufficient gross income and cash to satisfy the allocation/distribution; (2) the value of his interest in general and continuing partnership profits is relatively small in relation to the allocation in question; (3) the distribution relating to the allocation is fairly close in time to the rendering of the services; and (4) it is not unreasonable to conclude from all the facts and circumstances that the architect became a partner primarily for tax motivated reasons. If, on the other hand, the agreement allocates to the architect 20 percent of gross income for the first two years following construction of the building a question arises as to how likely it is that the architect will receive substantially more or less than his imputed fee of $40,000. If the building is pre-leased to a high credit tenant under a lease requiring the lessee to pay $100,000 per year of rent, or if there is low vacancy rate in the area for comparable space, it is likely that the architect will receive approximately $20,000 per year for the first two years of operations. Therefore, he assumes limited risk as to the amount or payment of the allocation and, as a consequence, the allocation/distribution should be treated as a disguised fee. If, on the other hand, the project is a "spec building," and the architect assumes significant entrepreneurial risk that the partnership will be unable to lease the building, the special allocation might (even though a gross income allocation), depending on all the facts and circumstances, properly be treated as a distributive share and partnership distribution.

Example 2

There may be instances in which allocation/distribution arrangements that are contingent in amount may nevertheless be recharacterized as fees. Generally, these situations should arise only when (1) the partner in question normally performs, has previously performed, or is capable of performing similar services for third parties; and (2) the partnership agreement provides for an allocation and distribution to such partner that effectively compensates him in a manner substantially similar to the manner in which the partner's compensation from third parties normally would be computed.

For example, suppose that a partnership is formed to invest in stock. The partnership admits a stock broker as a partner. The broker agrees to effect trades for the partnership without the normal brokerage commission. In exchange for his partnership interest, the broker contributes 51 percent of partnership capital and receives a 51 percent interest in residual partnership profits and losses. In addition, he receives an allocation of gross income that is computed in a manner which approximates his foregone commissions. It is expected that the partnership will have sufficient gross income to make this allocation. The agreement provides that the broker will receive a priority distribution of cash from operations up to the amount of the gross income allocation. In this case, even though the broker/partner's special allocation appears contingent and not substantially fixed as to amount, it is computed by means of a formula like a normal brokerage fee and effectively varies with the value and amount of services rendered rather than with the income of the partnership. Thus, this contingent gross income allocation along with the equivalent priority distribution should be treated as a fee under sec. 707(a), rather than as a distributive share and partnership distribution.

In addition to these examples, the committee intends that the provision will lead to the conclusions contained in Revenue Ruling 81-300, 1981-2 C.B. 143, and Revenue Ruling 81-301, 1981-2 C.B. 144, except that the transaction described in Revenue Ruling 81-300 would be treated as a transaction described in section 707(a).

b. Disguised sales

The bill provides that when a partner transfers money or other property to a partnership which when viewed in connection with a related direct or indirect transfer of money or other property to that partner or another partner is properly characterized as a sale of property, the transaction is to be treated (as appropriate) as a sale between the partners of property (including partnership interests) or as a partial sale and partial contribution of the property to the partnership. The selling partner will be required to recognize gain (or loss) on the amount of the sales proceeds treated as received in the transaction. This rule is intended to prevent the parties from characterizing a sale or exchange of property as a contribution to the partnership followed by a distribution from the partnership to defer or avoid tax on the transaction.

To accomplish this, the bill authorizes the Treasury Department to prescribe such regulations as may be necessary or appropriate to carry out the purposes of this provision. In prescribing these regulations, the Treasury should be mindful that the committee is concerned with transactions that attempt to disguise a sale of property and not with non-abusive transactions that reflect the various economic contributions of the partners. Similarly, the committee does not intend to change the general rules concerning the tax treatment of the partners under sections 721, 731, and 752 to the extent (1) contributed property is encumbered by liabilities not incurred in anticipation of the contribution, or (2) contributions to a partnership which, because of liabilities of the partnership incurred other than in anticipation of the contribution result in a deemed distribution under sec. 752(b).

It is anticipated that the regulations will apply the provision when the transfer of money or property from the partnership to the partner is related to the transfer of money or other property to the partnership in such manner that, taking into account all the facts and circumstances, the transaction substantially resembles a sale or exchange of all or part of the property (including an interest in the partnership). For example, when a partner contributes appreciated property to a partnership and receives a distribution of money or property within a reasonable period before or after such contribution, that is approximately equal in value to the portion of contributed property that is in effect given up to the other partner(s) the transaction will be subject to this provision. However, the distribution would not be so subject if there is a corresponding partnership allocation of income or gain, but that arrangement may instead be subject to the new provision relating to partnership payments for property or services described above. The disguised sale provision also will apply to the extent (1) the transferor partner receives the proceeds of a loan related to the property to the extent responsibility for the repayment of the loan rests, directly or indirectly, with the partnership (or its assets) or the other partners, or (2) the partner has received a loan related to the property in anticipation of the transaction and responsibility for repayment of the loan is transferred, directly or indirectly, to the partnership (or its assets) or the other partners.

Although the rule applies to sales of property to the partnership, the committee does not intend to prohibit a partner from receiving a partnership interest in return for contributing property which entitles him to priorities or preferences as to distributions, but is not in substance a disguised sale. Similarly, the committee generally does not intend this provision to adversely affect distributions that create deficit capital accounts (maintained in a manner consistent with Treasury regulations under section 704(b)) for which the distributee is liable, regardless of the timing of the distribution, unless such deficit capital account is improperly understated or not expected to be made up until such a distant point in the future that its present valu› is small. However, if this deficit creating distribution is coupled with an allocation of income or gain, the distribution/allocation arrangement may be subject to the new provision relating to partnership payments for services or property. Similarly, the contribution of encumbered property to a partnership would not suggest a disguised sale to the extent responsibility for the debt is not shifted, directly or indirectly, to the partnership (or its assets) or to the non-contributing partners. The committee anticipates that the Treasury regulations will treat transactions to which the provision applies as a sale of property or partnership interests among the partners or as a partial sale and partial contribution of the property to the partnership, with attendant tax consequences, depending upon the underlying economic substance of the transaction. These regulations may provide for a period, such as three years, during which contributions by and distributions to the same or another partner normally will be presumed related. Finally, it is anticipated that the regulations will take into account the effect of liabilities which may accompany effective sales of property to a partnership or another partner.

No inference regarding the tax treatment of contribution arrangements or any similar transactions under existing law should be drawn from the committee's action.

c. Definition of partner

For purpose of these provisions, the regulations will provide that persons who become partners after performing services for, or transferring property to, the partnership are to be treated as partners.

Effective Dates

The provision with respect to services performed for, or property transferred to, a partnership when there is a related allocation and distribution is effective for services performed on property transferral after February 29, 1984. Generally, the disguised sale rules apply to property transferred after March 31, 1984. The bill provides a transitional rule for the disguised sale provision under which prior law will apply to a contribution of property before December 31, 1984, if (1) there was a written private placement offering memorandum in existence on February 29, 1984, (2) the partners had expended $250,000 in connection with the offering of February 29, 1984, (3) the partner contributing encumbered property is the sole general partner, and (4) all of the encumbrances incurred in anticipation of the contribution are without recourse.

Revenue Effect

This provision will increase fiscal year budget receipts by $20 million in 1985, $51 million in 1986, $60 million in 1987, $69 million in 1988, and $78 million in 1989.

4. Character of Gain or Loss on Disposition of Contributed Property (sec. 58 of the bill and new sec. 724 of the Code)

Present Law

The character of income or loss from the disposition of property by a partnership is generally determined at the partnership level.

Under present law, a contribution of property to a partnership by a partner, followed by a sale of the property, may result in a character of gain or loss different from that which would have resulted from a direct sale by the partner. Thus, ordinary income may be converted into capital gain when dealer status exists at the partner but not at the partnership level. For example, a taxpayer having appreciated inventory may be able to convert the gain on such property from ordinary income to capital gains by contributing the inventory property to a partnership and having the partnership sell the property. Conversely, a capital loss may be able to be converted into an ordinary loss when dealer status exists at the partnership but not the partner level. For example, a taxpayer owning securities which have declined in value may attempt to convert his capital losses into ordinary losses by contributing the securities to a dealer partnership and claiming that the loss upon a later sale of the securities was incurred in the ordinary course of the partnership's trade or business.

This result can be contrasted with the treatment of certain ordinary income property distributed by a partnership and subsequently sold by the recipient. The character of gain or loss on property in such a case generally is determined by the character of the property in the hands of the distributee with two exceptions. First, in the case of certain inventory items, the ordinary income character of an asset in the hands of the partnership carries over to the partner for a 5-year period. Second, the ordinary income character of certain unrealized trade or business receivables also carries over to the partner on an indefinite basis (sec. 735).

Reasons for Change

The committee is concerned that, under some circumstances, a taxpayer may alter the character of gain or loss merely by contributing property to a new or existing partnership. In particular, the conversion of capital to ordinary losses by contributing securities to a dealer partnership may allow a taxpayer to receive the benefits of capital gain taxation on appreciated securities by selling them individually while deducting ordinary losses on the sale of securities which have declined in value (by having the dealer partnership sell them and allocate the resulting loss to the taxpayer). The committee believes that these potential abuses should be prevented by preserving the pre-contribution character of contributed (or substitute basis) property in appropriate cases.

For similar reasons, the committee believes the existing rules preserving the character of certain property distributed by a partnership should apply to property the basis of which is determined by reference to the distributed property.

Explanation of Provision

Under the bill, if a partnership disposes of property which was inventory property in the hands of a partner immediately before its contribution, any gain or loss recognized by the partnership on the disposition of the property for a period of 5 years after the date of the contribution will be treated as ordinary income or lcss. Gain or loss on a disposition of unrealized receivables contributed by a partner will be treated as ordinary income or loss regardless of the date of disposition. These rules generally mirror the present law treatment of unrealized receivables and inventory distributed to a partner by a partnership. The bill also provides that built-in losses on capital assets will retain their character as capital losses for a period of 5 years after the date of contribution, but only to the extent of pre-contribution unrealized losses.

To prevent avoidance of thc rules requiring a carryover of the character of contributed property by exchanging items of property, if contributed property subject to the rule is transferred in a nonrecognition transaction, any substituted basis property (other than stock in a C corporation received by the transferor which remains as such) resulting from the transaction (including the property contributed to the partnership) that is held by the transferor-partnership or a transferee will be subject to the same characterization rules, and such property will for purposes of these rules be treated as unrealized receivables or inventory. These rules also will be applied in the case of subsequent nonrecognition transactions involving the substituted basis property. Similar basis tainting rules are added to the existing provision regarding certain ordinary income property distributed by a partnership to a partner (sec. 735). It is intended that the basis tainting rules regarding contributed and distributed property will apply only for the period during which the underlying rules would apply if the property were not disposed of in a nonrecognition transaction. For example, if capital loss property were contributed to a partnership and subsequently disposed of in a nonrecognition transaction, capital loss treatment would apply to any substitute basis property only for the duration of the 5-year period beginning on the date of the original contribution.

The bill further provides that, for purposes of the rules regarding contributed and distributed property (i.e., the new rules and sec. 735 but not sec. 751), certain property which would qualify as a capital asset if held for one year or more by the partner or partnership prior to contribution or distribution (as the case may be) will not be treated as ordinary income property. This change prevents property which would have qualified for capital gain treatment if held by its original owner from receiving less favorable treatment following the transfer of the property.

Effective Date

The provisions regarding contributed property apply to property contributed to a partnership after March 31, 1984, in taxable years ending after that date.

The amendments to the provisions regarding property distributed by a partnership apply to property distributed after March 31, 1984, in taxable years ending after that date.

Revenue Effect

This provision will increase fiscal year budget receipts by $24 million in 1985, $63 million in 1986, $66 million in 1987, $67 million in 1988, and $69 million in 1989.

5. Transfers of Partnership Interests by Corporations (sec. 59 of the bill and new sec. 744 of the Code)

Present Law

The gain or loss on the sale or exchange of a partnership interest is generally a capital gain or loss. However, money or property received by a transferor partner in exchange for all or part of his partnership interest is subject to ordinary income treatment to the extent it is attributable to certain ordinary income assets of the partnership (sec. 751). For purposes of this provision, ordinary income items include the recapture of depreciation deductions previously taken on partnership property.

Also under present law, when a corporation distributes property (or sells property in the course of certain complete liquidations), income attributable to recapture property (and certain installment obligations) is taxed to the corporation, while other gain attributable to appreciation in value of the transferred property generally goes unrecognized.

Some taxpayers have taken the position that the present law recapture provisions do not apply to the distribution or liquidating sale by a corporation of an interest in a partnership that holds recapture property. According to this interpretation, a corporation may avoid recapture by contributing recapture property to a partnership and distributing interests in the partnership to its shareholders, or selling the interests in the course of liquidation. Taxpayers contend that the partnership interests themselves do not constitute recapture property and that, in any event, the corporate liquidation does not constitute an exchange under section 741. Thus it is argued that the corporation may claim that no gain is recognized on the transaction.

Basis adjustment.—Under present law (secs. 743 and 754), a partnership may elect on a sale or exchange or transfer by reason of death of interests in the partnership to adjust the basis of partnership assets to reflect differences between the basis of partner's interest in the partnership and the partner's share of the basis of the partnership property. The election must apply to all sales or exchanges of partnership interests and may be revoked only for sufficient reason (Treas. Reg. sec. 1.754-1(c)).

Reasons for Change

The existing corporate recapture rule is intended to insure that corporate income is recognized on a distribution of recapture property to a corporations' shareholders or upon a liquidating sale of such property. Similarly, the requirement that a taxpayer recognize ordinary income on sales or exchanges of certain partnership interests prevents taxpayers from avoiding ordinary income taxation by transferring interests in partnership which hold assets that would be subject to depreciation recapture (or otherwise subject to ordinary income treatment) if the assets themselves were disposed of.

If an interest in a partnership which holds recapture property may be distributed, or sold in liquidation, without being subjected to recapture, the corporation has effectively deferred and, perhaps may avoid, the recapture taxes. Thus the corporation may have benefitted from the tax advantages of depreciation (including accelerated depreciation) without being subject to recapture as would the case if the corporation distributed the recapture property directly to its shareholders. The committee believes that the Code should specifically prohibit this unintended tax benefit. To accomplish this, the bill generally requires that the distribution of the partnership interest be treated as if the corporation had made a direct distribution (or liquidating sale) of the recapture and other recognition assets.

Explanation of Provision

For purposes of determining the amount of gain recognized by a corporation on any distribution, the bill treats the distribution of a partnership interest as a distribution of the corporation's proportionate share of the recognition property of the partnership. Recognition property is defined as any property with respect to which the corporation would recognize gain if it distributed the property in a distribution (sec. 311 or 336) or sold the property in a liquidation sale (sec. 337). The corporation's proportionate share of recognition property shall be determined in accordance with the principles of section 751. In determining the amount of gain recognized on the transaction, the corporation is treated as if it had made a direct distribution (or liquidating sale or exchange) of the underlying recognition property.

The bill provides that, in determining whether property of a partnership is recognition property, the partnership shall be treated as owning its proportionate share of the property of any other partnership in which it is a partner. This rule is intended to prevent the avoidance of the rules above by the use of tiered or multitiered partnership arrangements. (See item 6. following).

The bill further provides that, under Treasury regulations, rules similar to the rules above shall apply in the case of interests in trusts. These rules will prevent the use of interests in trusts to achieve results similar to those prevented by the statute in the case of partnership interests.

No inference should be drawn from the committee's action regarding the treatment of these transactions under present law.

Basis adjustments.—When a partnership has an appropriate election in effect, the basis of partnership property may be adjusted following the sale or exchange or transfer by reason of death of interests in the partnership to reflect differences between the basis of partner's interest in the partnership and the partner's share of the basis of the partnership property on the transfer (secs. 743 and 754). Under the bill, the basis of partnership property is to be adjusted to take into account amounts recognized on transfers accomplished through distributions (whether by corporations or partnerships).

No inference should be drawn from the committee's action regarding the treatment of these transactions under present law.

Effective Date

The provision applies to distributions, sales, and exchanges made after March 31, 1984, in taxable years ending after that date.

Revenue Effect

This provision will increase fiscal year budget receipts by less than $5 million in 1985, and $50 million annually for years 1986 through 1989.

6. Use of Tiered Partnerships to Alter Character of Income on Exchanges of Partnership Interest (sec. 60 of the bill and sec. 751 of the Code)

Present Law

The gain or loss on the sale or exchange of a partnership interest is generally a capital gain or loss. However, money or property received by a transferor partner in exchange for all or part of his partnership interest is subject to ordinary income treatment to the extent it is attributable to certain ordinary income assets of the partnership (sec. 751). These items include (1) certain unrealized receivables of the partnership, and (2) inventory items of the partnership which have appreciated substantially in value. Generally, substantially appreciated inventory is defined as inventory having a fair market value greater than 120 percent of the partnership's adjusted basis for the property and greater than 10 percent of the fair market value of all partnership property, other than money. Unrealized receivables of a partnership include rights to payments that have not yet been taken into account under the partnership method of accounting and a variety of recapture amounts with respect to partnership property. Ordinary income treatment also applies to distributions to a partner that have the effect of causing a shifting of the various partners' interests in unrealized receivables or substantially appreciated inventory of the partnership. These rules prevent a partner from receiving capital gain treatment for gains attributable to ordinary income property of the partnership.

Under present law, some taxpayers have argued that ordinary income treatment of unrealized receivables and substantially appreciated inventory may be avoided when the assets are held in a second partnership. When assets are held in a second partnership, it is not clear whether the ordinary income rules of section 751 should be applied by regarding change in interests in the first partnership as an exchange of a capital asset (the interest in the second partnership) or of ordinary income assets (the assets owned through the second partnership).

Reasons for Change

The committee believes that taxpayers should not be allowed to convert potential ordinary income into capital gains by selling their partnership interests. This policy has been reflected in the 1954 Code since its enactment. The committee knows of no reason why the use of tiered partnership arrangements should be permitted to frustrate this policy.

Explanation of Provision

Under the bill, the ordinary income rules of section 751 will be applied by regarding income rights, as section 751 does under present law, as severable from the partnership interest.[5] Under this approach, a partner will be treated as disposing of such items independently of the rest of his partnership interest. The rule will apply regardless of how many tiers of partnerships exist between the transferring or distributee partner and the ordinary income assets.

The committee amendment also provides that this approach regarding income rights as severable is to apply to interests in trusts held by partnerships in the manner provided for in regulations.

The committee does not intend to create any inference regarding the tax treatment of these transactions under existing law.

Effective Date

The provision is effective for distributions, sales, and exchanges made after March 31, 1984, in taxable years ending after that date.

Revenue Effect

This provision has a negligible effect on fiscal year budget receipts.

[5] See H.R. Rep. No. 1337, 83rd Cong. 2nd Sess. pages 70, 71 (March 9, 1954).

7. Exchanges of Like-Kind Property (sec. 61 of the bill and sec. 1031 of the Code)

Present Law

General rules

An exchange, like a sale of property, is generally a taxable transaction. However, present law provides that no gain or loss is to be recognized if property held for productive use is the taxpayer's trade or business, or property held for investment purposes, is exchanged solely for property of a like-kind that is also to be held for productive use in a trade or business or for investment. This provision (sec. 1031) specifically does not apply to exchanges of stock in trade or other property held primarily for sale, or to stocks, bonds, notes, choses in action, certificates of trust or beneficial interest, or other securities or evidences of indebtedness or interest.[6]

The nonrecognition of gain in like-kind exchange applies only to the extent that like-kind property is received in the transaction. For example, if a taxpayer holding a parcel of land having a basis of $50,000 and a fair market value of $100,000 exchanges the property for a parcel of land worth $90,000 plus $10,000 in cash, the taxpayer would recognize $10,000 of gain on the transaction. The remaining $40,000 of gain would be deferred until the taxpayer disposes of the second parcel as a taxable sale or exchange. No losses may be recognized from a qualifying like-kind exchange.

Present law does not require specifically that a like-kind exchange be completed within a specified period in order to qualify for tax-free treatment. In *Starker* v. *United States*, 602 F.2d 1341 (9th Cir. 1979), the United States Court of Appeals for the Ninth Circuit held that an exchange qualified for like-kind treatment even though the property to be exchanged could be designated by the transferor for up to 5 years after the transaction and even though the transferor could have ultimately received cash rather than like-kind property. The case involved an exchange of real property in which the transferor eventually received like-kind property.

Installment sales

The Internal Revenue Code provides special rules for the reporting of income from installment sales (sec. 453). These rules allow gains from an installment sale to be spread out over the period during which installment payments are received. In general, the taxpayer reports income in each year for that proportion of the

[6] Special rules allow tax-free like-kind exchanges of stock of the same corporation (sec. 1036), certain insurance policies (sec. 1035), and certain U.S. obligations (sec. 1037). Additionally, the law provides for nonrecognition of gain in certain situations in which property lost or sold by the taxpayer is replaced, within a specified period, by property of a similar kind.

payments received during the year which is equivalent to the ratio which the gross profit from the sale bears to the total contract price. An installment sale is defined as a disposition of property in which at least one payment is received after the close of the taxable year in which the disposition occurs. For this purpose, payment includes property permitted to be received without the recognition of gain (sec. 453(f)(6)).

Exchanges of partnership interests

Present law does not state specifically whether an interest in one partnership may be exchanged for an interest in another partnership as a tax-free exchange of like-kind property. The Internal Revenue Service has ruled that the exception for equity interests in financial enterprises applies to partnership interests and thus they do not qualify as like-kind property that may be exchanged tax-free. Rev. Rul. 78-135, 1978-1 C.B. 256. Court decisions have held that exchanges of partnership interest may qualify for tax-free treatment as like-kind property exchanges where the underlying assets of the partnerships are substantially similar in nature. *Estate of Rollin E. Meyer, Sr.*, 58 T.C. 311 (1972), *aff'd per curiam* 503 F. 2d 566 (9th Cir. 1974); *Gulfstream Land and Development Co.*, 71 T.C. 587 (1979). However, the court in the *Estate of Meyer* case held that an exchange of a general partnership interest for a limited partnership interest does not satisfy the like-kind requirement.

Reasons for Change

Deferred like-kind exchanges

The committee is concerned that like-kind treatment of non-simultaneous exchanges has given rise to unintended results and administrative problems. These concerns extend to the underlying policy of the like-kind exchange rule.

The special treatment of like-kind exchanges has been justified on the grounds that a taxpayer making a like-kind exchange has received property similar to the property relinquished and therefore has not effectively "realized" a profit on the transaction. This rationale is less applicable in the case of deferred exchanges. To the extent that the taxpayer is able to defer completion of the transaction—often retaining the right to designate the property to be received at some future point—the transaction begins to resemble less a like-kind exchange and more a sale of one property followed, at some future point, by a purchase of a second property or properties. This is particularly true when (as was the case in the *Starker* v. *United States*) the taxpayer might have received like-kind or non-like-kind property in the future. The committee believes that like-kind exchange treatment is inappropriate in such situations and that the general rule requiring recognition of gain on sales or exchanges of property should apply to these cases.

The special treatment of like-kind exchanges has also been justified from an administrative standpoint because of the difficulty of valuing property which is exchanged solely or primarily for similar property. This rationale may also be less applicable to deferred like-kind exchanges, in particular exchanges which are "left open" until the taxpayer has selected a suitable exchange property. In such cases, the transferred property must be valued at a specific or near-specific dollar amount in order to determine the aggregate value of the properties that the taxpayer may receive in the future. Thus, the taxpayer's gain may be measured with reasonable accuracy in the year of the original transfer.

The committee is also concerned that the like-kind exchange rules significantly expand the ability of taxpayers to avoid recognition of gain on deferred payment sales. Unlike other nonrecognition rules (e.g., the rollover of gain on replacement of a principal residence), the like-kind exchange provisions have no express statutory time limit on the availability of nonrecognition treatment. Decisions such as that in *Starker* v. *United States* suggest that there may, in fact, be no limit on the time for which like-kind exchanges may be kept open. If this is the case, taxpayers, by combining the installment sale rules and the like-kind exchange provisions, may defer taxation on dispositions of property for an indefinite period of time, even if a right to receive cash instead of property is retained. If cash is ultimately received, the installment sale rules will achieve a deferral until the time of receipt, while if like-kind property is received, recognition will be even further delayed. By exercising the right to designate property shortly before death, a taxpayer may conceivably avoid any taxation on the sale. Interaction of the installment sale and like-kind exchange rules also raises serious administrative problems regarding the allocation of liabilities and basis among different properties, problems which may not be resolvable until all exchanges and payments required by the agreement have been completed. Thus the tax consequences of deferred exchanges may not be determined for many years after the transaction is initiated.

Exchanges of partnership interests

It is questionable whether the like-kind exchange provisions were originally intended to apply to exchanges of partnership interests. The statute by its own terms does not apply to exchanges of stock, certificates of trust or beneficial interest, or other securities or evidences of indebtedness or interest (sec. 1031). These exclusions prevent taxpayers from trading investment interests so as to take advantage of like-kind treatment on dispositions of appreciated property. The committee believes that, at least under current conditions, partnership interests typically represent investment interests similar to those items already excluded from like-kind treatment and should therefore also be excluded from such treatment.

In reaching the decision above, the committee is particularly concerned by the use of the like-kind exchange rules to facilitate the exchange of interests in tax shelter investments for interests in other partnerships. Under this arrangement, taxation of the gain inherent in an interest in a "burned out" tax shelter partnership—i.e., a partnership which has taken substantial deductions for nonrecourse liabilities without actually paying off such liabilities, and hence without the partners suffering real economic loss—may be able to be avoided if the interest is exchanged, tax-free, for an interest in another partnership, provided the old partnership has a section 754 election in effect and the new partnership does not.

While court decisions have limited like-kind exchange treatment to partnerships holding similar underlying assets, this rule may be inadequate to deal with the burned-out tax shelter abuses and the administrative hardships. The committee believes that such abuses and hardships are best prevented by specifically excluding partnership interests from the like-kind exchange rule.

Explanation of Provisions

Deferred like-kind exchanges

The bill provides that, for purposes of the like-kind exchange provision, any property received by the taxpayer more than 180 days (but not later than the due date of the taxpayer's tax return) after the date on which the taxpayer relinquishes property is not to be treated as like-kind property. Thus, tax-free treatment will be unavailable for exchanges not completed within this time period. In addition, property which was not identified as the property to be received by the taxpayer on the date the transferred property was relinquished will not qualify as like-kind property.

Exchanges of partnership interests

The bill specifies that the like-kind exchange rules do not apply to any exchange of interests in different partnerships. This rule is not intended to apply to an exchange of interests in the same partnership.

No inference should be drawn from the committee's action regarding the proper treatment of these transactions under present law.

Effective Date

The provisions are effective for transfers of property (by the taxpayer seeking like-kind exchange treatment) made after date of enactment.

Revenue Effect

This provision will increase fiscal year budget receipts by $226 million in 1985, $630 million in 1986, $667 million in 1987, $788 million in 1988, and $842 million in 1989.

F. Trust Provisions

1. Trust Distributions (sec. 82 of the bill and sec. 643 of the Code)

Present Law

Under present law, beneficiaries are taxed on amounts distributed from a trust or estate to the extent of the trust's or estate's distributable net income. The trust or estate is allowed a deduction for amounts taxed to its beneficiaries. The present Treasury regulations provide that distributions of property are deemed to carry out distributable net income to the extent of the property's value at the time of distribution. In such a case, there is no gain or loss realized by the trust or estate,[1] and the basis of the property in the hands of the beneficiary is its value to the extent it carries out distributable net income. Treas. Reg. sec. 1.661(a)-2(f).

Reasons for Change

Where a trust or estate has distributable net income and distributes property, the effect of the present Treasury regulations is to exempt the gain or loss entirely from tax. The committee believes that the gain or loss should be taxed to either the beneficiary or the trust (or estate). Accordingly, the committee bill provides that, in general, the distribution of property will be a taxable event resulting in the taxation of the gain or loss to the trust or estate. However, the committee bill provides that, at the election of the trustee or executor, the distribution of property by a trust or estate carries out distributable net income only to the extent of the lesser of the property's basis or fair market value and that the basis of the property carries over to the beneficiary. Under this election, the appreciation will be taxed to the beneficiary when the beneficiary disposes of the property.

Explanation of Provision

Under the committee bill, the distribution of property by a trust or estate results in the recognition of gain or loss on the distribution as if the property had been sold to the beneficiary.[2] Alternatively, the bill allows the trustee or executor to elect to treat distributions of property as carrying out distributable net income only to the extent of the lesser of the property's basis or its fair market value at the time of distribution. If the election is made, the basis of the property in the hands of the beneficiary would be the same

[1] Under Rev. Rul. 67-74, 1974-1 C.B. 194, the distribution of property to a beneficiary in satisfaction of his right to receive income currently results in the recognition of gain or loss to the trust.

[2] In the case of a distribution by a trust of property whose fair market value is less than its basis, section 267 would deny a loss deduction to the trust. However, section 267 does not apply to deny a deduction to an estate in such a case.

as the trust's or estate's. The bill does not change existing law in those cases where a distribution of property to a beneficiary results in recognition of gain or loss to the trust (or estate).

Effective Date

The provision iε effective with respect to distributions made after March 1, 1984, in taxable years ending after that date.

Revenue Effect

This provision will increase fiscal year budget receipts by less than $10 million in 1984, $64 million in 1985, $261 million in 1986, and $409 million in 1987, $438 million in 1988, and $467 million in 1989.

2. Taxation of Multiple Trusts (sec. 82 of the bill and sec. 643 of the Code)

Present Law

Trusts are treated as separate taxable entities with respect to certain accumulated and undistributed income (sec. 641). Trusts are taxed under a separate progressive rate schedule (sec. 1(e)).

Treasury regulations enacted following the Tax Reform Act of 1969 provide that multiple trusts will be treated as one trust if they have (1) the same grantor and substantially the same beneficiary, (2) no substantially independent purposes (such as independent dispositive purposes), and (3) as their principal purpose the avoidance or mitigation of progressive rates of tax (including mitigation as a result of deferral of tax) or avoidance or mitigation of the alternative minimum tax.[3]

In *Edward L. Stephenson Trust* v. *Commissioner*, 81 T.C. No. 22 (September 12, 1983), the Tax Court held that the Treasury regulations regarding multiple trusts were invalid because the Internal Revenue Code did not support a subjective test of tax avoidance motive as a basis for determining the existence of multiple trusts. The court further held that Congress, by enacting a series of more limited rules relating to multiple trusts in the Tax Reform Acts of 1969 and 1976, had implicitly accepted an earlier Tax Court decision which held that the motive for establishing and maintaining multiple trusts was irrelevant for tax purposes.[4]

Reasons for Change

Because of the progressive tax structure, it would be possible to significantly reduce income taxes by establishing multiple trusts having the same grantor and the same or similar beneficiaries. For example, if instead of establishing one $1,000,000 trust a taxpayer establishes ten essentially identical $100,000 trusts, the taxpayer will be able to secure a significantly lower marginal tax rate for the undistributed income of the trusts.

The committee is concerned that, without the restrictions of the existing Treasury regulations persons would be able to significantly reduce the taxation of investment income through the creation of multiple trusts. Accordingly, the committee believes that rules similar to the rules contained in the existing regulations should be legislated by the Congress.

[3] Treas. Reg. sec. 1.641(a)-0(c).

[4] *Estelle Morris Trusts* v. *Commissioner*, 51 T.C. 20 (1968), *aff'd per curiam* 427 F.2d 1361 (9th Cir. 1970).

Explanation of Provision

The bill provides that, under Treasury regulations, two or more trusts shall be treated as one trust if (1) the trusts have substantially the same grantor or grantors and substantially the same primary beneficiary or beneficiaries and (2) a principal purpose for the existence of the trusts is the avoidance of Federal income tax. For purposes of these rules, a husband and wife are to be treated as one beneficiary or grantor. Also, trusts will not be treated as having different primary beneficiaries merely because the trust has different contingent beneficiaries. Similarly, trusts will not be treated as having different grantors by having different persons making nominal transfers to the trusts.

For example, the committee expects that the Treasury regulations would treat the trusts in the following example as one trust:

> A establishes, with the principal purpose for the avoidance of Federal income tax, trust 1 for the benefit of his sister S1, his brother B1, and his brother B2; trust 2 for the benefit of his sister S2, his brother B1, and his brother B2; trust 3 for the benefit of his sister S1, his sister S2, and his brother B1; and trust 4 for the benefit of his sister S1, his sister S2, and his brother B2. Under each trust instrument, the trustee is given discretion to pay any current or accumulated income to any one or more of the beneficiaries.

Where there are substantial independent purposes, and tax purposes are not a principal purpose of the existance of separate trusts, the trusts will not be aggregated. The following is an example where separate trusts will not be aggregated under the committee bill:

> X establishes two irrevocable trusts for the benefit of X's son and daughter. Son is the income beneficiary of the first trust and the trustee (Bank of P) is required to pay all income currently to son for life. Daughter is the remainder beneficiary. X's daughter is an income beneficiary of the second trust and the trust instrument permits the trustee (Bank of D) to accumulate or to pay income, in its discretion, to daughter for her education, support and maintenance. The trustee also may pay income or corpus to son for his medical expenses. Daughter is the remainder beneficiary and will receive the trust corpus upon son's death.

Effective Date

This provision is effective for taxable years beginning after March 1, 1984.

Revenue Effect

This provision will increase fiscal year budget receipts by less than $5 million annually.

G. Time Value of Money and Other Accounting Changes

1. Timing and Measurement of Interest Inclusion and Deduction in Deferred Payment Transactions (secs. 25 and 28 of the bill and secs. 163(e) and 483 and new secs. 1274, 1275 and 7660 of the Code)

Present Law

Timing of inclusion and deduction of deferred interest

OID rules.—If in a lending transaction the borrower receives less than the amount that must be repaid, the difference represents "discount." Discount performs the same function as stated interest; it compensates the lender for the use of its money.[1] Present law (secs. 1232A and 163(e)) generally requires the holder of a discount debt obligation to include in income annually a portion of the original issue discount (OID) on the obligation and allows the issuer of the obligation to deduct a corresponding amount, irrespective of whether the issuer or holder uses the cash or accrual method of accounting (hereafter referred to as the "OID rules").[2]

Original issue discount is defined as the difference between the issue price of an obligation and its stated redemption price at maturity. This amount is allocated over the life of the obligation through a series of adjustments to the issue price for each "bond period" (generally, each one-year period beginning on the date of issue of the bond and each anniversary of that date). The adjustment of the issue price for each bond period is determined by multiplying the adjusted issue price (*i.e.*, the issue price as increased by adjustments prior to the beginning of the bond period) by the obligation's yield to maturity, and then subtracting the interest payable during the bond period. The adjustment of the issue price for any bond period is the amount of OID allocated to that bond period.

Present law provides exceptions to the rules requiring annual recognition and deduction of OID for the following: (1) obligations issued by individuals; (2) obligations with a maturity of less than one year; (3) obligations exempt from tax under section 103 or any other provision of law; (4) obligations issued in exchange for property where neither the obligation nor the property received is public-

[1] *United States* v. *Midland-Ross Corp.*, 381 U.S. 54 (1965) (a case decided under the 1939 Code). See also *Commissioner* v. *National Alfalfa Dehydrating & Milling Co.*, 417 U.S. 134 (1974).

[2] The purpose of the OID rules is to ensure that an OID obligation is treated for tax purposes in a manner similar to a nondiscount obligation requiring current payment of interest. They treat the borrower as having constructively paid the lender the annual unpaid interest accruing on the outstanding principal, which amount the borrower may deduct as interest expense and the lender is required to take into income. The lender is then deemed to have relent this amount to the borrower, who must in subsequent periods pay interest on this amount as well as on the original principal. This concept of accruing interest on unpaid interest is often referred to as the "economic accrual" of interest or interest "compounding."

ly traded; (5) obligations issued for the use of property; and (6) obligations issued in exchange for services.[3]

Measurement of interest in deferred payment transactions involving nontraded property

Section 483.—Parties to a deferred payment transaction involving a sale of property may be subject to the unstated interest rules of section 483.[4] If the parties to such a transaction do not specify a minimum (safe-harbor) rate of interest to be paid by the purchaser-borrower, section 483 recharacterizes a portion of principal as unstated interest assuming a higher "imputed" interest rate. The safe-harbor rate is a simple interest rate; the imputed rate is a compound rate. Currently, the safe-harbor and imputed rates are 9 percent and 10 percent, respectively. The maximum imputed interest rate applicable to certain transfers of land between members of the same family is 7 percent.

Section 483 provides exceptions (1) for transactions where the sales price does not exceed $3,000; (2) for payments made pursuant to a transfer described in section 1235(a) (relating to the sale or exchange of patents); (3) in the case of sellers, for sales of property if all of the gain on the sale would be ordinary; and (4) for certain other transactions.

If interest is imputed under section 483, a portion of each deferred payment is treated as unstated interest. The allocation between unstated interest and principal is made on the basis of the size of the deferred payment relative to total deferred payments. Amounts characterized as unstated interest are included in the income of the lender in the year in which the deferred payment is received (in the case of a cash method taxpayer) or due (in the case of an accrual method taxpayer). The borrower correspondingly deducts the imputed interest in the year in which the payment is made or due.

Section 482.—The regulations under section 482, relating to the allocation of income and deductions between commonly controlled organizations, trades or businesses, require a similar imputation of interest in the context of loans and deferred payment sales transactions between commonly controlled businesses where adequate interest is not provided for. The regulations employ a simple interest safe-harbor rate to test the adequacy of stated interest and assume a higher simple interest rate if this rate is not met.

Reasons for Change

Mismatching and noneconomic accrual of interest

The OID rules were enacted in 1969 to eliminate the distortions caused by the mismatching of income and deductions by lenders and borrowers. Prior to that time, an accrual method borrower could deduct deferred interest payable to a cash method lender in a

[3] Payments made to employees and nonemployees pursuant to nonqualified plans of deferred compensation are governed by sections 404 and 404A, which deny a deduction for such amounts until the year in which they are included in the income of the employee. Present law is unclear as to whether all deferred payments for services are within the scope of sections 404 and 404A.

[4] Section 483 does not apply to transactions covered by the OID rules. See Treas. Reg. secs. 1.483-1(b)(3), 1.483-1(d)(3)(ii).

period prior to the period in which the lender took the interest into income. The possibility of such mismatching still may exist in the case of obligations that come within one of the exceptions to the OID rules. Some taxpayers have attempted to exploit these exceptions, particularly the exception relating to obligations issued for nontraded property,[5] to achieve deferral of income tax on interest income and accelerated deductions of interest expense.

For example, real estate or machinery may be purchased for notes providing that interest will accrue annually but will not be paid until the notes mature. The issuer, who typically uses the accrual method of accounting, will claim annual interest deductions while the holder, who typically uses the cash method of accounting, will defer interest income until it is actually received. From the government's standpoint, the present value of the income included by the lender in the later period will be less than the present value of the deductions claimed by the borrower. As the disparity between the time when the borrower deducts the interest expense and the time when the lender reports the interest income grows, the revenue loss increases geometrically.[6]

The revenue loss is magnified if the accrual method purchaser computes its interest deduction using a noneconomic formula such as straight-line amortization, simple interest, or the "Rule of 78's."[7] Although the Internal Revenue Service recently issued a revenue ruling which proscribes the deduction of interest in an amount in excess of the economic accrual of interest for the taxable year,[8] the committee understands that some taxpayers are taking the position that this ruling is an incorrect interpretation of present law.

In view of the significant distortions occurring under present law, the committee believes that it is appropriate to extend the periodic inclusion and deduction rules of existing sections 1232A and 163(e) to obligations issued for nontraded property and to obligations issued by individuals. The committee believes that the valuation problems that may arise in situations where neither side of a transaction is publicly traded can be resolved by imputing a conservative rate of interest in appropriate cases. For similar reasons, the committee believes that it is no longer appropriate to

[5] The bill which became the Tax Reform Act of 1969, as reported by this committee and the House Ways and Means Committee, included within its scope essentially all transactions involving issuance of a debt obligation for property. A Senate floor amendment added the exception for obligations issued for nontraded property, reflecting concern that the parties to such sales might take inconsistent positions on valuation to the detriment of the Treasury. See letter from John S. Nolan, Deputy Assistant Secretary of the Treasury, to Sen. John J. Williams, dated November 28, 1969, 115 Cong. Rec. 36730-36731 (1969).

[6] The Conference Report to the Technical Corrections Act of 1982, which repealed the exception to section 1232 for publicly traded obligations issued in a reorganization, specifically referred to the mismatching problem in transactions involving nontraded property and indicated that further legislation might be appropriate in the near future if the Treasury Department was unable to deal with the problem administratively. H. R. Rep. No. 97-986, 97th Cong., 2d Sess. 21 (1982). While the Internal Revenue Service may be successful in challenging the deductions for accruing interest under certain theories, this result is unclear. See Canellos and Kleinbard, "The Miracle of Compound Interest," 38 Tax L. Rev. 565, 606–609 (1983).

[7] The Rule of 78's is a formula for allocating interest over the term of a loan that results in much larger deductions in the early years. To illustrate, in the case of a 30-year loan, interest would be calculated under the Rule of 78's by first taking the sum of the integers from 1 through 30 (*i.e.*, 1+2+3+4 . . . and so on up to 30), or 465. The borrower would accrue 30/465 (or 6.45 percent) of the total interest in the first year, 29/645 (6.24 percent) in the second year, and so on until the 30th year, when 1/465 (.22 percent) of the total interest would be accrued.

[8] Rev. Rul. 83-84, 1983-1 C.B. 9.

exempt holders of obligations that are not capital assets in the holders' hands from the periodic inclusion rules.[9]

Although the OID rules are somewhat complex, the committee believes that they can be extended to a broader range of transactions without disrupting the routine, legitimate transactions of individuals or small businesses, which might have difficulty understanding and applying the rules. The committee's bill exempts many of these transactions. Moreover, individuals rarely issue sizable long-term debt obligations that do not require current payments of interest outside of the context of tax-motivated transactions.

Mismeasurement of interest in transactions involving nontraded property

Recharacterization of interest as principal

The committee recognizes that it is possible in a deferred payment sales transaction involving nontraded property to manipulate the principal amount by understating the interest element of the transaction. Although the parties to a transaction in which interest has been artificially fixed at a below-market rate are, economically, in the same position as if interest had been accurately stated, significant tax advantages may result from characterizing the transaction as one involving low interest and high principal.

If recognized for tax purposes, this mischaracterization of interest as principal could overstate the principal amount of the loan and hence the sales price and tax basis of the property.[10] In cases where the property is a capital asset in the hands of the seller, the seller will have transformed interest income, which should be taxable as ordinary income in the year that it accrues, into capital gain taxable at lower rates and only when paid at maturity. If the property is depreciable in the hands of the purchaser, the inflated basis may enable the purchaser to claim excessive cost recovery (ACRS) deductions and investment tax credits.

Inadequacy of section 483 rates

The safe harbor and imputed interest rates provided in section 483 do not represent economic rates of interest for three reasons. First, although the rates have been changed over the years, they

[9] The capital asset exemption was designed to prevent the conversion of ordinary income into capital gain. The committee believes that in light of the increased significance of time value of money, the timing of the recognition of the income is equally important as the character of the income. It is noted that one effect of the bill will be to allow cash method borrowers to claim periodic deductions for discount that under prior law they could deduct only at the maturity of the obligation. Thus, the bill will permit annual interest deductions to an additional group of taxpayers. Particularly in view of this fact, the committee believes that recognition of income by lenders in transactions should not be deferred on the ground that they do not hold an obligation as a capital asset. For similar reasons, the bill repeals the exception to section 483 for debt instruments received in sales of ordinary income property (sec. 483(f)(3)).

[10] To illustrate, assume a sale of nontraded property, which Seller and Buyer agree is worth $100 in current dollars, and a market interest rate of 12 percent. Buyer agrees to pay, and Seller agrees to accept, a lump sum amount of $179 at the end of 5 years. From an economic perspective, the $179 lump sum payment is comprised of $100 principal and $79 interest. However, the parties could, by stating in the contract that interest will accrue at a rate of 9 percent compounded semiannually, artificially fix the principal amount, and hence the cost of the property, at $115 ($179 discounted to present value at a rate of 9 percent is approximately $115). (As discussed above, the parties might also characterize this same transaction as involving a sales price of $115 with annual accruals of simple interest on that amount at a rate of 12.8 percent, thereby accelerating the current interest deductions.)

have not kept pace with market interest rates. Second, the simple interest computation used in testing the adequacy of stated interest ignores the compounding of interest on unpaid interest which occurs as an economic matter.[11] Finally, the use of a single rate for all obligations regardless of the length of time before maturity fails to reflect the fact that lenders typically demand different returns on investment depending on the term of the loan.

Tax shelters have taken advantage of the artificially low safe harbor rate to obtain excessive ACRS deductions and investment credits, stating interest at just above the test rate and achieving an overstated sales price and tax basis.[12] (The committee intends no inference that the overstatement of the tax basis of property in these cases is permitted under present law.)

Explanation of Provisions

a. Extension of OID rules

Overview

The bill extends the rules for periodic inclusion and deduction of original issue discount by lenders and borrowers to debt instruments issued for nontraded property and which are themselves not publicly traded. "Property" for this purpose includes all tangible and intangible assets of any sort except money (United States currency and checks). The bill also repeals the exemption for obligations issued by individuals and the exemption from the income accrual requirement for cash method holders of obligations not held as capital assets. (See also sec. 124 of the bill, generally extending the OID and coupon stripping provisions to foreign investors.) Exceptions from the rules are provided to ensure that they will not ordinarily apply to routine transactions of individual taxpayers, or to *de minimis* transactions of individuals and others.

If either side of a transaction is publicly traded, the market value of the traded side will determine the issue price of an obligation, as under existing law. Where neither side is traded, however, the issue price and the amount of the OID will be determined by imputing interest to the transaction at a rate higher than the safe-

[11] A debt obligation maturing in 30 years bearing a stated rate of 9 percent simple interest actually bears interest at a rate of 4½ percent on a compound interest basis.

[12] The committee also understands that some shelters are exploiting section 483's method of allocating unstated interest among deferred payments to accelerate several years' interest charges into the year of the sale. To illustrate the potential for abuse, assume property with an established fair market value of $100,000 is sold for $2,500 in cash and two negotiable $100,000 notes, one maturing six months and one day after the sale (payments on an obligation are within the scope of section 483 only if they are due more than 6 months after the sale), the other 30 years after the sale. The present value of the cash and notes, assuming a 12 percent interest rate, would approximately equal the $100,000 value of the property. Since the notes have no stated interest, section 483 imputes interest at a rate of 10 percent, compounded semi-annually. Applying this rate, the total unstated interest in the deferred purchase contract is $99,408—the $200,000 aggregate face value of the notes less $100,592, the sum of their present values.

Since the deferred payments are made in two equal installments, the total unstated interest of $99,408 is allocated under section 483 one-half ($49,704) to the first note and one-half to the second. Thus, the purchaser in this example is arguably entitled to deduct as interest almost one-half the cost of the property in the year of purchase when, economically, virtually all of the imputed interest is paid in the second payment (although it is possible that the rules restricting deductions fcr prepaid interest will apply to limit the amount of the interest deduction in this situation). Although the section 483 rules would otherwise require the seller to recognize the same $49,704 as ordinary income in the year of payment, the seller may be able to avoid this result by disposing of the first note within 6 months of the sale.

harbor rate in cases where inadequate interest has been provided for. The safe-harbor interest rate used to test the adequacy of interest and the imputed interest rate will be equal to specified percentages of the "applicable Federal rate."

Applicable Federal rate

The safe-harbor rate will be 110 percent of the applicable Federal rate, and the imputed rate 120 percent of that rate. The applicable Federal rate will be a rate based on the average yield for marketable obligations of the United States government with a comparable maturity. Federal rates will be redetermined by the Secretary at 6-month intervals for 3 categories of obligations: short-term maturity (3 years or less); mid-term maturity (more than 3 years but not more than 9 years); and long-term maturity (more than 9 years). The applicable Federal rate for a transaction will be the rate in effect for that category of maturity as of the first day there is a binding contract for the sale or exchange. The committee expects that Federal debt obligations with characteristics that result in a yield that is substantially above or below a market rate of interest will be disregarded in making the computation of the applicable Federal rates. Thus, for example, the yield on bonds, the face amount of which may be used to satisfy Federal estate tax obligations (so-called "flower bonds"), would not be taken into account. The committee does not intend that taxpayers be permitted to manipulate transactions in order to obtain a more favorable Federal rate. Thus, in cases where there is evidence that a contract has been renegotiated primarily to take advantage of a lower safe-harbor rate, the Commissioner will be able to hold the parties to the rate in effect at the time the contract was originally entered into based on the statutory requirement that the rate be fixed "as of the first day on which there is a binding contract. . . ."

Transactions to which OID rules apply

The adequacy of the interest element in a transaction will be determined by comparing the stated redemption price of the debt instrument at maturity to (1) the principal amount determined by discounting, at a rate equal to 110 percent of the applicable Federal rate, all payments due under the instrument, and (2) the principal amount stated in the debt instrument.[13] The obligation will be subject to the OID rules only if either of these amounts is less than the stated redemption price. Accordingly, these rules will be inapplicable so long as interest has been provided at a fixed rate at least equal to 110 percent of the applicable Federal rate and is payable unconditionally at the stated rate on an annual basis.[14] Interest will be considered payable "unconditionally" only if the failure to pay the interest will result in consequences to the borrower that

[13] It is believed that the use of a safe-harbor rate equal to 110 percent of the applicable Federal rate will roughly correspond to the rate at which a good credit risk can borrow. Consequently, discounting all payments at this rate should provide a liberal estimate of the principal amount (and, therefore, the value of the property or services) involved in the transaction.

[14] Thus, the OID rules will be inapplicable only in cases where there is a matching of interest income and deductions by the parties. If, for example, the parties provide that interest is payable annually at a rate equal to the applicable Federal rate but accrues at a higher rate (based on a fixed rate of compound interest), the transaction will be within the OID rules and interest will be included and deducted annually at the higher stated rate.

are typical in normal commercial lending transactions. Thus, in general, interest will be considered payable unconditionally only if the failure to timely pay interest results in an acceleration of all amounts under the debt obligation or similar consequences.

In cases in which an obligation provides for periodic reductions of principal, the committee expects that rules similar to the serial obligations rules presently provided in Treasury regulations will apply. (See Treas. Reg. sec. 1.1232-2(b)(2)(iv).) Where the OID rules do not apply, the parties will report the transaction according to the terms of the instrument and their normal methods of accounting. In general, however, the committee expects that where a transaction involving deferred payments is not subject to the OID rules, any charges imposed for the borrower's right to the use of funds will be computed according to an economically sound method.

The committee intends that the OID rules will apply only to the extent the obligation represents a bona fide indebtedness of the purchaser-issuer. Thus, if a nonrecourse obligation is given in exchange for property having a value less than the principal amount of the purported debt obligation (determined in accordance with these new provisions), the obligation will be disregarded in whole or in part under general principles of tax law. Moreover, the unamortized original issue discount which is nonrecourse will be subject to a periodic deduction only to the extent that, at the time such periodic deduction would otherwise be taken into account by the issuer, the value of the property exceeds the principal balance of the obligation plus any previously amortized original issue discount.

Determination of principal amount

If the safe-harbor rate is not satisfied, the principal amount of the instrument will generally be deemed to be the sum of the present values of all payments due under the instrument using a discount rate equal to 120 percent of the applicable Federal rate. In addition, if the transaction involves a potentially abusive situation, the principal amount of any debt instrument received in exchange for property may not exceed the fair market value of the property. A potentially abusive situation includes any transaction involving a "tax shelter" as defined in section 6661(b)(2)(C). It may also include any other situation which because of (1) recent sales transactions, (2) nonrecourse financing, (3) financing with a term beyond the economic life of the property, or (4) other circumstances, is of a type which the Secretary by regulations identifies as having a potential for abuse.

For example, assume that the property that is the subject of a deferred payment sales transaction was bought by the seller 6 months prior to the sale for cash in an amount significantly less than the principal amount of the purchase money loan. Unless the seller has enhanced the value of the property through improvements or the higher purchase price can otherwise be justified, the parties will be limited to this amount as the purchase price, and the principal amount of the loan will be determined accordingly.

Determination of amount of OID

The amount of original issue discount subject to the periodic inclusion and deduction rules of present law will be the difference between the issue price and the stated redemption price at maturity. The issue price for this purpose will be the principal amount determined by discounting all payments using a discount rate equal to 120 percent of the applicable Federal rate (limited in accordance with the rule described in the preceding paragraph, where appropriate), or the principal amount payable at maturity, whichever is less. The OID determined under this formula will be treated as interest for all purposes of the Code (*e.g.*, secs. 163, 189, 265, and 543).

Likewise, the allocation between principal and interest resulting from application of the OID rules will determine the principal amount of the loan (and therefore the cost of the property or services). For example, under section 453 (relating to installment sales), the total contract price will include debt of the purchaser only to the extent of the principal amount of the debt instrument as determined under these provisions.

In cases where the principal amount of an obligation is limited pursuant to the fair market value rule described above, the committee expects that principal amounts in excess of the fair market value of the property generally will be treated as contingent purchase price amounts with respect to the property, and will give rise to additional tax basis to the purchaser at the time such amounts actually are paid to the seller.

The bill gives the Secretary regulatory authority to make appropriate modifications to the treatment under these provisions if, because of varying interest rates, put or call options, indefinite maturities, contingent payments, or other circumstances, the tax treatment otherwise accorded to the borrower and lender or the purchaser and seller is inconsistent with the purposes of these provisions. The bill also authorizes the Secretary to require that the amount of the original issue discount and the issue date be set forth on the face of the instrument. In the case of a privately placed instrument, however, the Secretary may not impose this requirement prior to a disposition of the instrument by the initial holder.

The bill contains a general requirement that issuers of publicly issued OID obligations will be required to furnish the Secretary with the amount of the OID on the obligation, the issue date, and other information that may be required by regulations. Issuers required to set forth information on the face of an instrument will be subject to a penalty of $50 for each instrument for which this requirement is not met.

Exceptions

Under the bill, the periodic inclusion and deduction rules will not apply to debt instruments received by an individual, estate, or testamentary trust, by a small business corporation (as defined in section 1244(c)(3), relating to losses on small business stock), or by a partnership whose capital is not in excess of the limits specified in section 1244(c)(3), in exchange for a farm. The determination of whether an entity meets the conditions of section 1244(c)(3) should be made as of the date of the issuance of the obligation in question. This exception would apply only if it can be determined at the time of sale that the sales price cannot exceed $1 million. An aggregation provision, to prevent avoidance of the $1 million limitation by splitting a single transaction into several smaller transactions, will require that sales and exchanges which are part of the same transaction or a series of related transactions be treated as one sale or exchange.

Exceptions are also provided for (1) debt instruments received by an individual as consideration for the sale or exchange of a principal residence (as defined in sec. 1034); (2) cash-method issuers (but not holders) of debt instruments issued in exchange for property substantially all of which will not be used by the issuer in a trade or business or held by the issuer for the production or collection of income; or (3) debt instruments received as consideration for the sale or exchange of property if the sum of the payments due under the instrument (whether designated principal or interest) and under any other debt instrument received in the sale, and the fair market value of any other consideration received in the sale, does not exceed $250,000. (An aggregation rule similar to that provided under the farm sale exception is provided to prevent circumvention of the $250,000 limitation.) Finally, an exception is provided with respect to a payment attributable to a transfer of a patent that qualifies for capital gain treatment under section 1235, provided such payment is contingent upon the productivity, use, or disposition of the patent. Thus, the exception would not apply in the case of a deferred lump sum amount payable for a patent.

The bill also excepts from the OID rules loans between members of the same family (within the meaning of section 267(c)(4)) if the principal amount of the loan is $10,000 or less. This exception does not apply, however, if a principal purpose of the loan is the avoidance of tax. A further exception from the OID rules is provided for borrowers under discount obligations (such as negative amortization loan transactions) where the proceeds of the loan are used to purchase property substantially all of which will not be used in a trade or business or held for investment. As under present law, the OID rules will not apply to obligations with a maturity date not more than 1 year after the issue date.

b. Modification of rules for making allocations of principal and interest in other deferred payment transactions

Since the scope of the OID rules will be significantly expanded under the bill, the scope of section 483 accordingly will be reduced. Section 483 will apply only in the case of deferred payment transactions involving a sale of property which are exempted from the OID rules (*e.g.*, sales of a principal residence; certain sales of farms; transactions involving total payments of $250,000 or less; and transactions subject to section 483(g)). The bill will revise the interest rates used in section 483 to conform to the new rates used for obligations subject to the OID rules. Thus, the 483 rules will apply using a compound safe-harbor and imputed interest rates, which will vary according to the maturity of the obligation and will be adjusted at 6-month intervals. Interest income or expense computed on an economic accrual basis will be reported or deducted as under present law, that is, when payment is made (in the case of a cash method taxpayer) or due (in the case of an accrual method taxpayer).

The bill retains the exception of present law under which the section 483 rules do not apply to transactions where the sales price does not exceed $3,000 or to amounts constituting annuities under section 72. The bill also retains the present law rule under which the maximum imputed interest rate applicable to real estate transactions between related parties involving $500,000 or less is 7 percent (sec. 483(g)). The exception for sales of ordinary income property in present law will, however, be eliminated.

The bill also continues the exception under section 483 for the transfer of patents when payment is contingent upon the productivity, use, or disposition of the property transferred.[15] A further exception to the unstated interest rules is provided for cash-method issuers (but not holders) of obligations issued in exchange for property substantially all of which will not be used by the issuer in a trade or business or held by the issuer for investment purposes. Under this rule, the purchaser of a home in which the purchaser expects to maintain an office would not be subject to the section 483 rules (or to the OID rules as revised by this bill).

In connection with the revision of section 483, the bill requires that the regulations under section 482 be amended to provide safe-harbor rates consistent with those applicable under section 483 as amended.

Effective Date

The amendments to the OID rules as they relate to nontraded property transactions and the amendments to section 483 generally will be effective for sales or exchanges occurring after December 31, 1984. The rule that the principal amount of the debt instrument received in exchange for property may not exceed the fair market value of the property is effective for transactions within existing section 483 occurring after February 29, 1984, and before January 1, 1985. However, the bill provides an exception to the revised OID and section 483 rules in the case of transactions for which there was a binding commitment in writing on February 29, 1984.

Transactions occurring after February 29, 1984, and prior to January 1, 1985, will also be subject to a provision which proscribes the deduction of interest prior to the period to which it is properly allocable. For these purposes, the principles of Rev. Proc. 83-84, 1983-1 C.B. 97, shall apply. However, this limitation will not apply in the case of a debt instrument pursuant to which the issuer of the instrument makes substantially equal annual payments to the holder.

The repeal of the capital asset limitation will be effective for obligations issued after December 31, 1984, for obligations that are not capital assets in the hands of the holder. The new information

[15] The committee intends that this exception and the identical exception to the OID rules apply only where the transfer qualifies for capital gain treatment under section 1235. The current exception under section 483 has been held to apply to the transfer of any patent described in section 1235(a), without regard to the other requirements of section 1235.

reporting requirements will be effective for debt obligations issued more than 30 days after the date of enactment of this bill.

Revenue Effect

It is estimated that the provision will increase fiscal year budget receipts by less than $10 million in 1984, $228 million in 1985, $724 million in 1986, a $1,253 million in 1987, $1,789 million in 1988, and $2,349 million in 1989.

2. Deferred Payments for Use of Property and Services (sec. 74 of the bill and new sec. 467 of the Code)

Present Law

Under present law, a lessor of property reporting income on the cash method includes rents from the property in income in the year in which the rent is actually or constructively received; an accrual method lessor reports rental income in the year in which all events fixing the lessee's liability for the rent have occurred and the amount thereof can be determined with reasonable accuracy (the "all-events test"). A cash method lessee otherwise entitled to a deduction for rental expense generally deducts rent in the year it is paid, while an accrual method lessee generally claims a deduction in the year the all-events test is satisfied. An accrual basis lessor or lessee which is a party to a lease under which rents are not payable currently normally will accrue a ratable portion of the rent income or expense annually over the term of the lease.

Thus, in the case of a multiple year lease between a cash method lessor and an accrual method lessee providing for deferred payments of rent, the cash method lessor will generally include the rent in income only when payment is received. The accrual method lessee, however, will claim a deduction for a portion of the rent in each year of the lease.

Reasons for Change

The committee is concerned that a number of tax shelters are taking advantage of the mismatching of the lessor's rental income and the lessee's expense deductions permitted by present law to achieve unwarranted tax benefits. In some transactions, payment of the rental amount is completely deferred until the end of the lease. In others, some rent is payable currently but the rental amounts are "stepped." That is, lower rents are paid in the early years of the lease, followed by higher rents in the later years. Such a rent structure is a common feature of many tax shelter sale-leaseback transactions. In one recent syndicated transaction, the lease provided for annual rent of approximately $4 million in each of the first five years, escalating to approximately $20 million in each of the years 16 through 25.

The effect of such a step-rate rent structure is to defer a portion of the income from the lease realized by the cash method lessor. There is also a potential for conversion of ordinary rent income into capital gain if the lessor sells the property or the lease at a price that reflects the higher-than-market rents payable under the lease in the later years. In effect, the excess of the true rent over the actual rent in the early years will be taxed to the lessor at long-term capital gain rates in the year of the sale rather than as ordinary income in the year to which the rent is attributable.

Mismatching of income and deductions may also occur in the context of certain deferred-payment services contracts.

The committee believes that it is desirable to eliminate the mismatching of rent income and expense which may occur in deferred payment rental transactions, and the deferral of income and conversion of ordinary income into capital gain inherent in step-rate rental transactions, except in certain de minimis cases. The committee also believes that mismatching of the interest element implicit in deferred-payment services contracts not covered by existing provisions should be eliminated. The committee intends no inference as to the treatment of deferred-payment leases and services contracts under existing law.

Explanation of Provision

The bill requires that rental and interest income attributable to a deferred rental payment agreement be reported as income by the lessor and deducted by the lessee as if both were on the accrual method, irrespective of their actual methods of accounting. A deferred rental payment agreement for this purpose means any agreement for the use of tangible property under which (1) there is at least one amount allocable to the use of property during a calendar year which is to be paid after the close of the calendar year following the calendar year in which such use occurs, or (2) there is at least one amount payable for the use of property for any lease period that is not commercially reasonable. Thus, the provision will generally apply both in the case where rent is payable in a lump sum at the end of the lease term (unless the lease is for a term of two years or less) and in the case where rents are "stepped" (unless the increases are commercially reasonable).

The determination of whether rents are commercially reasonable is to be made as of the time the lease is entered into, taking into account the type of property subject to the lease, the area in which it is located, and all other relevant facts and circumstances as determined under regulations prescribed by the Secretary. By way of illustration, a 15-year lease under which no rent is payable during the first two years of the lease term might be considered commercially reasonable in a particular rental market at a given point in time. Moreover, in the case of leases under which the amount of rent payable is based on a uniform percentage of the gross receipts of the lessee or similar amount, the rent might be considered commercially reasonable if the amount on which the rent is based and the applicable percentage are both commercially reasonable, even if the amount actually paid in a particular year were low in relation to fixed-amount rents payable for the use of similar property.

A stricter standard of commercial reasonableness is applied in the case of sale-leaseback transactions if the lessee or a related party owned the leased property at any time during the 2-year period immediately preceding the execution of the lease. Rents under leases in such transactions will be treated as commercially unreasonable if the increase in any payment over the preceding payment exceeds the greatest of (1) the percentage increase in the

Consumer Price Index (or any other index specified in regulations) during the period between the payments, (2) the Federal short-term rate under section 1274(d) (as added by this bill) which is in effect on the date the lease is entered into, or (3) the increase in specified costs payable by the lessor to unrelated parties during the period between the payments. However, if the parties to a sale-leaseback transaction file a ruling request on or before the date the lease is entered into and establish to the satisfaction of the Commissioner that the avoidance of tax is not a principal purpose of the agreement, this provision will not apply.

An exception to the general provision is provided for deferred payment transactions involving total payments of $250,000 or less. Exceptions are also provided for payments to which section 83, 267, 404, 404A, or 706(a) applies and transactions in which a debt instrument within the scope of new section 1273(b)(3) is issued.

If a transaction is subject to these provisions, the amount of rent to be accrued by the parties for a taxable year will be the portion of the "constant rental amount" allocable to the taxable year. The constant rental amount is the amount which, if paid as of the close of each lease period, would have a present value (determined using a discount rate equal to 120 percent of the applicable Federal rate, compounded semi-annually) equal to the present value of the aggregate payments to be made under the lease. (For example, in the case of a lease calling for a lump-sum payment at the end of the lease term, the constant rental amount is that amount which, if paid on the last day of each lease year into a bank account bearing interest at the indicated rate, would produce an account balance at the end of the lease equal to the amount of the deferred payment.) It is anticipated that the Treasury Department will issue regulations containing formulae which will facilitate the computation of the constant rental amount.

In addition, the lessor will annually accrue interest income, and the lessee will deduct interest expense, at a rate equal to 120 percent of the applicable Federal rate, on any excess of the constant rental amount over payments made during any year until such excess amount is repaid. Repayments will occur either at the end of the lease (in the case where a lump-sum payment is due at that time) or on an incremental basis in periods in which actual payments of rent exceed the constant rental amount (in the case of a step-rate rental agreement). Interest will accrue at the same rate on any interest imputed under this provision until such interest is paid. In the case of a step-rate rental agreement, it is intended that any excess of payments in a year over the constant rental amount will be treated first as a repayment of unpaid rent and then as a repayment of interest.

The bill provides similar rules, to be prescribed by regulations, where payments called for under an agreement decrease rather than increase over the term of the agreement.

Deferred payments under service contracts are treated in a manner similar to deferred rents, except that the annual inclusion and deduction rules apply only to the imputed interest element of the transaction.

Effective Date

The provisions are effective for agreements entered into after March 15, 1984, in taxable years ending after such date.

Revenue Effect

The provisions are estimated to increase fiscal year budget receipts by $60 million in 1984, $284 million in 1985, $552 million in 1986, $785 million in 1987, $1,067 million in 1988, and $1,237 million in 1989.

3. Premature Accruals (sec. 71 of the bill and sec. 461 of the Code)

Present Law

General

Under the accrual method of accounting, an expense is deductible for the taxable year in which all the events have occurred which determine the fact of the liability and the amount thereof can be determined with reasonable accuracy (the so-called "all events test") (Treas. Reg. sec. 1.461-1 (a)(2)). If the "all events" test is met, an accrual basis taxpayer generally can deduct the face amount of an accrued expense.

Fact of liability

In a number of early cases, the courts held that expenditures are deductible only when the activities that the taxpayer is obligated to perform are in fact performed, not when the "fact" of the obligation to perform is determined. For example, in *Spencer, White & Prentis, Inc.* v. *Commissioner*, 144 F.2d 45 (2d Cir. 1944), a contractor, who was engaged in the construction of a subway system and who was required under contract to restore certain property damaged or otherwise affected by the construction, was denied deductions for the accrued estimated costs of restoration. The court held that the liability for work done after the end of the taxable year had not been incurred because the work had not been performed. The court also held that deductions are only allowable when the taxpayer's liability to pay becomes definite and certain.

More recently, the courts generally have reached a different conclusion: a taxpayer may deduct the amount of a liability if all the events that fix the liability have occurred and the amount can be determined with reasonable accuracy, even though the activities the taxpayer is obligated to perform are not actually performed until a later year. For example, the Fourth Circuit held that surface mining reclamation costs that could be estimated with reasonable accuracy were properly accrued when the land was stripped although the land was not reclaimed until a subsequent year. *Harrold* v. *Commissioner*, 192 F.2d 1002 (4th Cir. 1951).

The position of the Fourth Circuit with respect to strip mining reclamation costs has been followed by courts in other situations. For example, the Ninth Circuit held that the fact of the liability under workmen's compensation laws[16] is determined in uncontested cases in the year in which injury occurs, even though medical services may be rendered at a future time. *Crescent Wharf & Warehouse Co.* v. *Commissioner*, 518 F.2d 772 (9th Cir. 1975).

[16] Under worker's compensation laws, employers generally are required to pay injured employees' medical expenses and disability benefits. In many cases, the employer's liability to provide benefits extends over several years.

A deduction for a contingent liability generally is not allowed under present law, because all of the events necessary to fix the liability have not yet occurred. However, in one recent case, the Third Circuit held that a taxpayer is allowed to deduct amounts paid to a trust to fund benefits under a negotiated supplemental unemployment benefit plan, including amounts accrued in a "contingent liability account" (at a fixed rate for each hour worked by eligible employees until a target funding amount is reached). *Lukens Steel Co.* v. *Commissioner*, 442 F.2d 1131 (3d Cir. 1971). The fact that the liability was to a group, rather than a specific individual, and that the time of future payment was indefinite, did not bar a deduction under the all events test.

The courts generally have held that the length of time between accrual and performance does not affect whether an amount is properly accruable. However, in *Mooney Aircraft, Inc.* v. *United States*, 420 F.2d 400 (5th Cir. 1969), the court held that a taxpayer, who gave to purchasers of its airplanes a bond redeemable when the plane was permanently retired from service, was not allowed a deduction because the possible interval between accrual and payment was "too long"; the court concluded that the likelihood of payment decreases as the time between accrual and payment increases.

The Internal Revenue Service takes the position that there must be a current liability to pay for an amount to be deductible, and that a deduction should not be allowed where there is a contingency as to payment of an obligation (other than the ability of the obligor to pay). Rev. Rul. 72-34, 1972-1 C.B. 132.

Amount of liability

In order for an amount to be deductible under the all events test, the amount of a liability must be determinable with reasonable accuracy. The courts have held that this rule is satisfied if the amount of the liability, although not definitely ascertained, can be estimated with reasonable accuracy. Generally, estimates based on industry-wide experience or on the experience of the taxpayer have been accepted by the courts as reasonable. In a recent case, the Ninth Circuit permitted the question of the reasonable accuracy of the amount reserved for anticipated liabilities to be determined by estimating the amount of the liability in aggregate rather than on an individual claim basis, as had generally been required in earlier cases. *Kaiser Steel Corp.* v. *United States*, 411 F.2d 235 (9th Cir. 1983).

The Internal Revenue Service generally takes a more restrictive position. Under their view, the exact amount of a liability must be determinable by a computation based on presently known or knowable factors. For example, the Service held that the taxpayer who was in the business of strip mining did not know, nor was it possible to know, the amount of an expenditure since the reclamation work was not rendered by the taxpayer nor did the taxpayer contract with a third party to perform the services (I.R.S. Letter Ruling 7831003).

Reserve accounts

The Internal Revenue Code of 1954, as originally enacted, contained a provision allowing accrual method taxpayers to establish reserves for estimated business expenses and to deduct reasonable additions to the reserve (sec. 462). Congress retroactively repealed the provision in 1955 primarily for revenue reasons (Pub. L. 84-74, 69 Stat. 134 (1955)).

Net operating losses

Net operating losses incurred in a taxable year generally may be "carried back" and offset against taxable income of the 3 years first preceding the year of loss and, if not fully absorbed, "carried forward" and offset against taxable income of the 15 years next succeeding the year of loss. A special 10-year carryback is permitted for product liability losses.

Reasons for Change

The committee believes that the rules relating to the time for accrual of a deduction by a taxpayer using the accrual method of accounting should be changed to take into account the time value of money. Recent court decisions in some cases have permitted accrual method taxpayers to deduct currently expenses that are attributable to activities to be performed or amounts to be paid in the future. Allowing a taxpayer to take deductions currently for an amount to be paid in the future overstates the true cost of the expense to the extent that the time value of money is not taken into account; the deduction is overstated by the amount by which the face value exceeds the present value of the expense.

The committee is concerned about the potential revenue loss from such overstated deductions. In many everyday business transactions, taxpayers incur liabilities to pay expenses in the future. The committee believes that because of the large number of transactions in which deductions may be overstated and because of the high interest rates in recent years, the magnitude of the revenue loss may be significant.

Finally, the failure of present law to take into account the time value of money has become the cornerstone for a variety of tax shelters. For example, a tax shelter partnership may obligate itself to pay someone to perform research and development in the future and claim a current deduction for the undiscounted amount of the costs to be incurred.

The committee recognizes that, in the case of noncapital items, a taxpayer, theoretically, should be allowed a deduction for either the full amount of a liability when the liability is satisfied or a discounted amount at an earlier time. However, the committee also recognizes that determining the discounted values for all kinds of future expenses would be extraordinarily complex and would be extremely difficult to administer. For instance, a system that allowed current deductions for discounted future expenses would have to include a complex set of rules for recalculating overstated and understated deductions when the future liabilities are reestimated or are actually satisfied at a time, or in an amount, different from that originally projected. Furthermore, in the case of future expenditures an appropriate discounting system may be equally complex. Therefore, in order to prevent deductions for future expenses in excess of their true cost while avoiding the complexity of a system of discounted valuation, the committee believes that expenses should be accrued only when economic performance occurs.

Explanation of Provision

In general

The bill provides that, in determining whether an amount has been incurred with respect to any item during the taxable year by a taxpayer using the accrual method of accounting, all the events which establish liability for such amount would not be treated as having occurred any earlier than the time economic performance occurs. If economic performance has occurred, the amount is treated as incurred for all purposes of the Code. If amounts incurred are chargeable to a capital account or, under any other provision of the Code, are deductible in a taxable year later than the year when economic performance occurs then such other provisions apply in determining the amount deductible each year.

Economic performance

The bill provides a series of principles for determining when economic performance occurs. The principles provided by the bill describe the two most common categories of liabilities: first, cases where the liability arises as a result of another person providing goods and services to the taxpayer and, second, cases where the liability requires the taxpayer to provide goods and services or undertake some activity as a result of its income-producing activities.

With respect to the first category of liabilities, if the liability arises out of the use of property, economic performance occurs as the taxpayer uses the property. If the liability requires a payment for the providing of property, economic performance occurs when the property is provided. However, the committee intends that the Treasury Department issue regulations providing that the time at which property is provided should include the time of delivery, shipment, or other time so long as the taxpayer accounts for such items consistently from year to year. If the liability of the taxpayer requires a payment to another person for the providing of services to the taxpayer by another person, economic performance generally occurs when such other person provides the services.

With respect to the second category of liabilities, if the liability of the taxpayer requires the taxpayer to provide property or perform services, economic performance occurs as the taxpayer provides the property or performs the services. For example, if a highway construction company engages a contractor to repair damaged properties, economic performance occurs as the contractor performs the work. Likewise, when the highway construction company itself repairs the damage, economic performance occurs as repairs are made. Under a special rule for workers' compensation and tort liabilities, economic performance occurs as payments are made.

In the case where the taxpayer is required to provide deferred benefits to employees other than through a qualified pension, profit-sharing, stock bonus plan or other deferred compensation arrangement to which section 404 or 404A apply, a deduction generally will be allowed only when payments are made to the employee even though the services are rendered prior to payment. However, a deduction will be permitted for deferred benefits in the year in which the employee performs services, as long as payment of such benefits is made earlier than 2½ months after the end of such taxable year.

In the case of any other liability of the taxpayer, economic performance will occur at the time determined under regulations to be prescribed by the Treasury.

The committee expects that these regulations will provide that economic performance might be considered to occur earlier than indicated by the above principles where existing regulations or rulings permit earlier accruals and the taxpayer accounts for such items consistently from year to year. For example, in the case of state or local property taxes, the regulations could provide that economic performance may be treated as having occurred at the time the tax lien attaches or the time the tax is assessed. Thus, the expense could continue to be accrued at the same time as under present law.

Exceptions

The bill provides several exceptions to the economic performance test. Under the first exception, the economic performance requirement will not apply to a liability of the taxpayer to provide benefits to employees of the taxpayer through a plan that meets the requirements for a qualified pension, profit-sharing, stock bonus plan, or other deferred compensation arrangement under section 404 or 404A. Under such arrangements, the taxpayer generally is allowed a deduction when contributions are made to the plan. Second, the economic performance requirement does not apply to contributions to a funded welfare benefit plan (i.e., present law generally applies to such contributions).[17] Third, the economic performance requirement does not apply to items to which other sections of the Code apply, such as the deductions allowable for additions to a reserve for bad debts (sec. 166), accrual of vacation pay (sec. 463), qualified discount coupons (sec. 466), additions to reserves by life and other insurance companies under the rules of subchapter L, and any other provision which specifically provides for a reserve for estimated expenses.

Example

Assume that a taxpayer using the accrual method of accounting closes a manufacturing plant. Under a negotiated contract, the corporation becomes liable to provide medical benefits to the terminated employees for a period ending with the earlier of the death of the employee or 20 years. The corporation's estimated liability (undiscounted) per employee is $200,000: an average of $10,000 per year for 20 years. Assume also that the estimated costs meet the requirement that they can be determined with reasonable accuracy. The present value of the estimated liability is $50,000. In year

[17] See section 96 of the bill for special rules dealing with contributions to funded welfare benefit plans.

5, the corporation's payments in satisfaction of certain of the liabilities is $12,000.

Under present law, the corporation may claim a deduction of $200,000, the full face amount of the estimated liability. Under the bill, the corporation could deduct each year only the amount of the actual expense incurred for health benefits provided that year. In year 5, for instance, the corporation would be allowed to deduct $12,000.

Special 10-year loss carryback

The bill provides for a 10-year carryback period for certain deferred liability losses. A deferred statutory or tort liability loss means the lesser of (1) the net operating loss for the year reduced by any foreign expropriation or product liability loss; or (2) the amount allowable as a deduction under this provision which is taken into account in computing the net operating loss for the year and is for an amount incurred with respect to a statutory or tort liability. This rule applies, in the case of a liability under Federal or State law, if the act (or failure to act) occurs at least 3 years before the beginning of the taxable year and, in the case of a tort liability, if the liability arises out of a series of actions (or failures to act) over an extended period of time a substantial portion of which occurs at least 3 years before the beginning of the year. For example, this rule will apply if a taxpayer incurs a tort liability for failure to protect another person from a hazardous substance, such as chemical waste, over an extended period of time.

The 10-year carryback rule will not apply unless the taxpayer used an accrual method of accounting throughout the period or periods during which the act (or failure to act) occurred.

The bill provides a special rule for the net operating loss carrybacks in the case of nuclear power plants (whether or not the taxpayer elects to deduct contributions to a reserve fund as provided by the bill). The amount of any net operating loss attributable to the decommissioning of nuclear power plants may be carried back to each of the taxable years during the period beginning with the taxable year in which the plant was placed in service.

Effective Date

The provisions of the bill will apply to amounts with respect to which deductions would be allowable (determined without regard to the provisions of this bill) after the date of enactment of this bill.

The bill provides a transition rule under which section 481 would apply to amounts that otherwise would have met the all events test of present law as of the date of enactment but do not meet the all events test under the bill because economic performance had not occurred as of the date of enactment of the bill.

Revenue Effect

This provision will increase fiscal year budget receipts by $209 million in 1984, $458 million in 1985, $448 million in 1986, $393 million in 1987, $351 million in 1988, and $321 million in 1989.

4. Prepayments of Expenses (sec. 71 of the bill and sec. 464 of the Code)

Present Law

In general.—A taxpayer is generally allowed a deduction in the taxable year which is the proper taxable year under the method of accounting used in computing taxable income (Code sec. 461). The two most common methods of accounting are the cash receipts and disbursements method and the accrual method. If, however, the taxpayer's method of accounting does not clearly reflect income, the computation of taxable income must be made under the method which, in the opinion of the Internal Revenue Service, clearly reflects income (sec. 446(b)). Furthermore, the income tax regulations provide that if an expenditure results in the creation of an asset having a useful life which extends substantially beyond the close of the taxable year, such an expenditure may not be deductible, or may be deductible only in part, for the taxable year in which paid by a taxpayer using the cash receipts and disbursements method of accounting, or in which incurred by a taxpayer using the accrual method of accounting (Treas. Reg. sec. 1.461-1(a) (1) and (2)).

Deductions for interest.—Under the cash receipts and disbursements method of accounting, deductions generally are allowed in the year in which the expenditures are paid. Under present law, if a taxpayer uses the cash receipts and disbursements method to compute taxable income, interest paid by the taxpayer which is properly allocable to any later taxable year is generally treated as paid in the year to which it is allocable; interest is allocable to the period in which the interest represents a charge for the use or forbearance of borrowed money (sec. 461(g)). An accrual method taxpayer can deduct interest (whether or not prepaid) only in the period in which the use of money occurs. Thus, under present law, interest is deductible in the same period for both cash and accrual method taxpayers.

Deductions other than interest.—Present law is unclear as to the proper timing of a deduction for prepaid expenses, other than interest. No specific statutory provision expressly permits expenses to be deducted in full when paid by a taxpayer using the cash receipts and disbursements method of accounting. Such deductions are not allowed, however, to the extent that they result in a material distortion of income.

Generally, the courts have examined all the facts and circumstances in a particular case to determine whether allowing a full deduction for the prepayment would result in a material distortion of income. In determining whether an expenditure results in the creation of an asset having a useful life extending substantially beyond the end of the taxable year, the court in *Zaninovich* v.

Commissioner, 616 F.2d 429 (9th Cir. 1980), adopted a "one-year" rule. Under this rule, prepayments generally may be deducted if they do not provide benefits that extend beyond one year. Thus, under this decision, a calendar-year, cash-basis taxpayer may be able to deduct a lease payment for the next year paid in December of the current year.

Special rule for farm syndicates.—Present law provides limitations on deductions in the case of farming syndicates. A farming syndicate is allowed a deduction for amounts paid for items (such as feed) only in the year in which such items are actually used or consumed or, if later, in the year otherwise allowable as a deduction. A farming syndicate is defined generally as a partnership or any other enterprise (other than a corporation which is not an S corporation) engaged in farming if (1) interests in the partnership or enterprise have been offered for sale in any offering required to be registered with any Federal or State agency or (2) if more than 35 percent of the losses during any period are allocable to limited partners or limited entrepreneurs (*i.e.*, persons who do not actively participate in the management of the enterprise).

Reasons for Changc

Many farming tax shelters operate to defer taxation of nonfarming income by prepaying farming expenses allocable to the following and subsequent years. Such tax shelters distort the measurement of taxable incomes of their investors and affect the operations of farmers that are not established for tax reasons. In order to avoid these distortions, the committee believes that limits should be placed upon the deductibility of prepaid expenses of certain farming tax shelters which do not fall within the farm syndicate rules.

However, the committee understands that, in the case of farming, numerous everyday business expenses are prepaid. Accordingly, the committee bill applies the limitations only in cases where more than 50 percent of the farming expenses for the year are prepaid. In addition, in order to assure that farmers with continuous year-round or full-time farming activities are not subject to the limitations, the committee bill provides exceptions where a farmer has more than 50 percent prepaid expenses because of unusual or extraordinary circumstances. The committee believes that these rules will limit the application of the new restrictions to cases where the abuse is serious. In addition, the committee believes that the new rules should not impose any significant additional accounting burden on farmers.

In adopting these limitations applicable to farming tax shelters, the committee does not intend to modify the rule applicable in other areas that prepaid expenses are not deductible if that deduction would result in a material distortion of income.

The committee intends that the provisions of this bill will operate independently of the farm syndicate rules under present law, that will remain unchanged.

Explanation of Provision

Under the bill, certain taxpayers engaged in the trade as business of farming who compute taxable income under the cash receipts and disbursements method will not be allowed a deduction with respect to any amount paid for feed, seed, fertilizer, and other similar farm supplies earlier than the time when the feed, seed, fertilizer, or other supplies are actually used or consumed.[18]

For purposes of this provision. the trade or business of farming is defined as in section 464(c) (generally the cultivation of land or the raising of any agricultural or horticultural commodity including the raising of animals).

The provisions of the bill will generally apply to any person engaged in the trade or business of farming if more than 50 percent of such person's farming expenses paid during the taxable year are prepaid expenses. (The bill does not, however, treat such taxpayers as farm syndicates.) For purposes of the 50 percent test, expenses will include the operating expenses of the farm such as ordinary and necessary farming expenses deductible under section 162, interest and taxes paid, depreciation allowances on farm equipment and other expenses (generally those reported on Schedule F of the taxpayer's income tax return).

The bill provides two exceptions to the 50 percent test. If either of these two exceptions are met, prepaid expenses will continue to be deductible as allowed by present law, even though those prepaid expenses are greater than 50 percent of farming expenses for that year. The first exception applies if an eligible farmer fails to satisfy the 50-percent test due to a change in business operations directly attributable to extraordinary circumstances, including government crop diversion programs and circumstances described in section 464(d). The second exception applies if over the preceding 3-year period an eligible farmer satisfies the 50 percent test on the basis of the three preceding taxable years. For purposes of this exception, the expenses for the 3-year period will be aggregated. The term "eligible farmer" will include (1) any person whose principal residence is on a farm, (2) any person with a principal occupation of farming, or (3) any family member of persons described in (1) or (2). The exception will apply only to an eligible person's farming activities attributable to the farm on which the residence is located, or to farms included in the "principal occupation" of farming activities.

These exceptions may be illustrated by the following examples:

Example (a): Assume that a cash basis farmer who has been farming for 20 years buys fertilizer and other supplies in February in anticipation of spring planting. Assume also that Congress enacts legislation such as the payment-in-kind (PIK) program that requires a farmer to take land out of production. If the farmer signs up for such a program in March, seed is not planted and fertilizer and other supplies are not used during the year. Thus, more than 50 percent of the expenses at year end are prepaid. In this example, under the first exception, the farmer would be allowed to

[18] For a more detailed description of these rules, see section 464.

deduct the prepaid expenses because of extraordinary and ususual circumstances.

Example (b): Assume that a cash-basis rancher, who for 10 years has been raising cattle, buys feed for the cattle in March. Because of unusual drought conditions experienced in May, the rancher sells most of the cattle herd. Due to the price of cattle, the rancher does not buy replacement cattle during the year. Only a small part of the feed purchased in March is consumed by the cattle before the cattle are sold because of the drought in May. The prepaid feed costs, which may exceed 50 percent of total expenses for the year, would nonetheless be deductible under the exceptions provided in the bill.

The bill does not amend the farm syndicate rules of section 464. In addition, the committee intends that farmers will not be required generally to take year-end inventories of prepaid items as a result of the provisions of this bill.

Effective Date

The provisions of the bill will apply to amounts with respect to which a deduction would be allowable under present law after March 31, 1984.

Revenue Effect

This provision will increase fiscal year budget receipts by $10 million in 1984, $22 million in 1985, $7 million in 1986, $8 million in 1987, $10 million in 1988, and $12 million in 1989.

5. Mine Reclamation and Similar Costs (sec. 71 of the bill and sec. 461 of the Code)

Present law

The Surface Mining Control and Reclamation Act of 1977 and similar State laws impose specific reclamation requirements on surface mine operators. Mine operators must guarantee their compliance with these requirements by posting bonds or otherwise proving their financial responsibility. In addition, Federal and State laws require reclamation of land used for the disposal of solid, liquid or hazardous waste.

Prior to 1978, several courts allowed a surface mine operator to accrue and deduct the estimated expenses of reclamation as mining operations progressed (i.e., State-mandated reclamation expenses accrued as mineral was extracted). *Harrold* v. *Commissioner,* 192 F.2d 1002 (4th Cir. 1951); *Denise Coal Co.* v. *Commissioner,* 271 F.2d 930 (3rd 1959). In 1978, the Internal Revenue Service issued a private letter ruling which stated that reclamation expenses cannot be accrued until the year in which reclamation occurs. Notwithstanding the Service's position, the Tax Court in *Ohio River Collieries* v. *Commissioner,* 77 T.C. 1369 (1981), held that surface mining reclamation costs that could be estimated with reasonable accuracy were properly accrued when the overburden was removed.

Reasons for Change

Currently, companies use a variety of accounting methods for accruing reclamation costs. The bill provides a uniform method, that may be elected, for deducting prior to economic performance reclamation costs which are mandated by Federal or State law. The committee believes that accounting methods which result in more accelerated deductions for reclamation costs provide unwarranted tax benefits and, subject to transition rules, the use of such methods is prohibited. The uniform method of deducting reclamation costs departs from the general principle, adopted in the bill, of allowing a deduction for future liabilities only when economic performance occurs. The committee believes that in the case of mine reclamation and closing costs (and reclamation costs associated with the disposal of solid; liquid; or hazardous waste required by Federal or State law), more liberal rules are appropriate.

Explanation of Provision

The bill provides that a taxpayer is subject to the general rule requiring accruals only as economic performance occurs, unless an election is made to adopt the uniform method for deducting site reclamation and closing costs of surface and deep mines and disposal sites for solid, liquid; or hazardous waste (not including superfund sites), associated with meeting the requirements of Federal or State law.

Site reclamation costs

Electing taxpayers may take a current deduction for the present-year dollar cost, after discounting, of reclaiming land that is: (1) disturbed in the current tax year, and (2) reasonably anticipated to be reclaimed by the end of the third subsequent tax year. For purposes of computing the deduction, estimated present-year dollar costs of reclamation will be discounted at a compound rate of 2 percent per year. Thus, 98.04 percent (1/1.02) of the present-dollar cost of reclamation estimated to be completed within one year may be deducted currently; the applicable percentages for discounting the present-dollar costs of reclamation estimated to be completed within two and three years are 96.12 and 94.23 percent, respectively.

Amounts deducted in each year for each parcel of land are subject to recapture. Recapture is computed with reference to the amount that would accumulate if the deduction were placed into a tax-free sinking fund which grows at one-half of the section 483 short-term rate, compounded annually. Reclamation expenses incurred with respect to each parcel are treated as having been paid using withdrawals from the book sinking fund created for that parcel, to the extent of the balance remaining in that fund. All such book sinking fund withdrawals must be included in the taxpayer's taxable income in the year the withdrawal is deemed to occur, and a deduction is allowed for the amount of reclamation cost paid in that year. At the end of the third tax year following the year in which a book sinking fund is created, under this provision, the remaining balance in the fund must be included in the taxpayer's taxable income, even if the parcel has not been completely reclaimed. The intent of this recapture rule is to ensure that excessive premature deductions with respect to each parcel, taking into account the time value of money, are included in taxable income at the end of each three-year reclamation period.

Mines and disposal sites in existence prior to the effective date, for which deductions were taken on a current cost of current reclamation basis, would not be subject to recapture accounting as provided by the bill. To the extent actual expenses attributable to pre-effective date operations exceed amounts previously deducted, the tax benefit rule will require such excess to be recaptured.

Site closing costs

Under the bill, electing taxpayers may take a deduction for the incremental cost of current closing, discounted at a compound rate of 2 percent per year, based on the units of production method (or units of capacity in the case of disposal sites.) For example, if in year 1 the estimated cost of site closing is 100 (allocable to ore mined in year 1 under the units of production method), and three years of productive life remain, then a deduction for $94.23 is permitted. If in year 2 the cost of current closing (allocable to ore mined in years 1 and 2) is $150, as a result of inflation or site expansion, then a deduction of $48.06 would be permitted (since the incremental closing cost is $50, of which 96.12 percent is deductible after discounting at a compound rate of 2 percent per year over the two remaining years of production).

Amounts deducted for site closing are subject to recapture. The recapture amount is computed with reference to the amount which would accumulate if the deductions were placed into a tax-free book sinking fund which grows at one-half of the section 483 long-term rate, compounded annually. As site closing costs are incurred, they are treated as having been paid using withdrawals from the book sinking fund. All such book sinking fund withdrawals must be included in the taxpayer's taxable income in the year withdrawal is deemed to occur, and a deduction is allowed for the amount of site closing costs paid in that year. In the tax year that site closure is completed, the remaining balance in the book sinking fund, if any, must be included in the taxpayer's taxable income. The Internal Revenue Service may, upon determination that a site has been substantially closed, require the taxpayer to include the book sinking fund balance in income. The intent of this recapture rule is to ensure that excessive deductions, taking into account the time value of money, are included in taxable income when site closing is substantially completed.

Mines and disposal sites, in existence prior to the effective date, are entitled to use the elective method only with respect to incremental site closing costs attributable to ore mined or capacity used after the effective date, provided that the site closing costs associated with such ore or capacity used have not previously been deducted. Site closing costs deducted prior to the date of enactment are recaptured according to the tax benefit rule in present law.

Effective Date

This provision is effective on the date of enactment.

With respect to fixed price ore supply contracts (which do not allow an adjustment for changes in tax liability resulting from the bill), entered into prior to the effective date, taxpayers will be able to continue to deduct estimated current reclamation costs without being subject to recapture accounting as provided by the bill.

With respect to application of both reclamation and closing costs, the Internal Revenue Service could not challenge the entitlement of a taxpayer to deductions, taken prior to the effective date, for future reclamation costs associated with land disturbed prior to the effective date. However, the IRS could challenge these deductions on the grounds that futures costs were not estimated with reasonable accuracy.

Revenue Effect

The revenue effect of this provision is included in the revenue effect of the "Premature Accruals" section of the report.

6. Nuclear Power Plant Decommissioning (sec. 71 of the bill and sec. 461 of the Code)

Present Law

Generally, under Federal and State law, utility companies that operate nuclear power plants are obligated to decommission (that is, close down and dismantle or otherwise render safe) the plants at the end of their useful lives. Decommissioning, which is an expensive process because of the high levels of residual radiation, may occur many years after the plant is placed in service. In some cases, a portion of the estimated future cost of decommissioning is being collected from the utility's current customers as a cost of service for ratemaking purposes. Such amounts may be placed in an unsegregated reserve on the utility's books, in a segregated internal reserve, or in an independent trust fund.

It is unclear under present law when a utility may properly accrue decommissioning expenses. There is also pending litigation on the issue of how, for tax purposes, a utility should treat amounts collected from customers and paid into a decommissioning trust fund.

Reasons for Change

The committee believes that the establishment of segregated reserve funds for paying future nuclear decommissioning costs is of sufficient national importance that a tax deduction, subject to limitations, should be provided for future amounts contributed to a qualified fund. This is a departure from the general industry practice of deducting decommissioning expenditures at the end of plant life when decommissioning is performed. This provision also departs from the general principle, adopted in the bill, that accrual method taxpayers should deduct future liabilities when economic performance occurs. However, the committee does not intend that this deduction should lower the taxes paid by the owners of a nuclear power plant in present value terms; instead, the provision is intended to spread the deduction of decommissioning expense over the life of the plant as contributions are made to a segregated decommissioning reserve fund.

Explanation of Provision

The bill provides an elective method for deducting contributions made to a reserve fund dedicated to paying future nuclear decommissioning expenses. Taxpayers who elect this method may deduct, subject to an annual limitation, contributions to a qualified nuclear decommissioning reserve fund. This is the exclusive method for obtaining a deduction for nuclear decommissioning expenses prior to economic performance.

Contributions to a qualified decommissioning reserve are deductible only to the extent these amounts are currently included in the cost of service, charged to customers, and included in the taxpayer's taxable income in that year. In addition, a deduction is only allowed to the extent that contributions are deposited in a separate reserve which is funded exclusively with contributions eligible for deduction under this provision (to simplify tax accounting). No amounts from a non-qualified reserve fund may be contributed to a qualified decommissioning reserve. In the event that non-deductible contributions are mistakenly made to this separate reserve, the taxpayer may correct the error, without penalty, subject to Treasury approval.

Under the bill, taxpayers must obtain a ruling from Treasury in order to obtain a deduction for contributions to a decommissioning reserve. The ruling will establish the maximum annual deduction which may be claimed for contributions to a qualified decommissioning reserve under this provision. Treasury shall issue regulations which set forth criteria for determining the maximum annual deduction. The limitation has two purposes: (1) to prevent taxpayers from accumulating more funds in a qualified decommissioning reserve than are required to fund the portion of future decommissioning costs allocable to remaining plant life, and (2) to ensure that contributions to the reserve are not accelerated (i.e., more rapid than level funding). For example, if two-thirds of a plant's useful life remains when a qualified decommissioning reserve is established, then the taxpayer's deductions would be limited to contributions necessary to fund two-thirds of estimated future decommissioning cost, on a level funding basis.

In determining the maximum annual deduction, Treasury shall take into account plant life and estimated current decommissioning costs, as well as inflation and prevailing interest rates. Treasury shall review this limit at least once during plant life, or more frequently by petition of the taxpayer.

The effect of the bill is to limit the deductible contributions to a decommissioning reserve to the minimum of: (1) the Treasury-specified limitation, (2) the actual contribution to the qualified reserve, and (3) the amount of decommissioning costs included in the cost of service, charged to customers, and included in the taxpayer's taxable income in that year. Under the bill, public utility commissions may determine the appropriate amount of current customer charges for future decommissioning expense. The intent of the bill is merely to limit the current tax deduction for contributions to a qualified nuclear decommissioning reserve.

To qualify under the bill, a nuclear decommissioning reserve must be a segregated fund the proceeds of which are used exclusively for the payment of decommissioning costs, taxes on reserve income, and management costs of the reserve fund. The reserve is treated as a separate taxable entity and is taxed at the maximum corporate tax rate (46 percent). Contributions to the fund are not subject to tax; however, the income of the fund is subject to tax, unless exempt under another provision of the Code. Other qualification requirements include rules which limit the fund to investments in the same assets which may be owned by a Black Lung

Disability Trust Fund, rules which prohibit the purchase of assets of a related party, and rules which prohibit self-dealing.

If a nuclear decommissioning reserve fund fails to comply with the qualification requirements, it may be disqualified by Treasury determination. In the event of disqualification, Treasury may require that some or all of the income and principal accumulated in the reserve fund be included in the taxpayer's taxable income. No deduction is allowed for contributions to a disqualified reserve fund. Treasury may disqualify a nuclear reserve fund for a particular plant if it determines that decommissioning has been substantially completed.

Withdrawals from a qualified decommissioning reserve fund, for whatever purpose, except payment of taxes imposed on the fund and costs of managing the fund, are includible in the nuclear plant owner's taxable income. Amounts paid for reasonable decommissioning expenditures, are deductible from the nuclear plant owner's gross income, as permitted by the Code. The bill requires that, in the taxable year that plant decommissioning is completed, any funds remaining in a qualified nuclear decommissioning reserve must be included in the taxpayer's taxable income.

The bill also requires that all customer charges for decommissioning expenses, whether or not contributed to a qualified reserve, must be included in the taxpayer's taxable income in that year.

Effective Date

This provision is effective for contributions to a qualified reserve made after the date of enactment.

Revenue Effect

The revenue effect of this provision is included in the revenue effect of the "Premature Accruals" section of the report.

7. Capitalization of Construction Period Interest and Taxes (sec. 72 of the bill and sec. 189 of the Code)

Present Law

Under present law, no immediate deduction is allowed for real property construction period interest and taxes (Code sec. 189).[19] This rule does not apply, however, to (1) low income housing, (2) residential real property (other than low income housing) acquired, constructed or carried by a corporation (other than an S corporation, a personal holding company or a foreign personal holding company), or (3) real property acquired, constructed, or carried if such property is not, and cannot reasonably expected to be, held in a trade or business or in an activity conducted for profit.

The capitalized interest and taxes are amortized generally over a 10 year period. Certain prepaid interest must be capitalized and deducted in the year to which properly allocable. In addition, taxpayers may elect to capitalize certain taxes and interest attributable to both real and personal property and include the capitalized items in the basis of the property (sec. 266).

Reasons for Change

The allowance of a current deduction for construction period interest and taxes is contrary to the fundamental accounting principle that expenses incurred in improving or constructing property with an extended useful life should be capitalized as part of the cost of the property and recovered accordingly. In the case of a taxpayer who incurs interest and taxes in connection with the construction of a building, current law attempts, at least partially, to recognize this capitalization concept by requiring that interest and taxes incurred during the construction period be deducted over at least a 10-year period.

Under present law, corporations are not required to capitalize construction period interest and taxes for residential real property. The committee believes that it is no longer appropriate to provide this exception since it is not compatible with the general objective of capitalizing the costs of construction of property with an extended useful life. In addition, individuals already are required to capitalize construction period interest and taxes on residential real property. The committee believes that corporations should be required to capitalize construction period interest and taxes on residential real property. The committee believes, however, that it is nonetheless appropriate to continue to provide an exception from this rule for low income housing.

[19] For this purpose, real property includes certain sec. 1245 property and certain "section 38 property" described in section 48(a)(1).

Explanation of Provision

The rules under section 189 are extended under the bill to require corporations (other than S corporations) to capitalize construction period interest and taxes for residential real property (other than low income housing). The definition of construction period is the same as under present law.

Effective Date

This provision will apply to interest or taxes paid or incurred in taxable years beginning after December 31, 1984, for the construction of residential real property begun after March 15, 1984.

Revenue Effect

This provision will increase fiscal year budget receipts by $67 million in 1985, $164 million in 1986, $220 million in 1987, $242 million in 1988, and $236 million in 1989.

8. Start-up Expenses (sec. 73 of the bill and sec. 195 of the Code)

Present Law

Under present law, ordinary and necessary expenses paid or incurred in carrying on a trade or business, or engaging in a profit-seeking activity, are deductible. Expenses incurred prior to the establishment of a business normally are not deductible currently since they are not incurred in carrying on a trade or business or while engaging in a profit-seeking activity. Expenditures made in acquiring or creating an asset which has a useful life that extends beyond the taxable year normally must be capitalized. These costs ordinarily may be recovered through depreciation or amortization deductions over the useful life of the asset. Generally, costs which relate to an asset with either an unlimited or indeterminate useful life may be recovered only upon disposition of the asset or the cessation of the activity to which such asset relates.

Present law provides, however, that a taxpayer may elect to treat start-up expenditures as deferred expenses (Code sec. 195). The taxpayer is allowed to deduct such expenses ratably over a period of not less than 60 months, as may be selected by the taxpayer. Start-up expenditures mean any amount paid or incurred in connection with (1) creating a trade or business, and (2) investigating the creation or acquisition of an active trade or business, which if paid or incurred in connection with the expansion of an existing trade or business would be allowable as a deduction in the year in which paid or incurred.

Reasons for Change

Present law is unclear whether a specific item should be capitalized expensed, or amortized as provided in section 195. For example, some taxpayers who do not elect to amortize to start-up expenditures under section 195 have argued that start-up expenditures are currently deductible as ordinary and necessary expenses under section 162, and, in any event, are deductible under section 212 as expenses paid or incurred in connection with property held for the production of income. The Internal Revenue Service disagrees with both these positions.[1]

The committee believes that start-up expenditures generally result in the creation of an asset which has a useful life which extends substantially beyond the year in which incurred. Therefore,

[1] The Tax Court has held that rental payments made pursuant to a leasehold interest in land on which the taxpayer was to construct and operate an office building are not deductible under sec. 162 for the period prior to completion of the building, since the taxpayer was not carrying on a trade or business at the time they were made. However, the court further held that a portion of the rental payments were deductible under sec. 212, since they were ordinary and necessary expenses paid or incurred for the management, conservation, or maintenance of property held for the production of income. *Herschel H. Hoopengarner* v. *Commissioner,* 80 T.C. 538 (1983).

such expenditures should not be fully deductible when paid or incurred but rather should be deducted over a lnnger term. In addition, the committee believes that present law should be clarified to decrease the controversy and litigation arising under present law with respect to the proper tax treatment of start-up expenditures. Accordingly, the committee believes that it is appropriate to require such expenses to be capitalized unless the taxpayer elects to amortize the start-up expenditures over a period of not less than 60 months.

Explanation of Provision

The bill provides that a taxpayer will be required to treat start-up expenditures for which no deduction is currently allowed as deferred expenses. However, a taxpayer will be allowed to amortize such expenses over a period of not less than 60 months as may be selected by the taxpayer. The committee also intends that the definition of start-up expenditures be generally the same as under present law but clarifies the definition to cover certain pre-opening costs. For example, the committee intends that the rent expenses permitted as a deduction in *Hoopengarner,* and similar expenditures, will be subject to this provision. If the trade of business is disposed of completely by the taxpayer before the end of such 60 month (or longer) period, such deferred expenses (to the extent not deducted under this section) may be deducted to the extent provided in section 165. Active trade or business means that the taxpayer is actively conducting a trade or business. This definition of active trade or business may include a trade or business that is in many respects passive. For example, a business where property is regularly based on a net lease basis is an active trade or business for this purpose.

Effective Date

This provision will apply to taxable years beginning after June 30, 1984.

Revenue Effect

This provision will increase fiscal year budget receipts by $23 million in 1985, $36 million in 1986, $31 million in 1987, $26 million in 1988, and $19 million in 1989.

H. Provisions Relating to Tax Straddles

(Secs. 75, 76, 77, 78, 79, 80, and 81 of the bill, and secs. 263, 1091, 1092, 1234, and 1256 of the Code)[1]

Present Law

The Internal Revenue Code contains specific rules to prevent the use of straddles to defer income or to convert ordinary income and short-term capital gain to long-term capital gain. In general, the deduction of losses from straddle positions involving actively traded personal property (other than stock) is limited to the amount by which losses exceed unrecognized gains on offsetting positions (sec. 1092). Gains and losses on regulated futures contracts ("RFCs") are reported under a mark-to-market rule that corresponds to the daily cash settlement system employed by U.S. commodity futures exchanges to determine margin requirements.

Taxation of stock options

The straddle rules, including the loss-deferral rule, do not apply to stock or to domestic exchange-traded stock options with respect to which the maximum exercise period is less than the minimum holding period for long-term capital gain treatment (sec. 1092(d)). Because all domestic exchange-traded stock options currently have a maximum term of approximately nine months, and the required holding period for long-term capital gain treatment is twelve months and one day, all such options are excluded from the straddle rules.

An option is considered an open transaction. The party that acquires property upon the exercise of an option to buy (a "call") or an option to sell (a "put") recognizes no gain or loss because the option and its exercise are, together, viewed as a purchase of the property. Both the holder of a call and the grantor of a put treat the premium paid or received as an adjustment to the purchase price of the underlying property. The party that sells the underlying property recognizes gain or loss. The holder of a put or the grantor of a call treat the premium paid or received as a reduction or increase of the amount realized on the sale of the underlying property.

Gain or loss from the sale or exchange of an option by an option holder is considered gain or loss from the sale or exchange of property that has the same character as the property to which the option relates has, or would have, in the hands of the holder (sec. 1234(a)). For purposes of applying this rule, if a loss is attributable

[1] Certain of these provisions relating to the tax treatment of options under the straddle rules were contained in S. 2062, reported by the Senate Committee on the Budget, on November 4, 1983. The bill modifies those provisions and contains additional rules relating to the treatment of straddles.

to failure to exercise an option, the option is deemed to have been sold or exchanged. Thus, if the property to which the option relates would be a capital asset in the hands of the holder, capital gain or loss would result. The capital gain or loss would be long-term or short-term depending upon the holding period of the option. These rules apply to options to buy or sell property.

In the case of a grantor of an option, gain or loss from a closing transaction with respect to the option, or the lapse of the option, is treated as short-term gain or loss (sec. 1234(b)). Because the rules of secs. 1234(a) and 1234(b) apply to options in property, it is unclear whether these rules apply to options that settle in (or could be settled in) cash. In addition, it is not clear whether gains and losses from transactions in cash settlement options are accorded capital gain or loss treatment under the rule (sec. 1234A) providing for such treatment on the termination of certain contracts.

Treatment of professional options traders

Historically, gain or loss from transactions in options granted or acquired in the ordinary course of a taxpayer's trade or business of granting options was treated as ordinary income or loss. In cases where a taxpayer grants or acquires options in the course of a trade or business and also holds options in connection with investment activities, the rules prescribed by section 1234 apply to the options granted or acquired as investments. Although the matter is not free from doubt, it appears that taxpayers who "make a market" with respect to a particular option are treated as granting or acquiring options in the course of a trade or business.

The short-sale rule

In the case of a "short sale" (*i.e.*, where the taxpayer sells borrowed property and later closes the sale by buying identical property and returning the same to the lender), any gain or loss on the closing transaction is considered gain or loss from the sale or exchange of a capital asset if the property used to close the short sale is a capital asset in the hands of the taxpayer (sec. 1233(a)). The Code contains several rules designed to eliminate specific devices in which short sales could be used to transform short-term gains into long-term gains. Under these rules, if a taxpayer holds property for less than the long-term holding period and sells short substantially identical property, any gain upon the closing of the short sale is considered short-term gain, and the holding period of the substantially identical property is generally considered to begin on the date of the closing of the short sale (sec. 1233(b)). These rules prevent a taxpayer from "aging" his holding period so as to convert short-term capital gain into long-term capital gain where the taxpayer has materially reduced his risk of loss. Also, if a taxpayer has held property for more than one year and sells short substantially identical property, any loss on the closing of the short sale is considered long-term capital loss (sec. 1233(d)). This rule is intended to prevent the conversion of long-term capital loss into short-term capital loss.

For purposes of these rules, property includes stock, securities, and commodity futures (sec. 1233(e)(2)(A)), but commodity futures contracts are not considered substantially identical if they call for delivery of the commodity in different calendar months (sec. 1233(e)(2)(B)). In addition, these rules do not apply in the case of hedging transactions in commodity futures (sec. 1233(g)).

For purposes of the short-sale rules, the acquisition of a put is treated as a short sale, and the exercise or failure to exercise such an option is considered as a closing of the short sale (sec. 1233(b)). If the put is acquired at a time when the underlying property has been held by the taxpayer for 12 months or less, or if the underlying property is acquired after acquisition of the put and before its termination, any gain on exercise or termination of the put is short-term capital gain. Further, the holding period of the underlying property is considered to begin on the earlier of (1) the date such property is disposed of pursuant to the put, or (2) the date the put is exercised, is sold, or expires, as the case may be.

However, if a put and the property identified to be used in its exercise are acquired on the same day, the acquisition of the put is not treated as a short sale (sec. 1233(c)). If the put is not exercised, the premium paid for the put is added to the cost basis of the identified property.

Application of wash-sale rule

The wash-sale rule disallows any loss from the disposition of stock or securities where substantially identical stock or securities (or an option to acquire such property) are acquired by the taxpayer during the period beginning 30 days before the date of sale and ending 30 days after such date (sec. 1091). Commodity futures are not treated as stock or securities for purposes of this rule. Rev. Rul. 71-568, 1971-2 C.B. 312.

Loss deferral rule

If a taxpayer realizes a loss on the disposition of one or more positions in a straddle, the amount of the loss that can be deducted is limited to the excess of the loss over the unrecognized gain (if any) in offsetting positions. Positions are offsetting if there is a substantial diminution in the risk of loss from holding one position by reason of holding one or more other positions in personal property. Deferred losses are recognized in the first year in which there is no unrecognized gain in offsetting positions.

Exception for identified straddles

The loss-deferral rule does not apply to losses on positions in an identified straddle. To qualify as an identified straddle, all of the positions in the straddle must be acquired on the same day, the straddle must have all its positions closed on the same day or have no positions closed at the end of the taxable year, and the straddle must not be part of a larger straddle. An identified straddle must be clearly marked as such on the taxpayer's records before the close of the day on which it is acquired.

Losses on positions in an identified straddle are treated as sustained not earlier than the day on which the taxpayer disposes of all the positions comprising the straddle.

Hedging exemption

The loss-deferral rule does not apply to hedging transactions. A hedging transaction is a transaction that is executed in the normal course of a trade or business primarily to reduce certain risks, and that results in only ordinary income or loss. To prevent manipulation of the hedging exemption by tax-shelter syndicators, the exemption was made inapplicable to syndicates. A syndicate is defined as any partnership or other entity (other than a corporation that is not an S corporation), if more than 35 percent of the entity's losses during any period are allocable to limited partners or limited entrepreneurs. A hedging transaction must be clearly identified before the close of the day the transaction is entered into.

Treatment of mixed straddles

In general, a straddle composed of both RFCs and positions that are not RFCs is subject to the loss deferral rule, and the RFC positions of the straddle are subject to the mark-to-market rule. However, the RFC positions in a mixed straddle are excluded from the mark-to-market rule if the taxpayer designates the positions as a mixed straddle. If a designated mixed straddle also qualifies as an identified straddle, the mixed straddle is exempt from the loss deferral rule.

Because the RFC positions and the non-RFC positions of a mixed straddle are taxed at different rates (and, possibly, at different times), a mixed straddle presents opportunities to defer tax and to convert long-term capital loss to short-term capital loss or short-term capital gain to long-term capital gain. However, under regulations to be prescribed by the Secretary, mixed straddles are subject to rules similar to the rules relating to short sales (described above), regardless of whether the straddle is designated as a mixed straddle or qualifies as an identified straddle (sec. 1092(b)). The statute contemplates that, under these rules, recognized losses will be recharacterized in appropriate cases.

Capitalization of interest and carrying charges

Taxpayers are required to capitalize certain otherwise deductible expenditures for property that is held as part of an offsetting position, and for charges for the temporary use of property borrowed in connection with a short sale constituting part of a straddle (sec. 263(g)). Expenditures subject to this requirement ("carrying charges") are interest on indebtedness incurred or continued to purchase or carry property, as well as amounts paid or incurred for temporary use of the property in a short sale, or for insuring, storing or transporting the property. The amount of carrying charges required to be capitalized is reduced by any interest income from the property (including original issue and acquisition discount), which is includible in gross income for the taxable year. The capitalization requirement does not apply to hedging transactions (as defined above for purposes of the similar exemption from the loss-deferral rule).

Mark-to-market rule

Each RFC held by a taxpayer at year-end is treated as if it were sold for its fair market value on the last business day of the year (sec. 1256(a)(1)). Ordinarily, the settlement price determined by an exchange for its RFCs on the year's last business day is considered to be the RFC's fair market value. Any gain or loss on the RFC is taken into account for the taxable year, together with the gain or loss on other RFCs that were closed out before the end of the year. If a taxpayer holds RFCs at the beginning of a taxable year, any gain or loss subsequently realized on these contracts is adjusted to reflect any gain or loss taken into account with respect to the contracts in a prior year (sec. 1256(a)(2)). The mark-to-market rule is inapplicable to hedging transactions.

Historically, under case law, commodity futures traders have been treated as buying or selling capital assets (unless the taxpayers came within a nonstatutory hedging exemption). By statute, any gain or loss with respect to an RFC that is subject to the mark-to-market rule is treated as if 40 percent of the gain or loss is short-term capital gain or loss, and as if 60 percent is long-term gain or loss. This allocation of capital gain results in a maximum rate of tax of 32 percent for investors other than corporations.

Definition of an RFC

An RFC is a contract that (1) is marked to market under a daily cash settlement system of the type used by U.S. futures exchanges to determine the amount that must be deposited due to losses, or the amount that may be withdrawn in the case of gains, as the result of price changes with respect to the contract during the day, and (2) is traded on or subject to the rules of a domestic board of trade designated as a contract market by the Commodity Futures Trading Commission ("CFTC"), or any board of trade or exchange that Treasury determines to have rules that are adequate to insure compliance with the mark-to-market rules (sec. 1256(b)). Cash settlement futures contracts are included in the definition of an RFC.

Certain foreign currency contracts are treated as RFCs (sec. 1256(g)). For purposes of this rule, a foreign currency contract is defined as a contract that (1) requires delivery of a foreign currency that is also traded through RFCs, (2) is traded in the interbank market, and (3) is entered into at arm's length at a price determined by reference to the price in the interbank market.

Reasons for Change

Taxpayers have attempted to exploit the exemption from the loss-deferral rule for exchange-traded stock options to defer tax on income from unrelated transactions. If effective, these straddles in stock options defer gains from one year to the next by creating a recognized loss on an option that is matched by an unrecognized gain on an offsetting option. A typical abusive straddle involves the acquisition of "deep-in-the-money" offsetting option positions. (A call is in-the-money to the extent that the exercise price (or strike price) is less than the market value of the stock when the option is granted; a put is in-the-money to the extent the strike price exceeds the stock's value.) Regardless of whether the value of the underlying stock increases or decreases, one option position will result in a loss that can be realized for tax purposes, while the other position results in a gain of approximately equal size that can be deferred until the next year. The unrealized gain can be preserved by adopting a new offsetting position to replace the loss position that is disposed of. Although the Internal Revenue Service may be successful in challenging these transactions under rulings and case law, the law is this area is unclear. The committee believes that tax-motivated straddling in stock options is just as objectionable as the straddling in other actively traded property that occurred prior to enactment of the loss-deferral rule.

One widely used investment strategy that would be affected by the extension of the straddle rules to stock options involves writing call options on stock owned by the taxpayer. The committee believes that it may be appropriate to exempt these transactions where they are undertaken primarily to enhance the taxpayer's investment return on the stock and not to reduce the taxpayer's risk of loss on the stock.

The committee is also concerned about the disparity in the tax treatment of options market makers on securities exchanges and professional traders on commodity exchanges. Although the trading activities of these taxpayers are in some respects similar, under the case law, professional commodity traders are traditionally viewed as realizing capital gains or losses on futures transactions. In contrast, it appears that options market makers trading on securities exchanges may be treated as realizing ordinary income or loss with respect to their options transactions. Moreover, an options dealer is considered to be a dealer in property subject to the option. As a result of the ordinary income or loss treatment that may be available to options professionals, tax-shelter syndicates purporting to be market makers have attempted to pass through ordinary losses on stock-option straddles to limited partners.

Another area of concern is that taxpayers may take inconsistent positions regarding the application of present law to new investment products that were not traded when the tax straddle rules were enacted in 1981. For example, the treatment of exchange-traded options that settle only in cash may be uncertain. Taxpayers with losses on cash-settlement options may claim ordinary loss treatment, while taxpayers with gains claim capital gain treatment under the rules generally applicable to options. The Technical Corrections Act of 1982 revised the definition of RFCs to expressly include cash-settlement futures contracts. In the view of the committee, the status of cash-settlement options should be clarified. In addition, options on RFCs ("commodity options") are now traded on domestic futures exchanges. Some taxpayers have taken the position that transactions in commodity options qualify for the 32-percent maximum rate of tax on gains provided by the statutory mark-to-market rule. (The Treasury Department has disputed this interpretation of the law.) However, taxpayers with losses may claim that they are subject to the general tax rules for options, and treat their losses as wholly short-term.

Among the cash settlement futures contracts defined as RFCs in 1982 are contracts based on stock indices. In addition, there are options on stock index futures and direct options on stock indices the tax treatment of which is unclear under present law. In clarifying the rules for such products, a question that arises is whether the mark-to-market rules should be extended to additional investor-held equity based products which were outside the scope of such rules as adopted in 1981.

The question of the proper tax treatment of other new investment products raises a broader issue regarding whether competing investment products traded on different exchanges should be taxed under the same tax regime. A related concern is the proliferation of mixed straddles between products that are subject to a 32-percent maximum rate of tax and products that are taxed at a 50-percent maximum rate. The committee believes that the number of mixed straddles should be limited where possible.

It has come to the committee's attention that the regulatory authority granted to Treasury to prescribe rules for mixed straddles may not be sufficient to insure the promulgation of rules that are effective.

The wash sale rule does not preclude the allowability of losses from short sales of stock in certain cases where the taxpayer closes a short sale and within a brief period before or after the closing, again sells substantially identical stock or sells the stock short.

For example, taxpayers may attempt to defer income by entering into a short sale of stock against the box (a short sale is referred to as being "against the box" if the seller holds stock that is identical to the stock sold short). If the value of the stock increases before the short sale is closed, the seller would acquire additional stock at the higher current price in order to close the short sale, generating a short-term capital loss. In this case, the rule that a short sale is deemed consummated on the date it is closed (Treasury reg. sec. 1.1233-1(a)(1)) would make the closing date the relevant date for applying the 61 day wash sale rule. The taxpayer could attempt to defer income by closing the short sale before year-end (offsetting unrelated income with the resulting short-term capital loss), and selling the retained stock after the beginning of the next taxable year. Even if the transactions occurred within a 61-day period, the wash-sale rule would not apply if the stock held by the taxpayer was not acquired within the 30-day period preceding the close of the short sale. Thus, the taxpayer could take the position that the short-term capital loss is deductible, even though there is no economic loss (because the loss would be offset by an equal amount of unrealized gain in the stock). Alternatively, the taxpayer could replace the closed short position by entering into a new short sale after the beginning of the next taxable year, in order to claim a tax loss, essentially without terminating his position.

The hedging exemption, the mixed straddle election, and the identified straddle rule are subject to a requirement that the taxpayer identify the position or positions before the close of the day on which it is acquired. A similar identification requirement applies to securities dealers seeking capital asset treatment with respect to their securities holdings. The identified straddle rule also requires the identification to be made on the taxpayer's records. Because of the volatility of price movement in some positions, the identification requirement may not operate to preclude taxpayers from claiming beneficial treatment with respect to built-in losses or built-in gains resulting from price movement during the day, contrary to the purpose of such requirement.

Explanation of Provisions

Overview

The bill repeals the blanket exceptions from the straddle rules for exchange-traded stock options and certain other interests in stock. In addition, the mark-to-market rule and the 32-percent maximum rate of tax are extended to non-equity based, exchange-traded options held by investors and to all listed options held by options market makers and professional commodity traders. Commodity options (other than options on stock index futures held by investors) are also made subject to the mark-to-market rule and accorded the 32-percent maximum rate of tax.

1. Repeal of exception for certain stock and stock options

Exchange-traded stock options and certain stock

In general, the straddle rules, including the loss-deferral rule, are extended to straddles involving exchange-traded stock options. An exception is provided for qualified covered call writing transactions. The straddle rules are also extended to any other interests in stock forming part of a straddle one of the positions of which is an option with respect to actively traded stock. The straddle rules also apply, under the bill, to stock of a corporation formed or availed of to take positions in personal property that offset positions taken by any shareholders. For purposes of applying the hedging exemption to transactions in offsetting position stock, members of the same affiliated group (as defined in section 1504(a)) are treated as one taxpayer. As a conforming amendment, the bill allows dividends on stock constituting part of a straddle as an offset to the amount required to be capitalized as carrying costs (sec. 263(g)).

Qualified covered call options

A covered call option is one that is written with respect to stock that is held by the taxpayer (or acquired by the taxpayer in connection with the granting of the option). The granting of a covered call option does not substantially reduce a taxpayer's risk of loss with respect to the underlying stock unless the option is deep-in-the-money. The bill contemplates that taxpayers can continue to write at-the-money and nondeep-in-the-money covered calls, without running afoul of the straddle rules.

In general, a qualified covered call option is an exchange-traded option (i) the gain or loss with respect to which is not ordinary income or loss, (ii) the term of which is more than 30 days, and (iii) which is not deep-in-the-money. The term "deep-in-the-money option" is defined as an option that has a strike price lower than the lowest qualified benchmark. Generally, the "lowest qualified benchmark" is the highest available strike price that is less than the "applicable stock price" (defined below). In the case of an option with a term of more than 90 days and a strike price of $50 or more, the lowest qualified benchmark is the second highest available strike price that is less than the applicable stock price.

Exchange rules currently provide for strike prices on options at five-dollar intervals (or "benchmarks") for options on stock trading at prices under $100. For stock trading at prices over $100, there are $10 benchmarks. The lowest strike price currently authorized is $10. Thus, for example, with respect to stock trading at $60, an exchange-traded call option that is granted more than 90 days before its expiration date with a strike price of $50 or more would qualify for the exception.

The term "applicable stock price" is generally defined as the closing price of the optioned stock on the most recent day on which such stock was traded before the date on which the option was granted. However, if the opening price of the optioned stock on the day the option is granted is greater than 110 percent of the closing price on the last previous trading date, then the opening price of the stock is treated as the applicable stock price.

In general, a qualified covered call option must be written on a national securities exchange registered with the Securities and Exchange Commission ("SEC"). The Secretary may designate other exchanges qualifying for this treatment if the exchange has rules adequate to carry out the purposes of the exception to the straddle rules for qualified covered calls. The bill contemplates that, as a condition of designating an exchange, the Secretary could require that trades on the exchange be subject to information reporting under section 6045 (relating to reports by brokers).

The Secretary is granted broad regulatory authority to modify the provisions of the bill (*e.g.*, to take account of changes in the practices of options exchanges or to prevent tax avoidance). The committee contemplates that the Secretary will prescribe rules for the determination of the applicable strike price if the options exchanges modify their benchmarks.

2. Treatment of gain or loss where the taxpayer is the grantor of a call option

The bill provides that, if at any time a taxpayer holds stock and is the grantor of an outstanding option to buy such stock, which option has a strike price that is less than the applicable stock price, then any amount that would otherwise be treated as a long-term capital gain with respect to the stock is treated as a short-term capital gain to the extent of any short-term capital loss recognized on the option. This short-term capital gain character would be preserved where the stock is transferred in a nonrecognition transaction (including a gift).

3. Extension of mark-to-market rule

The bill extends the mark-to-market rule (including the 60/40 treatment that results for individuals in a 32-percent maximum tax rate) to nonequity listed options and dealers' equity options. Rules are provided to prevent limited partners (or entrepreneurs) of an options dealer from recognizing gain or loss from equity options as 60 percent long-term capital gain or loss and 40 percent short-term capital gain or loss.

Definition of listed option contract

The bill defines a listed option as any option (other than a right to acquire stock from the issuer) that is traded on (or subject to the rules of) a qualified board or exchange. A qualified board or exchange is a national securities exchange registered with the SEC, a domestic board of trade designated as a contract market by the Commodity Futures Trading Commission, or any other exchange or board of trade that the Secretary determines has rules adequate to carry out the purposes of the relevant statutory provisions. The bill contemplates that, as a condition of designating an exchange or board of trade, the Secretary may require information reporting with respect to trading of U.S persons consistent with the rules of section 6045 (relating to returns of brokers).

Equity listed options

An equity option is defined to mean any option to buy or sell stock, and any other option the value of which is determined by reference to an index of stock, including an option on a stock index futures contract. Holders of equity options (other than dealers) remain subject to the general rules for the taxation of options, including the loss-deferral rule.

Nonequity listed options.—A nonequity option is defined as any listed option that is not an equity option. Under the bill, any holder of a nonequity option (whether an options professional or an investor) is treated as if the option were disposed of at year-end for a price equal to its fair market value, and any gain or loss is taxed as if it were 60-percent long-term and 40-percent short-term (just as the holders of RFCs are treated). All options on RFCs other than options on stock index futures are treated as nonequity options under the bill.

4. Treatment of dealer options

The bill changes the claimed present-law treatment of options market makers and codifies present law with respect to professional commodity traders by providing that both categories of traders (as well as all other persons who buy and sell RFCs) are treated as buying and selling capital assets, except to the extent that an option or future is acquired to hedge property that would generate ordinary income or loss. An options dealer is defined as any person who is registered with the SEC and an appropriate national securities exchange as a market maker or specialist in listed options, and any person registered with a domestic board of trade designated as a contract market by the CFTC who, in a place provided by the board of trade, purchases and sells commodity options subject to the rules of such board. Under the bill, an options dealer would not recognize ordinary income or loss with respect to his stock and securities transactions, unless the taxpayer is a dealer in stock and securities under general Federal income tax rules (determined without regard to his transactions in options in such property).

In addition to nonequity options, which are marked-to-market in the hands of all holders, equity options held by options professionals are also subject to the mark-to-market rule and 60/40 treatment. To prevent options professionals from passing through 60/40 treatment of equity options to limited investors, the bill provides that 60/40 treatment does not apply to gain or loss on dealer equity options that is allocable to limited partners or limited entrepreneurs (regardless of the percentage of such gain or loss that is so allocated). Partnerships will be required to separately account for each partner's share of gains and losses to which 60/40 treatment applies. Such gains and losses will not be netted against other short-term and long-term gains and losses of the partnership. Similar rules will apply to S corporations.

5. Hedging exemption

In general, the hedging exemption under present law remains available. However, the bill limits the ability of limited partners and limited entrepreneurs to deduct losses from hedging transactions against unrelated income where the hedging exemption is claimed.

Under the bill, an options dealer who is a dealer in the underlying property is treated the same as a commodity trader who is a dealer in the cash commodity. Thus, neither the loss-deferral rule nor the mark-to-market rule applies to an option or an RFC that is identified as a hedging transaction where gain or loss on both the option or the RFC and the underlying property would be ordinary income or loss (as determined under the bill).

For limited partners and limited enterpreneurs the bill limits the deductibility of any loss on a hedging transaction to the taxable income (determined without regard to such loss) derived from the conduct of the trade or business to which the hedging transaction relates. The committee intends that this rule be applied broadly so that, for example, a hedging loss sustained by a securities firm in its municipal bond operations could be deducted against profits from its other securities operations. However, limited partners could not deduct such losses against, for example, their dividend income. This provision is intended to prevent the passthrough of ordinary losses to limited investors from hedging transactions engaged in by traders who qualify as dealers in the underlying property.

The limitations on the deductibility of hedging losses allocable to limited partners and limited entrepreneurs apply to the following taxpayers: (i) any taxpayer who enters into a hedging transaction relating to stock or securities, (ii) any individual, and (iii) any corporation if at any time during the last half of the taxable year more than 50 percent in value of its outstanding stock is owned by five or fewer individuals. The term "hedging loss" is generally defined as the excess of (i) the allowable deductions for the taxable year attributable to hedging transactions (determined without regard to the rule limiting hedging losses), over (ii) income received or accrued by the taxpayer during such taxable year from such transactions. However, an exception to the limitations on losses is provided for cases in which an overall economic loss occurs. The bill provides that the limitations do not apply to a hedging loss to the extent that the hedging loss for the year exceeds the aggregate unrecognized gains from hedging transactions (including gains from hedged property) as of the close of the taxable year. The "aggregate unrecognized gain" is defined as that term is used for purposes of the straddle rules: (i) the amount of gain that would be taken into account with respect to property if such property were sold on the last business day of such taxable year at fair market value, plus (ii) in the case of any position with respect to which, as of the close of the taxable year, gain has been realized but not recognized, the amount of gain so realized.

6. Cash-settlement options

For cash-settlement options that are not subject to the mark-to-market rule (*e.g.*, options on stock indexes held by investors), the bill amends section 1234 to clarify that gain or loss on the sale, exchange, lapse, or exercise of the option is capital gain or loss with respect to grantors or holders. For purposes of the bill, a cash-settlement option is defined as any option which on exercise settles in (or could be settled in) cash or property other than the underlying property. As under present law, the receipt of cash on exercise of a cash-settlement option is a taxable event. In addition, the bill explicitly makes exercise of an option as to which the underlying property is an RFC an event requiring recognition of gain or loss, which under the bill constitutes option gain or loss not eligible for 60/40 treatment. No inference is intended as to the treatment of cash settlement options under present law.

7. Regulatory authority relating to mixed straddles

The bill broadens the scope of Treasury's regulatory authority to prescribe rules for mixed straddles. The bill requires the Secretary to prescribe such regulations with respect to gain or loss on straddle positions as may be necessary to carry out the purposes of the loss-deferral rule, within six months from the date of enactment. To the extent consistent with this purpose, the regulations should include rules applying the principles of the wash-sale rule and the short-sale rule.

8. Short sales against the box

The bill provides that rules similar to those requiring the deferral of losses from disposing of stock in wash sales (sec. 1091) will apply to require the deferral of losses incurred on closing short sale transactions where the taxpayer sells the stock or enters into a second short sale within the period beginning 30 days before and ending 30 days after the closing of the short sale.

9. Regulatory authority with respect to identification requirement

The Treasury is authorized under the bill to impose earlier identification deadlines under certain provisions requiring identification of a position by the close of the day on which the position is acquired. This requirement would be imposed by regulation and would apply to the hedging exemption, the mixed straddle election, identified straddles, and, in the case of securities dealers, the identification of securities held for investment. The Treasury could also provide by regulation for a method of identification other than on the taxpayer's records. It is contemplated that any additional identification requirements for the hedging exemption that may be imposed under the regulations will be consistent with the intended application of the identification rule for the hedging exemption expressed in the report of the Senate Finance Committee in 1981 as follows:

> Taxpayers, such as banks or securities dealers, who may conduct thousands of hedging transactions to hedge property held or to be held in their accounts, may identify such accounts as hedged accounts without marking individual items as hedges or hedged property, provided such accounts deal only with ordinary income (or loss) items. S. Rep. No. 144, 97th Cong., 1st Sess. 151 (1981).

Treasury would have the authority to require earlier identification only for particular classes of taxpayers, like tax shelters, or to exempt particular classes of taxpayers, like bona fide government securities dealers.

Effective Dates

General rules

In general, the provision repealing the exemption from the straddle rules for stock options and certain stock applies to positions established after October 31, 1983. The identification requirement under the hedging exemption will not apply with respect to stock and stock options acquired or entered into within 60 days after the date of enactment. However, the application of the straddle rules to offsetting position stock is effective for positions established on or after May 23, 1983.

The special rule for the treatment of gain where the taxpayer is the grantor of an option to buy stock applies to positions established after March 1, 1984.

The provisions extending the mark-to-market rule to nonequity options and dealer equity options generally apply to positions established after the date of enactment. However, with respect to non-equity based commodity options, the amendments made by the bill apply to positions established after October 31, 1983.

The provisions clarifying the treatment of cash-settlement options and requiring recognition of gain or loss on exercise of commodity options apply to options purchased or acquired after October 31, 1983. The amendments to the hedging exemption apply to taxable years beginning after December 31, 1984. The amendments relating to the time for identification of certain transactions apply to items identified after the date of enactment.

The application of the wash sale rules to certain short sales applies in the case of short sales entered into after the date of enactment.

Elections

The mark-to-market rules may be applied to nonequity options and dealer equity options on or before the general effective dates under either of two elections provided by the bill.

Positions held on the date of enactment.—Taxpayers can elect to apply the mark-to-market rule to nonequity options or dealer equity options that they held on the date of enactment. The election must cover all such positions held by the taxpayer on the date of enactment.

Positions held on or before the date of enactment.—In lieu of the election described above, taxpayers can elect to apply the mark-to-market rule to all positions held by the taxpayer during the taxable year that includes the date of enactment (the "transition year"). If the taxpayer makes this full-year election, all nonequity options and dealer equity options held at any time during the transition year must be marked-to-market.

With respect to stock options and stock that is ordinary income or loss property (to the extent offset by such options), any tax liability for the transition year which is attributable to appreciation in such options and such stock can be paid in two to five equal annual installments. Interest is charged on any unpaid installments of tax that are still outstanding after the due date for the first installment. The Committee does not intend that this rule-relative to deferred payments of tax attributable to appreciation in stock options create any inference as to whether straddle transactions undertaken in periods prior to the effective date of the bill are subject to challenge by the Service.

Revenue Effect

This provision will increase fiscal year budget receipts by $406 million in 1984, $163 million in 1985, $82 million in 1986, $60 million in 1987, $48 million in 1988, and $39 million in 1989.

I. Pensions, Welfare Benefit Plans, ESOPs

A. General Provisions

If a pension, profit-sharing, or stock bonus plan qualifies under the tax law (qualified pension plan), then (1) a trust under the plan generally is exempt from income tax, (2) employers generally are allowed deductions (within limits) for plan contributions for the year for which the contributions are made, even though participants are not taxed on plan benefits until the benefits are distributed, (3) benefits distributed as a lump sum distribution may be accorded special long-term capital gain treatment or 10-year income averaging treatment, or may be rolled over, tax-free, to an individual retirement arrangement (IRA) or another qualified plan, and (4) limited estate and gift tax exclusions are provided.

1. Deduction Limits for Qualified Pension Plans (sec. 85 of the bill and secs. 404 and 415 of the Code)

Present Law

Under present law, limits are imposed on the amount of employer deductions for contributions to a qualified pension plan. In addition, if an employer maintains a defined benefit pension plan or a money purchase pension plan and an annuity, profit-sharing, or stock bonus plan for the same employees, the employer's deduction for plan contributions for a year is limited to the greater of (1) 25 percent of compensation paid or accrued during the year to the beneficiaries of the plan or (2) the amount necessary to satisfy the employer's minimum funding requirement under either the defined benefit plan or the money purchase pension plan. If the employer maintains a defined benefit pension plan and a money purchase pension plan, the 25 percent of compensation limit does not apply because both plans are pension plans.

Present law provides overall dollar and percentage of compensation limits on the contributions and benefits that may be provided to participants under qualified pension plans. TEFRA reduced the dollar limits to $30,000, in the case of annual additions under a defined contribution plan, and $90,000, in the case of an annual benefits under a defined benefit plan. In addition, TEFRA suspended all cost-of-living adjustments to these dollar limits until 1986. Beginning in 1986, the limits will be adjusted for post-1984 cost-of-living increases under the formula then in effect to provide cost-of-living increases for social security benefits.

If an employee participates in both a defined contribution plan and a defined benefit pension plan maintained by the same employer, the fraction of the separate limit used by each plan for an employee is computed and the sum of the fractions is subject to an overall limit. The numerator of the defined benefit plan fraction is the projected annual benefit of the participant under the plan determined as of the close of the year and the denominator is the maximum benefit allowed. The numerator of the defined contribution plan fraction is the total amount of annual additions to the participant's account through the close of the year and the denominator is the maximum amount of annual additions that could have been made for the participant if the plan provided the maximum allowable annual addition for the year and all prior years of service with the employer. TEFRA generally reduced the combined limit on the sum of the fractions of the separate limits from 1.4 to 1.25 (1.0, in the case of certain top-heavy plans).

Reasons for Change

The committee is aware that larger deductions for plan contributions are available to an employer that maintains a defined benefit plan and a money purchase pension plan than would be allowable if the employer maintained a defined benefit plan and an annuity, profit-sharing, or stock bonus plan. Because a money purchase pension plan is a defined contribution plan under which an employee accumulates benefits in an individual account in much the same manner as in a profit-sharing or stock bonus plan, the committee believes that a combination of a money purchase pension plan and a defined benefit plan should be subject to the same overall deduction limit as a combination of defined benefit plan and an annuity, profit-sharing, or stock bonus plan.

In order to reduce excessive accumulations of tax-deferred funds by high-income individuals, TEFRA reduced the overall limits on contributions and benefits in situations in which an employee participates both in a defined contribution plan and a defined benefit plan maintained by the same employer. However, the committee believes that, in limited cases, it is appropriate to permit the use of higher combined limit on contributions and benefits because such plans may provide significant retirement benefits to rank-and-file employees.

Explanation of Provision

The bill applies the 25-percent deduction limitation to employers maintaining both a defined benefit plan and a money purchase pension plan. In no event, however, will the 25-percent limitation on the employer's deduction for a year be less than the amount necessary to satisfy the minimum funding requirement under the defined benefit plan.

In addition, the bill imposes an overall limit on an employer's deduction for contributions to a qualified pension or annuity plan for a year. Under this provision, the total amount deductible for a taxable year under all trusts of the employer is not to exceed the aggregate amount of compensation paid or accrued during the taxable years to the beneficiaries of the trusts. In applying this aggregation limit, benefits paid by a plan (within limits) will be treated as compensation paid during the year.

In any year in which the amounts contributed by an employer to a qualified pension plan or plans are not deductible under either the 25-percent limitation or the aggregate compensation limitation, such amounts are deductible in any succeeding taxable year in order of time. Under the provision, the carryover amount deductible for any succeeding year, when added to the amount otherwise deductible for the taxable year, is not to exceed 25 percent (or, if applicable 100 percent) of the compensation otherwise paid or accrued during the year to beneficiaries of the plan or plans.

Under the bill, in the case of an employee participating in both a defined contribution plan and a defined benefit plan maintained by the same employer, the combined limit on the sum of the fractions of the separate limits used by each plan is raised to 1.4. This rule applies only if, at all times after June 30, 1982, no plan of the employer is (1) a top-heavy plan or (2) integrated with social security within the meaning of sec. 408(k)(3)(E).

Finally, the bill postpones the cost-of-living increases to the dollar limits on contributions and benefits under qualified pension plans until 1988. Beginning in 1988, the limits will be adjusted for post-1986 cost-of-living increases under the formula then in effect to provide cost-of-living increases in social security benefits.

Effective Date

The provisions are effective for years beginning after December 31, 1984.

Revenue Effect

These provisions will increase fiscal year budget receipts by $18 million in 1985, $65 million in 1986, $116 million in 1987, $165 million in 1988, and $182 million in 1989.

2. Provisions Relating to Top-heavy Plans (sec. 86 of the bill and sec. 416 of the Code)

Present Law

Under present law, if a qualified pension plan is top heavy, certain minimum requirements must be satisfied. These rules require, among other things, that minimum benefits or contributions be provided to non-key employees. A qualified pension plan is top heavy if more than 60 percent of the value of accrued benefits is allocable to key employees. For purposes of determining whether a plan is top heavy, the accrued benefits of employees who have separated from service generally continue to be counted.

Present law provides that an individual is a key employee if the individual (1) is an officer (in the case of a corporate employer), (2) is one of the 10 employees owning the largest interests in the employer, (3) owns more than a 5-percent interest in the employer, or (4) owns more than a 1-percent interest in the employer and has compensation from the employer in excess of $150,000.

In addition, present law provides that the combined limit on contributions and benefits for a key employee participating in both a defined contribution plan and defined benefit plan maintained by the same employer is reduced from 1.25 to 1.0. This reduction in the combined plan limit does not apply if additional minimum benefits or contributions are provided to non-key employees. In the case of a super top-heavy plan i.e., a plan under which 90 percent of the accrued benefits or account balances are allocable to key employees, the reduction in the combined plan limit from 1.25 to 1.0 applies irrespective of whether additional minimum contributions or benefits are provided to non-key employees.

Under present law, in testing whether an employer has satisfied the minimum contribution or benefit requirement with respect to a non-key employee and for purposes of determining the amount that has been contributed to a plan on behalf of a key employee, amounts contributed pursuant to a salary reduction arrangement are not counted.

Reasons for Change

The committee is aware that special requirements which are unduly complicated or burdensome may tend to discourage employers from continuing or establishing qualified pension plans. Therefore, the committee believes that it is appropriate to make certain changes to the rules relating to top-heavy plans in order to make these rules easier for employers to administer.

Explanation of Provisions

Under the bill, the special combined limit on contributions and benefits under a super top-heavy plan is repealed. Thus, the reduction in the combined limit on contributions and benefits for a key employee from 1.25 to 1.0 does not apply to any top-heavy plan as long as additional minimum contributions or benefits are provided to non-key employees.

The bill amends the definition of the term "key employee" to exclude officers who earn less than twice the dollar limit on contributions under a defined contribution plan. For example, for years beginning before January 1, 1988, an officer is not treated as a key employee if the officer has annual compensation of less than $60,000.

Under the bill, if an individual has not been an employee with respect to any plan of the employer at any time during the 5-year period ending on the determination date, any accrued benefit (or account balance) of the individual is disregarded for purposes of determining whether the plan is top heavy.

The bill provides that amounts contributed to a qualified pension plan pursuant to a salary reduction arrangement are taken into account under the top-heavy provisions. The bill also exempts governmental plans (as defined in sec. 414(d)) from the top-heavy plan requirements.

Under the bill, if the Secretary of the Treasury fails to issue final regulations on the rules relating to top-heavy plans before January 1, 1985 (as in effect on the day before the date of enactment of these provisions), the Secretary is required to publish plan amendment provisions that may be incorporated into all qualified pension plans of an employer. If a plan is amended to incorporate these provisions, the plan is deemed to have met the top-heavy requirements and is not required to be amended further to comply with the top-heavy provisions until the date that is 6 months after the issuance of final regulations.

If the Secretary fails to publish the required plan amendment language by January 1, 1985, the plan is treated as meeting the top-heavy plan requirements if the plan is amended to incorporate such requirements by reference. In any case in which a plan is so amended and the plan does not specify the provisions that apply, the employer is considered, in those situations in which more than one provision may apply, to have elected the provision that maximizes the vested, accrued benefits for each non-key employee. For example, if the plan is amended to incorporate the top-heavy requirements by reference, the plan is deemed to have elected the vesting schedule that maximizes the vested, accrued benefits of any non-key employee. Thus, if a non-key employee separates from service after two years of service, the plan is considered to have incorporated the graduated vesting schedule with respect to that employee and the employee would have a 20-percent vested accrued benefit. On the other hand, if another non-key employee under the plan has at least three years of service, the plan is considered to have incorporated the three-year, 100-percent vesting schedule with respect to that employee. Similarly, if a plan is amended to incorporate the top-heavy plan requirements by reference, a non-key employee in the plan must be provided with the minimum contribution or benefit under such plan without regard to whether the non-key employee participates in another top-heavy plan of the employer.

The bill does not change the effective date of the top-heavy rules. In addition, the committee intends that the issuance, as final regulations, of regulations similar to the proposed regulations under sec. 416 (published on March 15, 1983) will constitute final regulations for purposes of this provision.

Effective Dates

Generally, the provisions are effective for plan years beginning after December 31, 1983. The provisions relating to separated employees and salary reduction arrangements are effective for plan years beginning after December 31, 1984.

Revenue Effect

These provisions will reduce fiscal year budget receipts by $31 million in 1984, $89 million in 1985, $107 million in 1986, $120 million in 1987, $134 million in 1988, and $150 million in 1989.

3. Distribution Rules for Qualified Pension Plans (secs. 87 and 88 of the bill and secs. 72 and 401 of the Code)

Present Law

Distributions prior to age 59½

Present law (sec. 72(m)(5)) imposes an additional income tax on certain distributions to key employees in top-heavy plans. Amounts received from or under a qualified pension plan before a participant attains age 59½, becomes disabled, or dies are subject to an additional 10-percent income tax to the extent that the amounts are includible in the participant's gross income and are attributable to years in which the participant was a key employee in a top-heavy plan. This 10-percent penalty tax also applies to distributions to a participant who is or has been a key employee to the extent that such amounts are in excess of the benefits provided for such individual under the plan formula.

Before-death distribution rules

Under the tax-qualification rules (sec. 401(a)(14)), unless a participant elects otherwise, the payment of benefits under a qualified pension plan generally must begin no later than 60 days after the end of the plan year in which the participant attains the normal retirement age under the plan (or age 65, if earlier). A plan may defer distribution beyond normal retirement age (or age 65) if the participant has not yet separated from service or has not participated in the plan for at least 10 years.

In addition, present law requires that benefits provided under a qualified pension plan must be for the primary benefit of an employee, rather than the employee's beneficiaries. Under this incidental benefit rule, a qualified pension plan generally must not permit any form of distribution under which the present value of the payments projected to be made to the participant, while living, is not more than 50 percent of the present value of the total payments projected to be made to the participant and his beneficiaries. The incidental benefit rule is satisfied, however, if payments are made to the participant and his spouse in accordance with the qualified joint and survivor annuity rules.

TEFRA enacted additional rules governing before-death distributions under qualified pension plans. Generally, these rules provide that a participant's benefits must be distributed by a benefit distribution date, which is the last day of the later of (i) the taxable year in which the participant attains age 70½, or (ii) the taxable year in which the participant retires. In the case of a key employee participating in a top-heavy plan, distributions must be made in the taxable year in which the key employee attains age 70½ without regard to whether the key employee has retired. Alternatively, distributions must begin no later than the applicable benefit distribution date and must be made over the life of the participant (or lives of the participant and the participant's spouse) or over a period not exceeding the life expectancy of the participant (or the joint life expectancy of the participant and the participant's spouse). Distributions may be made to the participant and a nonspouse beneficiary so long as the measuring lives remain those of the participant and the participant's spouse.

The distribution rules applicable to individual retirement arrangements (IRAs) are similar to the before-death distribution rules applicable to benefits under qualified pension plans except that the benefit distribution date for the owner of the IRA is the end of the taxable year in which the owner attains age 70½, without regard to whether the owner has retired. In addition, present law requires that the amount distributed by the end of each year after the owner has attained age 70½ must not be less than the balance in the IRA at the beginning of such year divided by the life expectancy of the owner (or the joint life expectancy of the owner and the owner's spouse). This "minimum distribution rule" requires that the life expectancy of the owner (or the joint life expectancy of the owner and the owner's spouse) is to be determined as of the date the owner attains age 70½ and is to be reduced by one for each taxable year commencing after the owner's attainment of age 70½.

After-death distribution rules

TEFRA amended the rules applicable to distributions under a qualified pension plan after the death of a plan participant. If a participant dies before the entire interest is distributed, amounts payable to a beneficiary (other than the participant's surviving spouse) generally must be paid to the beneficiary within five years of the participant's death. Also, if distributions have commenced, after the participant's death, to the participant's surviving spouse in a form that takes into account the life or life expectancy of such spouse, any amounts payable to a beneficiary of the surviving spouse upon the spouse's death must be paid to the beneficiary within five years of the spouse's death. Distributions that have commenced over a term certain not exceeding the life expectancy of the participant (or of the participant and the participant's spouse) are not limited by the five-year payout rule. The after-death IRA distribution rules also are similar to the after-death distribution rules applicable to benefits under qualified pension plans.

Qualifying rollover distributions

Under present law, an employee's benefits from or under a qualified pension or annuity plan generally are includible in income when the benefits are distributed. If the balance to the credit of an employee is paid to the employee or to the surviving spouse of the employee as a qualifying rollover distribution, all or any portion of the distribution may be rolled over, within 60 days of the date of the distribution, to another qualified pension or annuity plan or an IRA. If a rollover is made, tax is deferred on the portion of the distribution rolled over. Under present law, no rollover is permitted for a plan distribution that is not a total distribution.

Present law provides that if no part of a lump sum distribution from a qualified pension plan is rolled over, it may be accorded special 10-year income averaging treatment or, in some cases, capital gains treatment. Also, present law provides that if a lump sum distribution includes employer securities with unrealized appreciation, the unrealized appreciation generally is not includible in gross income until the securities are sold or exchanged. This rule applies whether or not all or a portion of the distribution is rolled over to another qualified pension plan or an IRA.

Reasons for Change

The committee is concerned that the TEFRA rules unduly restrict qualified pension plan distributions to beneficiaries other than the surviving spouses of participants. A participant may desire to provide one or more individuals, other than the participant's spouse, with the right to receive, in a form that is based on the life or lives of the beneficiary or beneficiaries, any portion of retirement benefits that remain at death.

The committee is concerned that an attempt to develop distribution rules that distinguish among nonspouse beneficiaries on the basis of financial dependency, family relation, or some other characteristic inevitably will preclude some participants from providing benefits to beneficiaries for whom the participant wishes to provide. Also, an attempt to develop such rules would impose additional administrative burdens on qualified plans and could affect the ability of the Internal Revenue Service to implement rules and monitor compliance.

Explanation of Provisions

Distributions prior to age 59½

Under the bill, the 10-percent penalty tax on premature distributions applies only to a participant to the extent that the distribution is attributable to years in which the participant was a 5-percent owner (as defined in section 416 of the Code) without regard to whether the plan was top heavy for such years.

Before-death distribution rules

The bill changes the before-death distribution rules applicable to qualified pension plans. Under these rules, a qualified pension plan must provide that a participant's entire interest will be distributed before the end of the taxable year in which (1) the participant attains age 70½, or (2) the participant retires, whichever is later. If a participant is a 5-percent owner (as defined in section 416) with respect to the taxable year in which the participant attains age 70½, the participant's entire interest must be distributed no later than the close of such year even though the participant has not retired. A plan is deemed to meet these distribution requirements if distributions are made no later than 90 days after the close of the taxable year in which distributions are required to be made.

Alternatively, the bill provides that a qualified pension plan must require that a participant's entire interest will be distributed, commencing on or before the applicable benefit distribution date, over the life of the participant (or the lives of the participant and spouse) or over a term certain not exceeding the life expectancy of the participant (or the joint life expectancy of the participant and spouse). For purposes of this rule, the committee expects that regulations will clarify that a participant's "entire interest" does not include ancillary benefits (such as lump sum death benefits) that are, in no event, available to the participant and that satisfy the incidental benefit requirement.

The committee expects that, in implementing these before-death distribution rules, regulations will require that distributions over any of the permissible periods must satisfy a minimum distribution rule similar to the rules under present law, except that the participant's life expectancy (or, if applicable, the joint life expectancy of the participant and the participant's spouse) may be recalculated no more frequently than once annually. This rule also changes the minimum distribution rule applicable to IRAs by permitting the annual recalculation of life expectancy.

Distributions over any of the permissible periods from or under a defined benefit plan are deemed to satisfy the minimum distribution rule if the plan makes substantially nonincreasing annual payments over any of these periods. The committee expects, however, that regulations will permit defined benefit plan distributions to increase in certain situations. For example, certain cost-of-living increases in a participant's annual payments, cash refunds of employee contributions upon an employee's death, an increase in annual benefit payments to the participant upon the death of the participant's beneficiary, and increases based on investment experience generally could be permitted. In no event, however, will increasing payments be permitted if the effect of such payments is circumvention of the general distribution requirements. The committee also expects that the regulations will permit a defined contribution plan and a defined benefit plan to satisfy the minimum distribution rule by distributing an immediate annuity contract that provides for substantially nonincreasing payments over any of the permissible periods.

Under the bill, a defined contribution plan or a defined benefit plan does not fail to satisfy the before-death distribution rules if it provides for the purchase, by the applicable benefit distribution date, of an immediate annuity contract that provides for substantially nonincreasing payments to be made over the lives of the participant and a nonspouse beneficiary (or over a term certain not exceeding the joint life expectancy of the participant and a nonspouse beneficiary.) A defined benefit plan would be permitted to make substantially nonincreasing payments directly from the plan, in lieu of distributing an annuity contract.

The committee intends that, as under present law, plan distributions, including distributions under annuity contracts distributed by a qualified pension plan must satisfy the incidental benefit rule. For example, if a plan provides a before-death distribution of an immediate annuity contract to the participant and a beneficiary, the present value of the payments projected to be paid to the participant must be more than 50 percent of the present value of the payments projected to be paid to the participant and the beneficiary. As under present law, distributions in accordance with the rules governing qualified joint and survivor annuities and distributions in accordance with the minimum distribution rule will continue to satisfy the incidental benefit rule.

After-death distribution rules

The bill generally continues the after-death distribution rules of present law. The bill also requires that, except as provided in regulations, distributions must commence to a beneficiary (including the participant's surviving spouse) within 90 days of the participant's death or the death of the surviving spouse of the participant. However, the committee expects that regulations will provide exceptions to this 90 day rule in certain situations, (e.g., if the plan is unable to locate the beneficiary) to the extent that the exceptions do not circumvent the general distribution rules. In addition, the five-year payout rule is satisfied, both for qualified pension plans and IRAs, by the purchase of an immediate annuity contract that provides for substantially nonincreasing payments over the life of the beneficiary or over a term certain not exceeding the life expectancy of the beneficiary. A defined benefit plan is permitted to make payments directly without purchasing an immediate annuity contract.

Qualifying rollover distributions

Under the bill, distributions of less than the balance to the credit of an employee under a qualified pension or annuity plan, or tax-sheltered annuity contract may be rolled over, tax-free, by the employee (or the surviving spouse of the employee) to an IRA. A rollover of a partial distribution is permitted only if (1) the distribution equals at least 50 percent of the balance to the credit of the employee, determined immediately before the distribution, (2) the distribution is not one of a series of periodic payments, and (3) the employee elects tax-free rollover treatment at the time and in the manner prescribed by the Secretary of the Treasury. For purposes of determining whether a distribution is at least 50 percent of the balance to the credit of the employee under a qualified pension plan or a tax-sheltered annuity contract, amounts credited under similar other qualified pension plans or tax-sheltered annuity contracts of the same employer are not aggregated.

As under present law, the rollover of a partial distribution must be made within 60 days after the date of distribution. If the employee or surviving spouse of the employee elects partial distribution rollover treatment, no portion of the distribution may be rolled over to another qualified pension plan or a tax-sheltered annuity. In addition, no special treatment is accorded to net unrealized appreciation of employer securities. Any subsequent distribution from the same plan (or any other plan of the employer required to be aggregated for the lump sum distribution rules) is not eligible for the special 10-year income averaging or long-term capital gain treatment accorded lump sum distributions. Similarly, if an employee elects partial distribution rollover treatment under a tax-sheltered annuity, a subsequent distribution under any other tax-sheltered annuity of the same employer is not eligible for long-term capital gains treatment.

In the case of a rollover of a partial distribution, the maximum amount rolled over may not exceed the portion of the distribution includible in gross income. Also, amounts in IRAs may not be rolled over to a qualified pension plan or to a tax-sheltered annuity contract if the balance in the IRA consists, in part, of a rollover of a partial distribution.

Effective Dates

The provision repeals the amendments to Code sec. 401(a)(9) that were enacted by section 242(a) of TEFRA and applied to plan years beginning after December 31, 1983. The new provisions generally are effective for plan years beginning after December 31, 1984. In the case of a governmental plan (as defined in section 414 (d)), the new distribution rules are effective for plan years beginning after December 31, 1986. In the case of plans maintained pursuant to one or more collective bargaining agreements, the new rules do not apply to years beginning before the earlier of (1) January 1, 1988, or (2) the date on which the last of the collective bargaining agreements relating to the plan terminates. Employee designations made before January 1, 1984, in accordance with section 242(b)(2) of TEFRA remain effective. Thus, if an employee made a proper designation before January 1, 1984, such designation continues to be effective and a plan that makes a distribution in accordance with such designation does not fail to satisfy these new rules.

Revenue Effect

These provisions will increase budget receipts by less than $5 million annually.

4. Treatment of Distributions of Benefits Substantially All of Which Are Derived From Employee Contributions (sec. 89 of the bill and sec. 72 of the Code)

Present Law

Under a qualified pension or annuity plan, tax-sheltered annuity contract, or government plan, contributions may be made by (1) the employer, (2) the employees, or (3) both. Thus, present law permits a qualified pension plan, etc., to be funded solely by employee contributions.

Employee contributions to a qualified pension plan generally are not deductible by the employee. Contributions by an employee that meet certain requirements, which are similar to the rules relating to IRAs, may be deductible from gross income. Employee contributions to a qualified plan (whether or not deductible) may not discriminate in favor of employees who are officers, shareholders, or highly compensated. Generally, employee contributions are presumed to be nondiscriminatory if (1) the amount contributed does not exceed certain limits expressed as a percentage of pay and (2) the opportunity to make the contributions is reasonably available to a nondiscriminatory group of employees.

Nondeductible employee contributions may be withdrawn from a qualified pension plan at any time without a tax penalty. In addition, the first withdrawals of nondeductible contributions (prior to the annuity starting date) are treated as a return of the nondeductible contributions, which are not includible in gross income. After the balance of the nondeductible contributions has been exhausted, other withdrawals are considered to be income.

Reasons for Change

The committee understands that some financial institutions are promoting master and prototype qualified pension plans that provide for no employer contributions, but instead permit only nondeductible employee contributions. The favorable tax treatment of amounts contributed to qualified pension plans and the ready availability of amounts attributable to employee contributions enable these plans to be used as tax-favored savings and brokerage accounts. In fact, these plans could offer employees the opportunity to withdraw funds using credit cards or checks without any amount being included in the employee's income. The committee believes that the tax treatment of the employee contributions in these situations should be altered to ensure that these plans are used as bona fide retirement plans.

Explanation of Provisions

Under the bill, in the case of any qualified pension or annuity plan, tax-sheltered annuity, or government plan in which substantially all of the accrued benefits are derived from employee contributions, the amounts contributed by the employee generally are treated as if the amounts have been contributed to the purchase of a tax-deferred annuity. Thus, the first amounts withdrawn from such a plan are treated as coming out of earnings in the employee's account. In addition, if an employee receives (directly or indirectly) any amount as a loan under the plan, the bill treats the amount of the loan as a withdrawal from the plan.

The committee expects that, in determining whether substantially all of the accrued benefits are derived from employee contributions, the Secretary may take into account such factors as the extent to which (1) employer contributions have not been made under a profit-sharing plan because of the employer's lack of profits, (2) benefits attributable to employer contributions have been distributed (so long as the plan continues to provide for the accrual of significant employer-provided benefits), and (3) the investment experience on the employee-contribution accounts invested at the employee's direction is greater during a particular year than the experience on assets attributable to employer contributions.

Effective Dates

The provisions are effective with respect to any amount received by an employee 90 days or more after the date of enactment. The provisions relating to loans under the plan are effective with respect to any loans received by an employee after the 90th day after the date of enactment. For purposes of determining whether an employee receives a loan after the effective date, a demand loan that is outstanding on the effective date is treated as giving rise to a new loan on that date.

Revenue Effect

The provision will increase fiscal year budget receipts by $1 million in 1985, $2 million in 1986, $2 million in 1987, $4 million in 1988, and $6 million in 1989.

5. Repeal of Estate Tax Exclusion for Qualified Pension Plan Benefits (sec. 90 of the bill and sec. 2039 of the Code)

Present Law

Under TEFRA, a $100,000 aggregate limit was imposed on the estate tax exclusion for certain retirement benefits payable under qualified pension plans, tax-sheltered annuities, individual retirement arrangements (IRAs), and certain military retirement plans. The TEFRA changes were effective for decedents dying after December 31, 1982. This estate tax exclusion for retirement benefits is allowed in addition to any other exclusion or deduction (e.g., the marital deduction (sec. 2056)) allowed with respect to such benefits.

Present law provides that no amount included in a lump sum distribution payable under a qualified pension plan is eligible for the $100,000 exclusion unless the beneficiary irrevocably elects to treat the distribution as taxable without regard to the capital gain and 10-year income averaging rules generally applicable to lump sum distributions. Similarly, amounts payable from an IRA are eligible for the exclusion only to the extent such amounts are payable as a qualifying annuity (sec. 2039(e)).

Reasons for Change

The committee recognizes that the $100,000 limit on the estate tax exclusion imposed by TEFRA has created complex allocation problems for purposes of calculating the amount of retirement benefits that are excludible from the gross estate. In addition, the committee believes that a separate estate tax exclusion for retirement benefits provided under qualified pension plans, etc., is unnecessary because such benefits are eligible for the unlimited marital deduction and the unified credit. Finally, the committee generally believes that special estate tax exclusions based on the source of the assets are inappropriate. Therefore, the committee believes it is appropriate to repeal the separate estate tax exclusion for retirement benefits.

Explanation of Provisions

The bill repeals the separate $100,000 limit on the estate tax exclusion for retirement benefits under qualified pension or annuity plans, tax-sheltered annuities, IRAs, and certain military retirement plans. Retirement benefits remain excludible from the gross estate under the unlimited marital deduction provisions and eligible for the unified credit of present law.

Effective Dates

The provisions generally are effective with respect to decedents dying after December 31, 1984. An exception is provided for the estate of any decedent who is in pay status on the date of enactment, and who, prior to that date, makes an irrevocable election to designate the beneficiaries who will receive the retirement benefits and the form such benefits will take.

The effective date of the cutback of the estate tax exclusion of TEFRA is amended to provide an exception for the estate of any decedent who was in pay status on December 31, 1982, and who, prior to that date, had made an irrevocable election to designate the beneficiaries who would receive the retirement benefits and the form of such benefits.

Revenue Effect

This provision will increase fiscal year budget receipts by $50 million in 1986, $50 million in 1987, $50 million in 1988, and $50 million in 1989.

6. Affiliated Service Groups, Employee Leasing Arrangements, and Collective Bargaining Agreements (sec. 91 of the bill and secs. 414 and 7701 of the Code)

Present Law

Under present law, all employees of employers that are members of an affiliated service group are treated as employed by a single employer for purposes of the qualification requirements for pension plans. An affiliated service group consists of certain service organizations and related employers.

In addition, present law provides that, for purposes of certain of the tax-law rules for qualified pension plans and simplified employee pensions (SEPs), certain leased employees are treated as employees of the lessee. Present law includes a safe harbor rule under which the leased employee is not treated as the employee of the lessee if certain requirements are met.

Under present law, many of the nondiscrimination standards of the Code applicable to qualified pension plans and certain statutory fringe benefit programs do not apply to plans or programs maintained pursuant to a collective bargaining agreement if there is evidence that retirement benefits, etc., were the subject of good faith bargaining.

Reasons for Change

The committee believes it is necessary to change the attribution rules applicable to the determination of whether a group of employers constitutes an affiliated service group in order to prevent abusive circumvention of the qualified pension plan requirements. In addition, the committee is aware that some individuals have interpreted the present law safe-harbor rule for employee leasing arrangements as overriding traditional common-law employee rules. The committee believes that present law should be clarified to prevent this interpretation.

The committee is concerned that, in some circumstances, owners, officers, and executives of an employer are forming collective bargaining units for purposes of qualifying for the special treatment accorded to qualified pension plans and to certain statutory fringe benefit programs with respect to employees covered by collective bargaining agreements. This treatment was intended to be limited to legitimate collective bargaining agreements and was not intended to provide a means of avoiding obligations to employees through negotiations between an employer's management, sitting as an employer, and itself, sitting as an employee representative.

Explanation of Provisions

Under the bill, in determining whether a group of employers constitutes an affiliated service group, the constructive ownership rules of sec. 318(a), rather than those of sec. 267(c), apply.

The bill clarifies the present law definition of a leased employee to include only those individuals who are not otherwise employees of the lessee.

Finally, the bill clarifies present law by providing that, for purposes of determining whether there is a collective bargaining agreement between employee representatives and one or more employers, an organization is not to be considered an employee representative if more than one-half of its members are employees who are also owners, officers, or executives of the employer. Self-employed individuals who are considered to be employees under the rules for qualified pension plans also are included for purposes of this test.

Effective Dates

The provisions relating to affiliated service groups are effective for plan years beginning after December 31, 1984. The employee leasing provisions are effective for plan years beginning after December 31, 1983. The provisions relating to collective bargaining agreements are effective after March 31, 1984.

Revenue Effect

The provisions will have a negligible effect on budget receipts.

B. Welfare Benefit Plans

1. Additional Requirements for Tax-Exempt Status of Certain Organizations (secs. 95 and 96 of the bill and new secs. 505 and 4976 of the Code)

Present Law

Deductions for contributions to welfare benefit plans

The Code generally allows a deduction for ordinary and necessary expenses paid or incurred during a taxable year in carrying on a trade or business, including a reasonable allowance for salaries and other compensation for personal services actually rendered. The deduction for compensation is limited to amounts that constitute reasonable compensation. Treasury regulations provide for the deduction of amounts "paid or accrued within the taxable year for dismissal wages, unemployment benefits, guaranteed annual wages, vacations, or a sickness, accident, hospitalization, medical expense, recreational, welfare, or similar benefit plan ... if they are ordinary and necessary expenses of the trade or business". Additional limitations and restrictions are provided by other provisions of the Code.

Under Treasury regulations, an employer may be allowed a deduction for a contribution to a fund that provides welfare benefits. The fund may be held by a tax-exempt voluntary employees' beneficiary association (VEBA), supplemental unemployment compensation benefit trust (SUB), or group legal services organization. An employer may be allowed a deduction for a contribution to a benefit fund before the benefit is actually provided to an employee.

For both cash and accrual method taxpayers, Treasury regulations provide that if an expenditure results in the creation of an asset having a useful life which extends substantially beyond the close of the taxable year, such an expenditure may not be deductible, or may be deductible only in part, for the taxable year in which made or incurred. The regulations provide for ratable amortization of such items. For example, if a cash method taxpayer prepays premiums on insurance provided as an employee benefit, proration of the premiums has generally been required to determine the amount deductible in a particular year. Proration has also been required in the case of life insurance premiums paid by an accrual method taxpayer.

Voluntary employees' beneficiary associations (VEBAs)

The Code provides tax-exempt status to an organization described in the following broad terms: "Voluntary employees' beneficiary associations providing for the payment of life, sick, accident, or other benefits to the members of such association or their dependents or designated beneficiaries, if no part of the net earnings of such association inures (other than through such payments) to the benefit of any private shareholder or individual." Regulations amplify the meaning of these terms.

Eligibility for membership

Under the regulations, membership in a VEBA must consist of individuals whose eligibility is determined by reference to objective standards that constitute an employment-related common bond. Membership in a VEBA generally is limited to employees. Under the regulations, the term employee means an individual who maintains a legal and bona fide relationship as an employee with respect to the employer (e.g., for employment tax purposes or for purposes of a collective bargaining agreement).

The regulations provide that membership in a VEBA must be voluntary, although an employer may automatically include employees provided that no detriment is incurred by the employees (e.g., deductions from pay) as a result of membership. Under present law, membership in a VEBA may not be limited to one employee.

Permissible benefits

In general, a VEBA may provide life, sick, accident, or other benefits in cash or in kind to members or their dependents or beneficiaries. The regulations specify that "other" benefits means benefits similar to life, sick, or accident benefits. Under the regulations, such benefits must either (1) be intended to safeguard or improve the health of a member or a member's dependents or (2) protect against a contingency that interrupts or impairs a member's earning power. The following benefits are permissible "other" benefits: (1) vacation benefits, (2) vacation facilities, (3) reimbursed vacation expenses, (4) subsidized recreational activities, (5) child care facilities for pre-school and school age dependents, (6) job readjustment allowances, (7) income maintenance payments in the event of economic dislocation, (8) temporary living expense loans and grants at times of disaster (such as fire or flood), (9) supplemental unemployment compensation benefits, (10) severance benefits, (11) personal legal services, and (12) any benefit provided in the manner permitted under section 302(c)(5) et seq. of the Labor Management Relations Act of 1947.

Benefits that are not similar to life, sick, or accident benefits may not be provided by a VEBA. Such impermissible benefits include accident or homeowner's insurance benefits for damage to property, malpractice insurance, loans to members (other than distress loans), savings facilities, and any benefit similar to a pension or annuity payable at the time of mandatory or voluntary retirement or any benefit similar to a benefit provided by a profit-sharing or stock bonus plan. A VEBA benefit is considered to be similar to a pension or retirement benefit if it becomes payable by reason of the passage of time, rather than as the result of an unanticipated event. Severance pay benefits have, in some cases, been designed to provide cost-of-living adjustments and actuarial reductions for severance prior to attainment of a specified age. It has been suggested that such benefits more closely resemble pension benefits than severance pay benefits.

Nondiscrimination requirements

The Code provides that no part of the net earnings of a VEBA may inure, other than through the payment of permissible benefits, to the benefit of any private shareholder or individual. Prohibited inurement is a concept unique to tax-exempt organizations. In general, the proscription is designed to ensure that tax-exempt status will be retained only if the organization is operating for tax-exempt purposes, rather than for the benefit of private individuals. Under Treasury regulations, a VEBA violates this prohibition against inurement if it does not meet certain nondiscrimination standards. Accordingly, eligibility criteria for VEBA membership or benefits may not be established or administered in a manner that limits membership or benefits to officers, shareholders, or highly compensated employees. Further, the eligibility criteria may not have the effect of entitling officers, shareholders, or highly compensated employees to benefits that are disproportionate in relation to benefits that are provided to other employees.

Upon termination of a VEBA, no assets may revert to employers who have contributed to the VEBA. Thus, the assets must be used to purchase permissible benefits in a manner that does not result in prohibited discrimination. Under the regulations, the assets can be distributed on the basis of objective and reasonable standards that do not result in either unequal payments to similarly situated members or disproportionate payments to the officers, shareholders, or highly compensated employees. If the only members remaining upon termination of the VEBA are officers, shareholders, or highly compensated employees, prohibited discrimination may not result if the assets are distributed to these members in the form of permissible benefits.

Supplemental unemployment compensation benefit trusts

Present law provides that a trust forming part of a plan providing for the payment of supplemental unemployment compensation benefits is eligible for tax exemption if (1) it is impossible, at any time prior to the satisfaction of all liabilities, for any part of the assets of the trust to be used for the purpose of providing other than unemployment compensation benefits, (2) the employees eligible for the benefits satisfy a classification that does not discriminate in favor of employees who are officers, shareholders, supervisors, or highly compensated employees, and (3) the benefits provided do not discriminate in favor of officers, shareholders, supervisors, or highly compensated employees.

In determining whether a supplemental unemployment compensation benefit trust (SUB) is nondiscriminatory, present law provides that discrimination does not exist merely because the benefits received under the plan bear a uniform relationship to compensation. Similarly, a plan is not discriminatory merely because the benefits under the plan are reduced by a sick, accident, or unemployment benefit received under state or Federal law or merely because eligibility for the benefits is limited to employees who are not eligible for sick, accident, or unemployment benefits under state or Federal law.

Qualified group legal services organization

Under present law, an organization or trust created or organized exclusively to form part of a group legal services plan (within the meaning of sec. 120) may be entitled to tax exemption.

Reasons for Change

The committee is concerned that the rules of present law prohibiting discrimination are not sufficiently clear to prevent abuse of the tax-exempt status provided for voluntary employees' beneficiary associations. In addition, the committee is concerned that advance-funded welfare benefit plans which are disportionately for the benefit of the employers' owners may present an unwarranted opportunity for employers to accumulate large amounts on a deductible tax-free basis. Presently, if these accumulated amounts are paid out to employee-owners in a discriminatory fashion, the only sanction is loss of the tax-exempt status of the organization in the year of the payout. In order to provide a more effective penalty to prevent this from happening, the committee has provided utilization tests and excise taxes intended to eliminate the possible tax benefits of contributions to a plan which is or later becomes "top-heavy."

Explanation of Provisions

a. Additional requirements for tax-exempt status of certain organizations

In general

Under the bill, an organization will generally not qualify as a tax-exempt voluntary employees' beneficiary association (VEBA), supplemental unemployment compensation benefit trust (SUB), or group legal services organization for a year unless the plan of which it is a part meets requirements limiting the proportion of benefits that is provided for key employees. In addition, an organization will not be tax exempt as a VEBA or group legal services organization unless the plan of which it is a part meets new standards prohibiting discrimination in favor of employees who are highly compensated.

Limitation on benefits for key employees

Under the bill, benefits provided by the plan of which a VEBA, SUB or group legal services organization is a part are tested to determine the percentage of each class of benefits provided by the plan for key employees. If the portion of the benefits provided for key employees for a year exceeds 25 percent, then the organization forming a part of the plan is not exempt for its taxable year in which that plan year begins or ends.

The bill provides that each separate class of benefits provided by the organization is to be tested separately under the limits. The bill authorizes the Secretary of the Treasury to prescribe regulations defining classes of benefits. Generally, under these regulations, the committee expects that a class of benefits will be defined on the basis of the nature of the benefit provided by the group of employees eligible for the benefit and by any limitation or contingency applicable to the benefit. The bill also authorizes the Secretary of the Treasury to prescribe regulations under which the amount of benefits allocated to a particular employee is to be determined.

In the case of a benefit payable by reason of the occurrence of a contingency (e.g. death, severance, or disability), the benefit is tested on the basis of the assumption that the contingency occurred during the year. For example, with respect to a disability plan, the test is implemented by measuring the present value of the stream of benefits which would be received if everyone eligible for the benefit in that year became disabled. If no employee were eligible for the benefit during a year (e.g., because of minimum length-of-service requirements), then the test does not apply and the benefit is not considered top heavy.

If the amount of a benefit is not related to compensation or length of service, and is provided on equal terms to all employees who are members of a group, the 25-percent limit would be satisfied unless more than 25 percent of the members of the group were key employees. If the amount of a benefit is related to compensation or length of service (or both), the benefit is tested by measuring the percentage of benefits that would be paid with respect to key employees under the plan.

Generally, an employee is a key employee, under the limits provided by the bill, if the employee is a key employee under the rules relating to top-heavy pension plans (sec. 416) (without regard to an employee who is a key employee solely because the employee is one of the top ten owners of the employer or is a 1-percent shareholder with compensation in excess of $150,000. Under the bill, however, any member of the family of a key employee (sec. 318(a)(1)) is treated as a key employee. In addition, the bill provides that an individual's key employee status continues permanently.

Prohibition against discrimination

In general, a VEBA or group legal services organization meets the nondiscrimination standard of the bill only if, under the plan of which it is a part, (1) each class of benefits is available to employees under a classification which is set forth in the plan and that is found by the Secretary of the Treasury not to be discriminatory in favor of employees who are highly compensated, and (2) such class of benefits provided does not discriminate in favor of highly compensated employees. In testing whether the benefits are available to a nondiscriminatory classification of employees, employees who decline to make required contributions as a condition of obtaining such benefits must be taken into account. As under present law, the nondiscrimination standard of the bill is applicable with respect to the form of a plan (or exempt organization), its operation, and its termination.

Generally, an employee is considered highly compensated under the new nondiscrimination standard of the bill if that employee would be considered highly compensated under the rules for medical reimbursement plans (sec. 105(h)). However, an employee who is considered to be highly compensated because of the relative level of compensation is not to be considered to be highly compensated unless the employee is among the 10 percent highest compensated employees.

Under the bill, if a plan provides a benefit of a type for which an exclusion from gross income is provided by the Code, then that benefit is not subject to the general nondiscrimination standard. Such a benefit is to be permitted under a VEBA or a group legal service organization if (and only if) it meets the requirements for exclusion (except with respect to group-term life insurance that is not excludible solely because it exceeds the exclusion limit). For example, a benefit provided by a medical reimbursement plan could be provided by a VEBA if (and only if) the benefit meets the nondiscrimination standard provided by section 105(h)(3) and (4).

Under the nondiscrimination standard for benefits provided by a VEBA, a life, disability, severance pay, or supplemental unemployment compensation benefit is not considered to be discriminatory merely because the benefit bears a uniform relationship to the total compensation, or to the basic or regular rate of compensation, of covered employees. Generally, such a benefit could not be integrated with social security benefits, or with a qualified plan or simplified employee pension. In the case of a disability benefit, however, integration with the employer-provided portion of social security disability benefits (or contributions) would be allowed to the extent that employer-provided social security benefits (or contributions) are not taken into account in determining benefits provided under a qualified pension, profit-sharing, or stock bonus plan, or a simplified employee pension. Of course, if other features of the plan (e.g., the waiting period between the time the disability begins and the time payment begins or the duration of benefits during any disability) are not uniform across the workforce, the plan would be divided into different classes of benefits for purposes of testing discrimination.

In determining whether the nondiscrimination standards of the bill are satisfied, the committee intends that the Secretary may take into consideration benefits that vary on account of reasonable and significant geographic disparities.

Special rules

Multiemployer plans.—The new key employee limit and the nondiscrimination requirements do not apply to an organization that is a part of a plan maintained under a multiemployer plan (sec. 414(f)). In addition, the committee intends that, in applying these requirements to plans maintained under collective bargaining agreements, it is to be presumed that the plans do not violate the key employee limit or the nondiscrimination standard. Although the nondiscrimination standards of the bill do not apply to a VEBA or group legal services organization maintained under a multiemployer plan, the nondiscrimination rules applicable to such organizations under present law will continue to apply.

Aggregation of plans, etc.—All VEBAs, SUBs, and group legal services organizations of an employer are to be treated as a single organization in applying the tests provided by bill. In addition, all welfare benefit plans of an employer are to be treated as a single plan and all employees of related employers (sec. 414(b), (c), and (m)) are treated as employed by a single employer. Further, certain leased employees (sec. 414(n)) are to be treated as employees of the recipient of their services (whether or not certain pension benefits are provided for them).

Educational assistance and dependent care.—The bill provides that an educational assistance benefit or a dependent care benefit provided by a plan of which a VEBA forms a part, is not subject to the key employee limitation and the nondiscrimination standard of the bill. Under the bill, however, a VEBA is not tax exempt if it provides an educational assistance benefit that does not meet specified requirements for exclusion from gross income (sec. 127) and is not allowed to provide a dependent care assistance benefit that fails to be excludible from gross income because it does not meet similar standards for such benefits (sec. 129).

Use of facilities.—Under the bill, an organization is not to be a taxable organization merely because it fails to meet the key employee limitation or the nondiscrimination standard with respect to a class of benefits which consists of the right to use a facility (other than a dependent care or educational assistance facility). (See, however, the excise tax described below.)

Certain arrangements.—The bill provides that if there is no plan, but a method or arrangement of employer contributions or benefits which has the effect of a plan, the rules of the bill are to apply as if there were a plan. In addition, under the bill, if any plan would be a welfare benefit plan (including, of course, method, etc., having the effect of a plan) but for the fact that there is no employee-employer relationship, then the bill is to apply as if there were such a plan.

Reports.—Under the bill, the return of an employer maintaining a plan of which a VEBA, SUB, or group legal services organization is a part is to indicate whether the key employee limitation and nondiscrimination standard of the bill have been satisfied. The committee expects that the return of VEBA, SUB, or group legal services organization will require the disclosure of whether the organization has applied for recognition of exempt status.

b. Excise taxes involving funded welfare benefit plans

In general

The bill imposes nondeductible excise taxes on key employees who use facilities under certain circumstances and on employers with respect to facilities and excess reserve amounts held in a top-heavy welfare benefit fund.

Excise tax on employers with respect to top-heavy funds

The bill adds a new, nondeductible excise tax designed to discourage the formation and maintenance of top-heavy welfare benefit funds. The tax applies to an employer who maintains welfare benefit fund that is top heavy for a taxable year and has an excess reserve amount as of the close of the year. The tax is intended to eliminate the possible tax benefit associated with accumulated reserves held by the top-heavy fund. The tax applies whether or not the fund is a tax-exempt organization. The committee intends that a plan is to be considered a plan if the employer contributes to the plan (directly or indirectly), controls the plan, or controls any fund under the plan.

Tax recovery element.—Under the bill, the amount of the nondeductible excise tax imposed with respect to a top-heavy welfare benefit fund for a year is the sum of a "tax recovery" element and an "interest recovery" element. The tax recovery element is the product of (1) the excess reserve amount as of the close of the year, and (2) the highest rate of tax imposed on a corporation (sec. 11(b)) for taxable years beginning in calendar years with or within which the determination year ends. Under the bill, the determination year is the year for which the excise tax is to be determined. The bill provides that if the excise tax is paid with respect to an excess reserve amount because of top-heaviness in a particular year, the tax is not imposed again with respect to the same excess reserve amount because of top-heaviness in a later year.

Interest recovery element.—The interest recovery element of the excise tax for a year consists of the interest attributable to the part of the excess reserve amount that arose in each prior year of the existence of the welfare benefit fund. For example, if the excess reserve amount of a welfare benefit fund were $1,000 in 1985, $2,000 in 1986, $1,500 in 1987, and $3,000 in 1988 and 1989 (1989 is the year the fund becomes top heavy), then $1,000 of the excess would be considered to arise in 1985, $500 in 1986, and $1,500 in 1988. Under the bill, in such a case, the interest recovery element of the excise tax would be equal to the sum of the interest attributable to the excess arising in 1985, 1986, and 1988.

The bill provides that the interest rate is to be the rate in effect at the close of the determination year. Accordingly, the interest rate would be applied to the $1,000 excess arising in 1985 and would be compounded from 1985 through 1988. The interest on the excess arising in 1986 would be compounded from 1986 through 1988, and the interest for 1988 would be compounded only for that year. In determining the interest recovery element of the excise tax, the bill provides that a year is not to be taken into account if it begins before the date of enactment of the bill. In determining the year (or years) in which an excess reserve amount arose, the bill provides that unless the taxpayer establishes otherwise, the excess as of the close of the determination year is to be considered to have arisen in the first year to which the bill applies.

Excess reserve amount.—Under the bill, the excess reserve amount is the excess of the sum of (1) benefits paid by the fund during the year and (2) the excess of the amount of the reserve of the fund as of the close of the year, over (3) the reserve limit for the year. Under the bill, the amount of the reserve of the fund is the sum of the money and the fair market value of other property of the fund.

The bill provides that the reserve limit for a fund is the sum of (1) 3 times the average annual long-term disability benefits paid by the fund for the year and the preceding year for total and permanent disability (sec. 105(d)(4)), and (2) 1/3 of the average annual benefits paid by the fund during the year and the preceding year for medical care (sec. 213), severance pay, and supplemental unemployment compensation. In computing the reserve limit for a year, premiums paid for the purchase of insurance during the year are not to be taken into account as benefits paid.

Tax with respect to facilities used by key employees

Tax on key employees.—The bill provides that if the benefits provided to key employees for the use of any facility (other than a facility used to provide educational assistance described in section 127 or dependent care assistance described under sec. 129) exceed 25 percent of the benefits provided to all employees for use of the facility for a year, then an excise tax is to apply to each key employee who used the facility during the year. The tax is equal to the fair market value of the use of the facility by the key employee during the year. Of course, in determining the value of the use of a facility, seasonal fluctuations and time-of-day fluctuations in the value of the use are to be taken into account.

Tax on employers.—Under the bill, if a welfare benefit fund is top heavy for any taxable year, an excise tax is imposed, with respect to any facility used in the provision of benefits, on the employer (or employers) who maintains the fund. The tax is equal to the product of (1) the highest rate of tax applicable to a corporation (sec. 11) and (2) the fair market value (as of that time) of any facility of the fund used to provide benefits under a welfare benefit plan of the employer. 'The bill provides that no tax is to be imposed more than once with respect to any facility to the extent of the fair market value of the facility with respect to which the tax was previously imposed.

Tax with respect to other benefits of key employees

Under the bill, or if the benefits provided to key employees for any class of benefits (except facilities) the use of any facility exceed 50 percent of the benefits provided to all employees, then the amount of benefits (both taxable and nontaxable) provided to each key employee is subject to an excise tax. The rate of the tax is equal to the highest rate of income tax imposed on individuals (section 1) for taxable years beginning in calendar years with or within which the year ends.

Definition of welfare benefit fund

Under the bill, a welfare benefit fund is any fund which is a part of a plan of an employer, and through which the employer provides welfare benefits to employees or their beneficiaries. The bill provides, however, that a plan of deferred compensation is not a welfare benefit plan (secs. 404 and 404A). In addition, the bill provides that a plan is not a welfare benefit plan to the extent that the special rules for transfers of property in connection with services apply (sec. 83(h)). Also, under the bill, a vacation pay plan under which there is an election to use the special rules for accrual of vacation pay (sec. 463) is not a welfare benefit plan.

The bill defines a fund as (1) an exempt social club, a VEBA, SUB, a group legal services organization, or (2) any trust, corporation, or other organization not exempt from income tax (including an account held by any such organization). For example, a fund (or account) held by a life insurance company to provide life insurance for retired employees is a fund under the bill. In addition, a premium stabilization account held by an insurance company on behalf of an employer may be a fund. On the other hand, an employer's direct purchase of a term insurance benefit from an insurance company on a non-experience-rated basis generally would not be treated as a fund.

The bill provides that if there is no plan, but a method or arrangement of employer contributions or benefits which has the effect of a plan, the rules of the bill are to apply as if there were a plan. In addition, under the bill, if any plan would be a welfare benefit plan (including, of course, a method, etc., having the effect of a plan) but for the fact that there is no employee-employer relationship, then the bill is to apply as if there were such a plan.

Definition of top-heavy welfare benefit fund

Under the bill, benefits provided by the plan of which a welfare benefit fund is a part are tested to determine the percentage of each class of benefits provided by the plan for key employees. If the portion of the benefits provided for key employees for a year exceeds 50 percent, then the fund is generally top heavy for the year. A welfare benefit fund is not to be treated as top heavy for a year on account of the provision of educational benefits or dependent care benefits provided by a plan of which the fund is a part unless the benefits fail to meet certain requirements for exclusion from gross income (secs. 127 or sec. 129) in addition to failing the 50-percent test described in the previous sentence.

The bill also provides rules for aggregating funds, plans, and employees (sec. 414(b), (c), and (m)). In addition, the bill treats certain leased employees as employees of the recipient of their services (whether or not certain pension benefits are provided for them (sec. 414(n)).

Effective Dates

The provision relating to additional requirements for tax-exempt status applies for taxable years and plan years beginning after December 31, 1984.

The provision relating to excise taxes applies for years beginning after December 31, 1984.

2. Treatment of Certain Medical, etc., Benefits under Section 415 (sec. 97 of the bill and secs. 401 and 415 of the Code)

Present Law

Present law permits a tax-qualified pension plan ("qualified pension plan") to provide for the payment of sickness, accident, hospitalization, and medical expenses for retired employees, their spouses, and their dependents. If benefits are provided under a defined contribution plan, present law requires separate allocated accounts maintained for each participant. Such separate accounts generally are not required under a defined benefit plan. A plan providing medical benefits must not discriminate in favor of employees who are officers, shareholders, or highly compensated as to the availability or amount of the benefits.

Under present law, a plan providing post-retirement medical benefits must meet certain requirements. The medical benefit, when added to any life insurance protection provided under the plan, must be subordinate to the retirement benefits provided by the plan. The medical benefits are considered subordinate to the retirement benefits if, at all times, the aggregate of contributions to provide such medical benefits and any life insurance protection does not exceed 25 percent of the aggregate contributions, other than contributions to fund past service credits.

In addition, present law requires that upon satisfaction of liabilities under the plan for post-retirement medical benefits, the remaining assets must revert to the employer and cannot be distributed to the retired employees. If an individual's right to medical benefits is forfeited, the forfeiture must be applied to reduce the employer's future contributions for post-retirement medical benefits.

If the requirements with respect to post-retirement medical benefits are met, employer contributions to fund these benefits are deductible under the general rules relating to deductions for contributions to qualified pension plans. The amount deductible may not exceed the total cost of providing the medical benefits, determined in accordance with any generally accepted actuarial method that is reasonable in view of the provisions and coverage of the plan, the funding medium, and any other relevant considerations. In addition, the amount deductible for any taxable year may not exceed the greater of (1) an amount determined by allocating the remaining unfunded costs as a level amount or a level percentage of compensation over the remaining future service of each employee or (2) 10 percent of the cost that would be required completely to fund or purchase such medical benefits.

Under present law, post-retirement medical benefits are not covered by the rules governing the dollar limits on contributions and benefits that may be provided under a qualified pension plan.

Reasons for Change

The committee understands that substantial amounts are being contributed to qualified pension plans to provide post-retirement medical benefits to employees with significant ownership interests in their employers. The committee believes that the favorable tax treatment accorded these contributions may be subject to abuse unless they are taken into account under the limits on contributions and benefits. Accordingly, the committee believes that employer contributions to qualified plans on behalf of significant owners for medical benefits should be subject to these limits.

Explanation of Provision

In applying the overall limits on contributions and benefits under qualified plans, the bill provides that any contributions allocated to an individual medical benefit account (sec. 401(h)(2)) of an employee under a top heavy (sec. 416) qualified pension plan is to be treated as an annual addition under a qualified defined contribution plan. Accordingly, the amount allocated for a year would be included, together with employer contributions and reallocated forfeitures, in determining whether the pension plan and any other plan of the employer meet the separate limits and the combined limits provided with respect to such plans. To the extent provided by Treasury regulations, an amount allocated to a medical benefit account under a top heavy pension plan before the effective date of the provision could be reallocated to the individual medical benefit account of a participant without inclusion in the annual addition. Under the bill, if a plan is top heavy, it is required to maintain an individual medical benefit account for each key employee for all subsequent years (whether or not the plan continues to be top heavy).

The bill provides that an account is an individual medical benefit account if it is established for a participant in a pension plan, all medical benefits permitted to be paid under the plan with respect to the participant, the participant's spouse, or their dependents are payable solely from the account, and the account may be used for no other participant.

Under the bill, a top heavy pension plan that provides medical benefits for retired employees is required to maintain an individual medical benefit account for any plan participant who, at any time during any of the 5 preceding plan years, is a 5-percent owner (as defined in sec. 416(i)(1)(B)(i)). Of course, the medical benefits provided under a qualified pension plan are required to meet nondiscrimination standards.

Effective Date

The provision applies to years beginning after March 31, 1984.

3. Employer and Welfare Benefit Fund Treated as Related Persons under Section 1239 (sec. 99 of the bill and sec. 1239 of the Code)

Present Law

Under present law, the gain from the sale of depreciable property between certain related taxpayers is treated as ordinary income. The rules of present law do not generally treat an employer and a welfare benefit fund controlled by the employer as related parties.

Reasons for Change

The committee is concerned that employers may be encouraged by present law to assign inappropriate values to property contributed to an employer-controlled fund under a funded welfare benefit plan. Accordingly, the committee believes that it is appropriate to treat such a transaction as a transaction between related parties and, thus, any gain realized by the employer would be treated as ordinary income instead of capital gain.

Explanation of Provision

Under the bill, welfare benefits funds are treated as related parties with respect to an employer under the rules of the Code treating gain on certain transactions as ordinary income. The bill provides that an employer (and any person related to the employer) is considered to be related to a welfare benefit fund which is controlled directly or indirectly by the employer, by a person related to the employer, or by the employer and the person related to the employer.

Effective Date

The provision applies to sales or exchanges after the date of enactment, in taxable years ending after that date.

4. Revenue Effect of Welfare Benefit Plan Provisions

These provisions will increase fiscal year budget receipts by $20 million in 1985, $48 million in 1986, $60 million in 1987, $72 million in 1988, and $90 million in 1989.

C. Retirement Savings Incentives

Special Rules Relating to Individual Retirement Accounts (sec. 100 of the bill and sec. 219 of the Code)

Present Law

Under present law (sec. 219), an individual generally is entitled to deduct from gross income the amount contributed to an individual retirement account or annuity (an IRA). The limit on the deduction for a taxable year generally is the lesser of $2,000 or 100 percent of compensation (earned income in the case of income from self-employment).

Under a spousal IRA, an individual is allowed an additional deduction for contributions to an IRA for the benefit of the individual's spouse if (1) the spouse has no compensation for the year, (2) the spouse has not attained age 70½, and (3) the couple files a joint income tax return for the year. If deductible contributions are made (1) to an individual's IRA and (2) to an IRA for the noncompensated spouse of the individual (a spousal IRA), then the annual deduction limit on the couple's joint return is increased to the lesser of $2,250 or 100 percent of compensation includible in gross income, if less. The annual contribution may be divided as the spouses choose, so long as the contribution for neither spouse exceeds $2,000.

Present law provides, in certain cases, that alimony received by a divorced spouse can be taken into account under the limits on deductions for IRA contributions. If the requirements of the Code are met, then the IRA deduction limit is not less than the lesser of (1) $1,125 or (2) the sum of the individual's compensation and certain alimony includible in the individual's gross income for the year. This deduction limit applies, however, only if (1) an IRA was established for the benefit of the individual at least 5 years before the beginning of the calendar year in which the decree of divorce or separate maintenance was issued and (2) for at least 3 of the most recent 5 taxable years of the former spouse ending before the taxable year in which the decree was issued, the former spouse paying the alimony was allowed a deduction under the spousal IRA rules for contributions for the benefit of the individual.

Reasons for Change

The committee recognizes that the present law rules for spousal IRAs treat a spouse with no earned income less favorably than a spouse with earned income, even though spouses with no earned income have the same need to save for retirement. Thus, the committee believes that the IRA deduction rules should be revised to place noncompensated spouses on an equal basis with spouses with earned income.

In addition, the committee believes that whether alimony may be treated as compensation for purposes of the IRA limits should not depend upon whether spousal IRA contributions were made on behalf of the divorced spouse in years prior to the divorce.

Explanation of Provision

Under the bill, the amount of the spousal IRA deduction limit may not exceed the excess of (1) the lesser of the applicable amount or the sum of the includible compensation for the individual and the individual's spouse for the taxable year, over (2) the amounts deductible for the individual and the individual's spouse under the general IRA rules for the taxable year. The applicable amount is determined as follows: (1) for taxable years beginning in 1985 and 1986, $2,750, (2) for taxable years beginning in 1987, and 1988, $3,250, (3) for taxable years beginning in 1989 and 1990, $3,750, and (4) for taxable years beginning in 1991 and thereafter, $4,000.

In addition, the provision repeals the special rules for alimony and treats all taxable alimony received by a divorced spouse as compensation for purposes of the IRA deduction limit.

Effective Dates

The provisions apply for taxable years beginning after December 31, 1984.

Revenue Effect

The provisions will reduce fiscal year budget receipts by $118 million in 1985, $331 million in 1986, $445 million in 1987, $652 million in 1988, and $720 million in 1989.

D. Employee Stock Ownership Provisions (secs. 101-108 of the bill and secs. 170, 404, 415, 1202, 1361, 2002, and new secs. 132, 1041, and 2210 of the Code)

Present Law

An employee stock ownership plan ("ESOP") is a qualified stock bonus plan or a combination stock bonus and money purchase pension plan under which employer stock is held for the benefit of employees. The stock, which is held by one or more tax-exempt trusts under the plan, may be acquired through direct employer contributions or with the proceeds of a loan to the trust (or trusts). Dividends paid on stock held in trust for employees may be distributed to employees or may be held in the trust (or trusts). Gain realized on the sale of employer securities to an ESOP is generally taxed at capital gain rates.

An ESOP under which an employer contributes stock or cash in order to qualify for a credit against income tax liability is referred to as a tax credit ESOP. Under present law, the income tax credit is limited to a prescribed percentage of the aggregate compensation of all employees under the plan. For compensation paid or accrued in calendar years 1983 and 1984, the tax credit is limited to one-half of one percent. With respect to compensation paid or accrued in 1985, 1986, and 1987, the limit is three-quarters of one percent. No credit is provided with respect to compensation paid or accrued after December 31, 1987.

An ESOP that borrows to acquire employer stock is referred to as a leveraged ESOP. Under a leveraged ESOP, the employer is allowed a deduction, within limits, for contributions to the plan which are applied by the plan to repay loan principal. Such limits apply notwithstanding the deduction limits applicable to other tax-qualified pension plans sponsored by the employer. No deduction limit applies to an employer's ESOP contributions that are applied by the plan to pay interest on the loan.

Under present law, employer securities that have been allocated to participants' accounts under a tax credit ESOP may not be distributed for 84 months after the date of allocation. The 84-month holding period requirement does not apply in the case of (1) death, disability, or separation from service, (2) certain transfers of participants to acquiring employers, and (3) certain sales of subsidiaries.

Present law provides overall limits on annual additions under a qualified defined contribution plan. Generally, the limit on annual additions for a year equals the lesser of (1) $30,000 (for years before 1988) or (2) 25 percent of compensation for the year. However, in the case of an ESOP under which no more than one-third of the employer contributions are allocated to employees who are officers, are 10-percent shareholders, or have annual compensation exceeding $60,000 (for years before 1988), the limit on annual additions equals the sum of (1) $30,000 (for years before 1988) and (2) the lesser of $30,000 (for years before 1988) or the value of employer securities contributed, or purchased with cash contributed, to the ESOP.

Reasons for Change

The committee believes that, in light of the current budget situation, it is appropriate to postpone for one year the scheduled increase in the maximum tax credit for employer contributions to tax credit ESOPs. However, the committee also believes that alternative tax incentives, applicable with respect to both tax credit ESOPs and leveraged ESOPs, are important to encourage employee stock ownership.

Explanation of Provisions

1. Freeze on maximum credit

Under the bill, the income tax credit for contributions to a tax credit ESOP is limited to one-half of one percent for compensation paid or accrued in 1985. The limit for contributions in 1986 and 1987 remains at three-fourths of one percent.

2. Tax-free rollover on sale to employees

The bill provides for nonrecognition of gain, at the election of the seller, from the sale of "qualified securities" if (1) the securities are sold to an ESOP or to an eligible worker-owned cooperative and (2) within a qualified period, the seller acquires securities of a domestic corporation, the income of which, for the taxable year in which the security is issued, consists of not more than 25 percent passive investment income. However, the acquisition of stock by an underwriter in the ordinary course of the trade or business as an underwriter is not an acquisition qualifying for this special treatment.

Under the bill, the term "qualified securities" means employer securities (within the meaning of sec. 409A(1)) that (1) are issued by a domestic corporation that has no readily tradable securities outstanding, (2) have been held by the seller for more than one year, and (3) have not been received by the seller as a distribution from a qualified pension plan or as a transfer pursuant to an option or other right to acquire stock granted by an employer. The qualified period during which the seller must acquire replacement securities begins 3 months before the date of the sale to the ESOP or cooperative and ends 12 months after the sale.

The bill defines an eligible worker-owned cooperative to mean any organization if (1) it is described in sec. 1381, (2) a majority of the membership of which is comprised of employees of the organization, (3) a majority of the voting stock of which is owned by members, (4) a majority of the board of directors of which is elected by the members, who each have a single vote, and (5) a majority of the allocated earnings and losses of which are allocated to members on the basis of patronage, capital contributions, or some combination of patronage or capital contributions.

The basis of the seller in replacement securities acquired during the qualified period is reduced by the amount of gain not recognized pursuant to the seller's election. Under the bill, if more than 1 item of replacement securities is acquired by the seller, an allocation rule is provided to determined the seller's basis in each item.

Under the bill, the seller's nonrecognition election is made by filing (as prescribed by the Secretary) an election no later than the due date of the seller's income tax return for the taxable year in which the sale occurs. In addition, the bill provides that the statute of limitation period with respect to the nonrecognition transaction does not expire before 3 years from the date on which the seller notifies the Secretary of (1) the seller's cost of acquiring replacement securities, (2) the seller's intention not to acquire replacement securities, or (3) the seller's failure to acquire replacement securities.

The bill requires that securities acquired by an ESOP or an eligible worker-owned cooperative in a nonrecognition transaction to which the bill applies must be held by the ESOP or cooperative for at least 84 months after the date of acquisition. Exceptions to this holding period requirement similar to the exceptions that currently apply to ESOPs required to hold securities for 84 months will apply. The committee intends that, in prescribing regulations under this provision, the Secretary will require the seller to notify the ESOP or cooperative that the seller is electing not to recognize gain on the sale. If the ESOP or cooperative fails to satisfy the holding period requirement, a 10-percent excise tax is imposed on the ESOP or the cooperative. This tax is applied to the fair market value of the securities acquired in the nonrecognition transaction.

In addition, if more than 25 percent of the qualified securities acquired by the ESOP or by the cooperative are allocated or accrue to the benefit of the seller, a member of the seller's family, or an employee owning more than 25 percent in value of any class of outstanding employer securities, an excise tax of 10 percent of the amount qualifying for the nonrecognition treatment is imposed on the ESOP or the cooperative. The committee intends that an ESOP is not to be considered to fail any of the requirements for tax qualification merely because it allocates the qualifying securities in a manner designed to avoid imposition of this excise tax.

3. Deduction for dividends paid on ESOP stock

The bill permits a deduction for dividends paid on stock held by an ESOP (including a tax credit ESOP), provided the dividends are either paid out currently to employees or used to repay an ESOP loan. Dividends may either be paid directly to plan participants by the corporation or may be paid to the plan and distributed to participants no later than 60 days after the close of the plan year in which paid.

Alternatively, the dividends (or some portion thereof) will qualify for the deduction if applied by the plan to repay a loan incurred under the plan to acquire employer securities. Because such dividends are deductible to the employer corporation, they do not qualify for the partial exclusion from income otherwise permitted under Code section 116.

4. Partial exclusion of interest earned on ESOP loans

Under the bill, a bank, insurance company, or other commercial lender that is a corporation may exclude from income 50 percent of the interest received on loans to a leveraged ESOP, the proceeds of which are applied by the plan to acquire employer securities. For this purpose, the loan may be made directly to an ESOP or may be made to the sponsoring corporation which, in turn, lends the proceeds to an ESOP.

5. Reduced tax rate for sales of stock to certain corporations

In the case of a sale or exchange of securities acquired by a taxpayer as part of an original issue in a company with a specified degree of employee stock ownership by a taxpayer other than a corporation, the bill generally increases from 60 percent to 80 percent the amount of the gain (qualified corporate gain) on the sale that is allowed as a deduction from gross income. Similarly, a lower tax rate applies with respect to the qualified corporate gain on a sale of securities by a corporation.

The bill defines a qualified corporate gain as the net capital gain of the taxpayer for the taxable year from the sale or exchange of qualified securities in corporations with a specified degree of employee ownership. Qualified securities mean any securities held by the taxpayer for at least 3 years. In order to qualify, the gain must be realized on the sale of securities in a domestic corporation in which (1) not less than 50 percent of the total value of shares of all classes of stock is owned by, or on behalf of, qualified employees and (2) not less than 50 percent of the qualified employees own not less than 25 percent of such stock in the corporation. An employee of the corporation is a qualified employee only if the employee is not an officer or a member of the board of directors of the corporation. In testing whether the corporation satisfies the employee ownership tests, any stock owned by a seller who is also an employee of the corporation is disregarded. In addition, all employees of the corporation who are related persons (sec. 267(b)(1)) are treated as a single qualified employee. In testing the stock ownership of employees, all shares of stock of the corporation held by a qualified pension plan are considered to be owned by the qualified employees of the corporation.

Under the bill, whether a corporation has the required degree of employee ownership is determined immediately after the sale of securities. In addition, the corporation must continue to meet the requirements for employee ownership during the 2-year period following the date of sale. A corporation is deemed to satisfy these requirements if the corporation meets these requirements for at least one day during each calendar quarter during the 2-year period. Failure to satisfy the holding period requirement triggers a 10-percent excise tax on the corporation. In addition, the failure of the corporation to certify on its income tax return that it continues to satisfy the holding period requirement results in imposition of the excise tax. The bill provides that all corporations that are members of a controlled group of corporations (within the meaning of sec. 414 (b) and (c)) are treated as a single corporation for purposes of these rules.

6. Assumption of estate tax liability by ESOP

Another provision of the bill permits an ESOP to assume the liability for estate taxes in return for a transfer from the estate of stock of an equal value, provided the sponsor company guarantees payment of the tax and agrees to pay such tax over a period of years. As under current law, this provision would permit an initial period of deferral of payment of estate tax, with up to ten equal annual installments permitted after the deferral period. The special 4-percent interest rate of present law would apply to estate taxes on the first $1 million of value of an interest in a closely held business; on the balance, interest would be paid at the adjusted prime rate as determined under Code section 6621. Under the bill, for purposes of computing the first $1 million in value of an interest in a closely held business, the value of the estate for which liability is assumed by the ESOP is aggregated with the balance of the estate and is determined as a percentage of such balance. Similarly, the provisions of current law would apply to accelerate payment of any remaining unpaid tax in the event of a delinquent payment of either interest or tax.

The executor of the estate for which the ESOP agrees to assume estate tax liability must elect the application of the provision at the time prescribed for filing the estate tax return in the manner prescribed by the Secretary by regulations. In addition, the bill provides that the return filed by the executor to elect application of this special rule must include a statement of the portion of tax to be paid by the plan administrator. Under the bill, the Secretary may prescribe regulations that require any statements or information returns as may be necessary to assure compliance with the requirements of this provision.

7. Estate tax exclusion for sales to employees

The bill permits an exclusion from the gross estate of 50 percent of the proceeds from the sale of employer securities to an ESOP or a worker-owned cooperative. The proceeds from such sale are disregarded for this purpose to the extent that such securities are allocated under the plan to the donor (or decedent), family members of the donor (or decedent), or shareholders owning more than 25 percent in value of any class of outstanding employer securities. The partial exclusion does not apply if the securities were received by the taxpayer as a distribution from a qualified pension plan or as a transfer pursuant to certain stock options.

8. Charitable contributions to ESOPs

Under the bill, a taxpayer generally is allowed an income, gift, or estate tax deduction under the charitable contribution rules for contributions of employer securities to an ESOP. However, no deduction is allowed unless (1) the securities are, within three years, allocated under the plan in a manner that does not discriminate in favor of officers, shareholders or highly compensated employees, (2) no part of the contributed securities is allocated under the plan to the donor (or decedent), a member of the donor's family, or an employee owning more than 25 percent in value of any class of outstanding employer securities, and (3) no amounts are allocated to any employee based on compensation of the employee in excess of $100,000 for the year.

Employer securities contributed to an ESOP pursuant to this provision of the bill may be allocated to an employee under the plan without regard to the qualified pension plan rules that generally limit an employee's annual addition under the plan.

Under the bill, if the taxpayer is permitted a charitable contribution deduction with respect to the contribution of stock to an ESOP, no deduction is permitted for the contribution under the usual rules for deductions for employer contributions to a qualified pension plan and no portion of the amount contributed is eligible for any credit against income taxes.

Effective Date

The provisions of the bill are generally effective for years beginning after December 31, 1984. The provisions relating to the assumption of estate tax liability and partial exclusion from estate tax apply with respect to those estates of decedents that are required to file returns after the date of enactment.

Revenue Effect

It is estimated that these provisions will increase fiscal year revenues by $301 million in 1985 and $160 million in 1986, and will decrease fiscal year revenues by $67 million in 1987, $158 million in 1988; and $266 million in 1989.

E. Miscellaneous Pension Provisions

1. Elimination of Retroactive Application of Amendments Made by Multiemployer Pension Plan Amendments Act of 1980 (sec. 111 of the bill)

Present Law

The Multiemployer Pension Plan Amendments Act of 1980 (MPPAA), was enacted on September 26, 1980. That Act generally imposes liability on an employer who withdraws from a multiemployer defined benefit pension plan. The withdrawal liability provisions of the MPPAA generally apply retroactively to withdrawals after April 28, 1980.

Reasons for Change

Many employers who withdrew from multiemployer plans prior to the date of enactment of the MPPAA may have unexpectedly incurred significant retroactive withdrawal liability. The committee believes that the amounts of money involved in the withdrawals that took place during the retroactive period are not necessary to protect the financial integrity of multiemployer defined benefit pension plans.

Explanation of Provisions

Generally, under the bill, any liability incurred by an employer under the withdrawal liability provisions of MPPAA, as a result of the complete or partial withdrawal from a multiemployer plan before September 26, 1980, is void. The bill provides for refunds of amounts paid by an employer to a plan sponsor as a result of such withdrawal liability, reduced by a reasonable amount for administrative expenses incurred by the plan sponsor in calculating, assessing, and refunding the payments.

The bill provides that it is not to increase the liability incurred by any employer under the withdrawal liability rules. Accordingly, the amounts payable with respect to withdrawals after September 25, 1980, are not to be increased merely because of the refunds provided by the bill.

Under the bill, in the case of an employer who, on September 26, 1980, had a binding sale agreement to withdraw from a multiemployer plan, the effective date for withdrawal liability is changed to December 31, 1980.

Effective Date

The provision is effective on the date of enactment.

Revenue Effect

The provision will have a negligible effect on budget receipts.

2. Treatment of Certain Distributions From a Qualified Terminated Plan (sec. 112 of the bill)

Present Law

If a lump sum distribution is paid to an employee (or the spouse of a deceased employee) under a qualified pension plan, tax is deferred on the portion of the distribution rolled over, within 60 days, to another qualified plan or to an IRA.

A distribution from a qualified plan is not a lump sum distribution unless it consists of the balance to the credit of the employee under the plan and is made within one taxable year of the recipient.

Reasons for Change

The committee believes that present law has unfairly denied rollover treatment to a taxpayer who received payments from a qualified pension plan in December 1976, and January 1977. The committee believes that these distributions should be accorded tax-free rollover treatment.

Explanation of Provision

The bill provides special relief for certain pension plan distributions received during 1976 and 1977 and transferred to an IRA. Under the bill, the transfers are treated as qualifying rollover contributions. Thus, to the extent the payments were, in fact, rolled over to an IRA within 60 days of receipt, the distribution will not be includible in income.

In addition, the bill provides an extension of the usual period of limitation for filing a claim for credit or refund of taxes paid (generally, three years after the later of (1) the date prescribed for filing the tax return, or (2) the date the return was actually filed). Under the bill, the statutory period of limitation is extended to permit the filing of a claim for credit or refund attributable to changes made by the bill within one year of the date of enactment.

Effective Date

The bill is effective upon enactment.

Revenue Effect

The provision will have a negligible effect on budget receipts.

3. Special Rule for Trans-Alaskan Pipeline Employees (sec. 113 of the bill)

Present Law

In general

Under a qualified pension plan, benefits are provided to participants under plan formulas that determine the amount of the benefit a participant may earn, the portion of that benefit that has been earned, and the portion of the earned benefit that is vested or nonforfeitable.

The rules of ERISA and of the Code generally require that a qualified pension plan meet one of three alternative minimum vesting schedules. Under these schedules, an employee's right to benefits derived from employer contributions become nonforfeitable (vest) to varying degrees upon completion of specified periods of service with an employer.

Under one of the minimum schedules, full vesting is required upon completion of 10 years of service (no vesting is required before the end of the 10th year). Under a second schedule, vesting begins at 25 percent after completion of five years of service and increases gradually to 100 percent after completion of 15 years of service.

Partial terminations

Under ERISA and the Code, in the event of the partial termination of a qualified pension plan, the rights of all affected employees to benefits accrued to the date of the partial termination generally must be nonforfeitable to the extent those benefits are funded.

Under the Code, whether a partial termination of a qualified pension plan has occurred (and the time of its occurrence) is determined by the Commissioner of Internal Revenue on the basis of all the facts and circumstances in a particular case. According to Treasury Regulations, the facts and circumstances include (1) the exclusion, by reason of a plan amendment or severance by the employer, of a group of employees who previously have been covered by the plan; and (2) plan amendments that adversely affect the rights of employees to vest in benefits under the plan. The partial termination rule is designed to protect the benefits earned by employees and funded by an employer against forfeiture due to an act or design by the employer. If the benefits were forfeitable, the funds held by the plan to provide those benefits could create or increase a reversion of assets to the employer and encourage the employer to cause a partial termination.

Reasons for Change

The committee believes that in the unusual case of the Trans-Alaska Oil Pipeline construction project, the partial termination rules should not apply.

Explanation of Provision

Under the bill, in applying the rules of the Code relating to partial terminations, a partial termination will not be treated as occurring if requirements are satisfied as to the occurence of the partial termination, discrimination in favor of certain employees, and reversions.

The bill applies to a partial termination only if it occurs by reason of the completion of the Trans-Alaska Oil Pipeline construction project. Further, the bill is limited to a partial termination occurring after December 31, 1975, and before January 1, 1980, with respect to participants employed in Alaska. Also, under the bill, the relief from the usual rules for partial terminations does not apply if the partial termination causes contributions or benefits under the plan to discriminate in favor of employees who are officers, shareholders, or highly compensated. In addition, the bill does not apply to a plan unless the plan precludes any reversion of plan assets to an employer who maintains the plan as the result of the exclusion of any employee from further participation in the plan.

Effective Date

The provision is effective on the date of enactment.

Revenue Effect

The provision will have a negligible effect on budget receipts.

4. Distribution Requirements for Accounts and Annuities of an Insurer in Rehabilitation Proceedings (sec. 114 of the bill)

Present Law

Under present law, distributions to the owner of an individual retirement arrangement (IRA) must be made by the end of the taxable year in which the owner attains age 70½, or must commence by such date and be made over either the life of the owner (or the lives of the owner and the owner's spouse) or a period not extending beyond the life expectancy of the owner (or the joint life expectancy of the owner and the owner's spouse).

In addition, under present law, distributions generally must be made to the beneficiaries of the owner within 5 years after the death of the owner.

In the event that distributions are not made as required under present law, an excise tax of 50 percent applies to the amount that was required to be distributed and was not distributed. A limited exception to this excise tax applies if the grantor establishes that the failure to withdraw sufficient amounts was due to reasonable error and reasonable steps are taken to remedy the error.

Reasons for Change

The committee is aware that some owners of IRAs are facing potential excise taxes because the insurer holding the IRAs is engaged in rehabilitation proceedings. The committee believes it is inappropriate to impose the sanctions of present law for failure to make a required withdrawal or distribution under these circumstances.

Explanation of Provision

Under the bill, an amount is not required to be distributed under the usual rules for IRAs to the extent that the amounts are held by an insurer that, on March 15, 1984, is engaged in a rehabilitation proceeding under applicable State insurance laws. This special rule applies only for the period during which the insurer is engaged in the rehabilitation proceeding.

Effective Date

The provision is effective on March 15, 1984.

Revenue Effect

The provision will have a negligible effect on budget receipts.

5. Extension of Time for Repayment of Qualified Refunding Loans (sec. 115 of the bill and sec. 236 of TEFRA)

Present Law

TEFRA imposed limits on the extent to which an individual can borrow amounts from a qualified pension plan without the loan being treated as a distribution to the individual under the plan. Under TEFRA, a transition rule was provided for certain "qualified refunding loans" made on or after August 13, 1982, and repaid before August 14, 1983.

TEFRA defined a qualified refunding loan as a loan used to make a required principal repayment on a loan that was outstanding on August 13, 1982, if that repayment was required to be made before August 14, 1983.

Reasons for Change

The committee is concerned that some individuals may not have been able to secure alternate financing in order to repay a qualified refunding loan by August 14, 1983. Therefore, the committee believes it is appropriate to extend the repayment period on such loans for certain individuals.

Explanation of Provision

The bill extends the period for making and repaying a qualified refunding loan to January 1, 1985, with respect to individuals who are not key employees, without regard to whether the plan is top heavy.

Effective Date

The provision is effective as if enacted in TEFRA.

Revenue Effect

This provision will have a negligible effect on budget receipts.

6. Pension Poıtability Involving Telcommunications divestiture (sec. 116 of the bill)

Present Law

Minimum participation, vesting, and benefit accrual requirements

In general.—Under a qualified pension plan, benefits are provided to participants under plan formulas that determine the amount of the benefit a participant may earn, the portion of that benefit that has been earned, and the portion of the earned benefit that is vested or nonfortfeitable. Accordingly, plans provide rules for determining whether an employee is a plan participant (the employee participation rules), for measuring benefits (the benefit formula), for determining the portion of the benefit that has been earned (the benefit accrual rules), and for determining the vested percentage of a participant's benefit (the vesting schedule).

Under present law, a qualified pension plan must satisfy certain minimum standards relating to the conditions under which employees may be excluded from plan participation, to the method under which plan benefits are accrued, and to the vesting schedule. The participation standards limit the permissible exclusions based on the age and period of service completed by an employee. The benefit accrual standards are based upon the number of years of plan participation. The vesting schedule standards are generally based upon the number of years of service with the employer that the employee has completed.

Participation and benefit accruals.—Under present law, a qualified pension plan generally may not require an employee to complete more than one year of service or attain an age greater than 25 as a condition of plan participation. In general, for purposes of the participation requirements, the term "year of service" means a consecutive 12-month period during which an employee has worked at least 1,000 hours.

Vesting.—The rules for plan qualification generally require that a plan meet one of three alternative minimum vesting schedules. Under these schedules, an employee's right to benefits derived from employer contributions become nonforfeitable (vest) to varying degrees upon completion of specified periods of service with an employer.

In general, all years of service with the employer maintaining the plan must be taken into account for purposes of the minimum participation requirements. Years of service during any period for which the employer did not maintain the plan or a predecessor plan need not be taken into account in determining years of service for vesting purposes. In any case in which an employer maintains a plan of a predecessor employer, service for the predecessor is treated as service for the employer.

Limits on contributions and benefits.—The Code provides limits on contributions and benefits under qualified pension plans. The limits are based, in part, on the number of years of an employee's service with an employer and on the employee's compensation from the employer.

Court order.—Pursuant to a court order in the case of *United States* v. *Western Electric, et alia,* No. 82-0192, relating to the divestiture of its former subsidiaries, the assets and liabilities of the pension plan of the American Telephone and Telegraph Company (AT&T) are to be allocated between AT&T and its former subsidiaries. Under the court order, as required by the minimum standards of ERISA and the Code, an employee's service with AT&T (including service with a company that was affiliated with AT&T immediately before the divestiture) is to be treated as service with a former subsidiary. The order is referred to as the "modified final judgment".

Under the modified final judgment, if an employee was employed by an affected company (an entity subject to the modified final judgment) on December 31, 1983, and subsequently transfers from one of the affected companies to another, then that employee's service during 1984 is to be taken into account by any other affected company to which the employee may transfer. The employee's service after 1984, however, is prohibited under the judgment from being taken into account by any of the affected companies other than the one for whom the service was performed.

Reasons for Change

The committee believes that, under the circumstances, employees who are transferred between AT&T and its former subsidiaries or between former subsidiaries as a result of the divestiture should be credited by the formerly affiliated companies with post-divestiture service. The committee also believes that special rules for the allocation of assets to plans maintained by the former subsidiaries are appropriate.

Explanation of Provisions

General rule.—Under the bill, the recognition after December 31, 1983, of creditable service of a transferred qualifying employee, and the treatment after that date of associated accrued benefits and assets, are to be governed by the provisions of the modified final judgment as those provisions applied during calendar year 1984 with respect to transfers to or from the divesting corporation and any divested exchange carrier. The provision applies in the case of a qualifying employee who transfers between any entities subject to the modified final judgment. The bill does not limit benefits that would otherwise be provided under the modified final judgment or under applicable law.

Qualifying employee.—The bill provides that a qualifying employee is an individual who is an employee of an entity subject to the modified final judgment, who is serving in a covered position, and who, on December 31, 1983, was an employee of any such entity serving in a covered position. Under the bill, a position is a covered position if it (1) is not a supervisor position (within the meaning of section 2 (11) of the National Labor Relations Act, or (2) the annual base pay rate for the position is not more tham $50,000, adjusted by the percentage increase in the consumer price index (all items—United States city average, published by the Bureau of Labor Statistics) since December 31, 1983.

Modified final judgment.—The bill defines the term "modified final judgment" as the judgment of the United States District Court for the District of Columbia, in the case of *Western Electric, et alia,* No. 82-0192, as modified. Under the bill, an entity is an entity subject to the modified final judgment if it is a carrier divested as a result of that judgment, the corporation owning such a carrier before divestiture, or any affiliate of any such carrier or corporation.

Limits on contributions and benefits.—Under the bill, in computing the limits on contributions and benefits (sec. 415 of the Internal Revenue Code) for any employee who, on December 31, 1983, was an employee of an entity subject to the modified final judgment, contributions and benefits under all plans of such entities shall be taken into account. Accordingly, contributions and benefits provided after December 31, 1983, for such employees, are to be taken into account together with contributions and benefits provided as of December 31, 1983.

Effective Date

Generally, the provision applies on the date of enactment. The provisions with respect to the limits on contributions and benefits apply for years ending after December 31, 1983.

Revenue Effect

The provision will have a negligible effect on budget receipts.

J. Foreign Provisions

1. Income From Factoring Trade Receivables (sec. 121 of the bill and secs. 553, 861, 954 and 956 of the Code).

Present Law

Under present law, when a seller of goods or services takes back a receivable (a promise to pay in the future) in exchange therefor, and then sells the receivable to a third party (a "factor") at a discount, the seller's income on the sale of the goods or services is reduced by the amount of that discount, and upon payment of the obligation, the factor realizes income equal to the difference between the amount the factor paid for the receivable and the amount received when the receivable is collected.

The Tax Court, in *Elk Discount Corp.* v. *Commissioner*, 4 T.C. 196 (1944), held that the discount, or factoring, income earned by an active factoring business is not interest within the definition of personal holding company income. In that case, both the seller of the receivable and the factor were U.S. corporations doing business in the United States. A number of issues have arisen under present law as to the tax treatment of a factoring transaction when the factor is a controlled foreign corporation related to the seller. Arguably, the factoring income could be foreign base company income that is currently taxable to the foreign corporation's U.S. shareholders under the anti-tax haven activity rules of subpart F as interest or as income from the performance of services for a related party. These rules provide, in general, that if foreign base company income is less than 10 percent of gross income of a controlled foreign corporation, no part of its gross income is treated as foreign base company income; in general, if foreign base company income is more than 70 percent of gross income of a controlled foreign corportion, all its gross income is treated as foreign base company income. However, the Internal Revenue Service has held in one instance that factoring income was not interest for purposes of subpart F (private letter ruling 8338043, June 17, 1983).

A loan from a controlled foreign corporation to a related U.S. person is generally treated as an investment in U.S. property under section 956, with the result that the amount of the loan is treated as constructive distribution from the controlled foreign corporation to its U.S. shareholders and is taxable to the U.S. shareholders to the extent of the earnings and profits of the controlled foreign corporation. Similarly, certain indirect loans from controlled foreign corporations to related U.S. persons are treated as investments in U.S. property (Rev. Rul. 76-192, 1976-1 C.B. 205). The purchase of a receivable of a U.S. person from a related U.S. corporation could arguably be treated as an investment in U.S. property in certain cases. In that event, the amount paid for the receivable would be treated as a constructive distribution from the controlled foreign corportion to its U.S. shareholders and would be taxable to the U.S. shareholders to the extent of the earnings and profits of the controlled foreign corporation.

In some cases, it might also be argued that a foreign corporation factoring U.S. receivables is engaged in business in the United States, and that its factoring income is, therefore, subject to U.S. tax.

In certain cases, if the bulk of a taxpayer's income is derived from the active conduct of a trade or business in a U.S. possession, and if the bulk of the taxpayer's income arises within a U.S. possession, favorable U.S. tax rules apply. For example, in the case of a U.S. corporation, foreign source business income earned in the possessions generally (most notably Puerto Rico) may be effectively exempt from U.S. tax under the possession tax credit (sec. 936). Similarly, in the case of a Virgin Islands corporation or a U.S. corporate inhabitant of the Virgin Islands, the United States may impose no tax on its income, and the Virgin Islands may reduce its tax on the corporation's income (sec. 934(b)). Under present law, it is not clear if income from factoring is derived from the active conduct of a trade or business for the purpose of these rules. Similarly, it is unclear whether factoring income arises where the factor has its place of business, where the obligor of the receivable resides or does business, or where the seller of the receivable resides or does business. If income from factoring constitutes income from the active conduct of a trade or business at the place where the factor does business, and if income from factoring arises at the place where the factor does business, income from a factoring business in a U.S. possession may be eligible for these favorable tax rules.

Reasons for Change

The purpose of subpart F of the Code is to enforce capital export neutrality by preventing the shifting of earnings to a jurisdiction having no natural business nexus with the income and where the income will not be taxed. Otherwise, there would be an incentive to shift earnings into tax havens and away from the United States. Factoring income is financing income that can easily be shifted from one country to another even where the country in which the income is finally earned has no economic nexus with the underlying transaction. In cases in which the factored receivable results from a sale by a U.S. taxpayer to either a U.S. or foreign person, the U.S. tax base has been directly reduced, and the U.S. tax has not been replaced by a foreign tax paid in a natural business locus in which the income arises. Accordingly, a tax incentive exists to maximize the income from factoring in a tax haven. In addition, there is the further opportunity to accumulate earnings in the tax haven to which the income has been shifted.

Although not as direct, the same concern is present when the factoring transaction involves a receivable that arises from the sale of goods or services by a foreign corporation to a related or unrelated foreign or U.S. person. The factoring transaction again transfers a portion of the profit to a country that may have no natural business nexus with the underlying income. If the factoring income is not taxed in the country in which earned the resulting overall reduction in foreign tax on the combined transaction in effect increases the after-tax return on the foreign investment in the overseas manufacturing or service business (possibly below that of the U.S.). This could make foreign investment preferable to U.S. investment, contrary to the basic principle of capital export neutrality.

A factoring transaction can also be used to circumvent the provision of present law that treats investment in U.S. property as a distribution of foreign earnings. To permit these factoring transactions would once again violate the basic principle of capital export neutrality, by permitting the tax-free repatriation of low-taxed foreign earnings.

Finally, the committee intends to make it clear that taxpayers will not be able to avoid tax on factoring income by using entities organized in the U.S. possessions.

Explanation of Provision

Under the bill, the earnings of a foreign personal holding company or controlled foreign corporation from factoring the trade or service receivables of related parties will be treated as foreign personal holding company income. Thus, when a controlled foreign corporation collects a receivable that (1) it bought directly or indirectly from a related person, and (2) the related person had taken in exchange for inventory or services, the controlled foreign corporation's factoring income will be foreign personal holding company income, and its U.S. shareholders will be currently taxable on that income (under subpart F). The related person may be either a foreign person or a United States person. The income will be taxed to the U.S. shareholders without regard to the general 10-percent de minimis exception from foreign base company income. Factoring income will nonetheless count as subpart F income in determining whether 10 percent or 70 percent of gross income is subpart F income. Income from factoring where the factor buys receivables from a related person which (1) is created or organized under the laws of the same foreign country under the laws of which the factor is organized and (2) has a substantial part of its assets used in its trade or business located in that same country will not be treated as foreign personal holding company income and, thus, will not be subject to current U.S. tax, even if the related person had taken the receivables in exchange for inventory or services.

The provisions apply to "trade or service receivables". A trade or service receivable is defined as an account receivable or other evidence of indebtedness initially arising out of either the disposition of property described in Code section 1221(1) (generally inventory or property held by the taxpayer primarily for sale to customers in the ordinary course of trade or business), or the performance of services, by a person who is related to the person who earns income from the satisfaction or disposition of the receivable or evidence of indebtedness. For this purpose, related persons include certain trusts, estates, and partnerships. The term, however, does not encompass a receivable or evidence of indebtedness arising out of the disposition of property or the performance of services by a person not related to the person realizing income from the receivable or evidence of indebtedness. Assume, for example, that a hotel accepts an evidence of indebtedness having a face amount of 100 from a customer in payment for services. The hotel transfers such evidence of indebtedness at a discount (95) to an unrelated person (for example, a company whose trade or business consists of factoring evidences of indebtedness for unrelated persons). The evidence of indebtedness is not a "trade or service receivable" in the hands of the unrelated person or a transferee from the unrelated person (other than a person related to the hotel business) since the evidence of indebtedness initially arose out of the performance of services by the hotel rather than by a person related to the ultimate holder of the receivable. The bill also makes it clear that an income from factoring the receivables of related parties in a U.S. possession is subject to tax. Income from a trade or service receivable is not eligible for the possession tax credit, nor is it eligible for reduction of Virgin Islands tax.

In addition, the bill treats certain factoring transactions as though they were loans from a controlled foreign corporation to a related U.S. shareholder. The bill amends the definition of U.S. property (in sec. 956) to include any trade or service receivable (except certain export receivables) generated by a related U.S. person's disposition of inventory or performance of services. Therefore, the U.S. shareholders of a controlled foreign corporation will be currently taxable on the amount that is paid for factoring such a trade or service receivable (up to the amount of the controlled foreign corporation's earnings and profits). Furthermore, the committee intends that a loan by a foreign subsidiary to another foreign subsidiary of the same parent, which factors the receivables of the parent, is an investment by the first foreign subsidiary in U.S. property for purposes of section 956 (i.e., the principles of Rev. Rul. 76-192, 1976-1 C.B. 205 will apply).

The bill provides that the definition of U.S. property (in sec. 956) will not include certain export receivables. For purposes of this exception, export receivables generally mean trade or service receivables arising from: (1) the sale, exchange or other disposition of export property, or (2) the lease or rental of export property which is used by the lessee outside the United States.[1] However, receivables arising from export transactions involving a buy-sell or commission DISC or FSC (a Foreign Sales Corporation under title V of the bill) will not be eligible for this exception.

Income from factoring the receivable of a related U.S. person will generally be treated as income from sources within the United States. In addition, any distribution from a foreign corporation (and any amount included in the income of U.S. shareholders under sec. 951) that is attributable to such factoring will be treated as income from sources within the United States. However, income from factoring export receivables (as defined above) will be treated as 50 percent income from sources within the United States and 50 percent income from foreign sources. Likewise, any distribution (or amount included in income under section 951) that is attributable to factoring of export receivables will be treated as 50 percent

[1] These export receivables are receivables from transactions that produce qualified export receipts as defined in sec. 993(a)(B)A) and (B).

income from sources within the United States and 50 percent foreign source income.

Effective Date

These provisions of the bill will apply to accounts receivable and evidences of indebtedness transferred after March 1, 1984, in taxable years ending after such date.

Revenue Effect

This provision will increase fiscal year budget receipts by $306 million in 1985, $534 million in 1986 and $576 million in 1987.

2. Taxation of Certain Transfers of Property Outside the Un!ted States (sec. 122 of the bill and secs. 367, 1492, 1494, 7477, 7482, and new sec. 6038B of the Code.)

Present Law

U.S. citizens, residents, and corporations are generally subject to tax on their worldwide income. In contrast, the United States generally taxes foreign corporations only on their U.S.-source income and foreign-source income that is effectively connected with a U.S. trade or business. Because of the application of these rules, taxpayers can defer U.S. tax on earnings derived through a foreign corporation until the earnings are distributed as dividends or the taxpayer disposes of the shares in the corporation. The advantage of using a foreign corpo·ation to defer U.S. tax is enhanced when the corporation is organized in a country that imposes little or no tax on the corporation's earnings.

Certain transfers of appreciated property, in the course of a corporate organization, reorganization, or liquidation, can be made without recognition of gain to the corporation involved or its shareholders. However, except for transfers of stock or securities of a foreign corporation that is a party to the exchange, a foreign corporation is not considered a corporation unless, pursuant to a request filed no later than the close of the 183rd day after the beginning of the transfer, the taxpayer establishes to the satisfaction of the Internal Revenue Service (IRS) that the exchange did not have the avoidance of Federal income taxes as one of its principal purposes (sec. 367(a)). Because corporate status is essential to a tax-free organization, reorganization, or liquidation, the failure to obtain a favorable ruling could result in the recognition of gain realized by the participant corporation and shareholders. This rule prevents the tax-free removal of appreciated assets from U.S. tax jurisdiction prior to their sale without prior IRS review.

The types of exchanges subject to post-transaction clearance by the IRS are contributions of property to the capital of a controlled corporation (sec. 351), tax-free corporate reorganizations (secs. 354, 355, 356, and 361), and liquidations of subsidiary corporations (sec. 332). The statute authorizes the Secretary to designate by regulation exchanges, otherwise subject to the ruling requirement, that do not require the filing of a ruling request. However, the Secretary has not yet issued regulations pursuant to this authority.

No ruling is required for exchanges involving foreign corporations that are not treated as transfers out of the United States (sec. 367(b)). Examples of exchanges that do not require rulings are the liquidation of a foreign subsidiary corporation into a U.S. parent (sec. 332) and acquisitions of stock or assets of foreign corporations in exclusively foreign transactions (secs. 351, 354, 355, or 361). With respect to these transactions, a foreign corporation is not treated as a corporation to the extent that the Secretary provides in regulations that are necessary or appropriate to prevent the avoidance of Federal income taxes. The statute contemplates that regulations promulgated with respect to this group of transactions will enable taxpayers to determine the extent, if any, to which there is immediate U.S. tax liability. Pursuant to this statutory authority, temporary regulations have been promulgated under which (i) a notification requirement is ›mposed and (ii) taxpayers are required to include in income appropriate amounts to reflect realization of gain with respect to certain transactions (Temp. Treas. Regs. sec. 7.367(a)-1 through 7.367(c)).

Internal Revenue Service Guidelines

In 1968 the IRS issued guidelines (Rev. Proc. 68-23, 1968-1 C.B. 821) as to when a ruling ordinarily will be issued that an exchange does not have as one of its principal purposes the avoidance of Federal income tax. The guidelines serve only to implement the principal purpose test of the statute. The determination of whether an exchange has the avoidance of Federal income tax as a principal purpose depends in every case upon the particular facts and circumstances. Thus, the IRS reserves the right to issue an adverse ruling, and a taxpayer is free to establish that a favorable ruling should be issued.[2]

Transfers for use in a trade or business

In the case of an exchange involving the transfer of property (other than certain "tainted assets" described below) to a foreign corporation controlled by the transferor after the transfer (a "section 351 exchange"), a favorable ruling ordinarily will be issued when the transferred property is to be devoted by the foreign corporation to the active conduct of a trade or business in a foreign country. The guidelines contemplate that the foreign corporation, in addition to devoting the property to the active conduct of a trade or business, will have need for a substantial investment in fixed assets in such business or will be engaged in the purchase and sale abroad of manufactured goods.

Tainted assets

Where property falling within any of several categories of "tainted assets" is transferred in a section 351 exchange to a foreign corporation (along with either property to be devoted by the foreign corporation to the active conduct of a trade or business or certain foreign corporate stock) the IRS generally will issue a favorable ruling only if the transferor agrees to include in its gross income an appropriate amount to reflect the realization of income or gain with respect to the tainted assets (the "toll charge"), regardless of whether the transfer is made for use in an active trade or business. The character of the toll charge and any basis adjustments are determined as though the tainted assets were transferred in a taxable exchange. The categories of tainted assets include:

[2] Later Revenue Procedures and Revenue Rulings have modified and amplified the guidelines (*e.g.*, Rev. Proc. 80-14, 1980-1 C.B. 617). This report's references to the guidelines are to the guidelines as modified and amplified.

(1) Inventory, certain copyrights, and other property described in section 1221 (1) and (3) of the Code;

(2) Accounts receivable, installment obligations, and similar property on which income has been earned, unless the income has been or will be included in the transferor's gross income;

(3) Property to be transferred under circumstances which make it reasonable to believe that its subsequent disposition by the transferee is one of the principal purposes of the transfer;

(4) Property leased or licensed by the transferor to a user (other than the transferee) at the time of the transfer;

(5) Property to be transferred under circumstances making it reasonable to believe that the property will be leased or licensed by the transferee after the transfer; however, in the case of tangible property, a favorable ruling ordinarily will be issued if the leasing of the property is part of the active conduct of a trade or business by the transferee in the foreign country, the transferee will have a need for substantial investment in fixed assets in such business, and the lessee will not use the property in the United States (*See* Rev. Proc. 80-14, 1980-1 C.B. 617);

(6) Certain U.S. and foreign patents, trademarks, and similar intangibles (discussed in more detail below); and

(7) With a limited exception, stock and securities.

Treatment of stock or securities

The guidelines provide an exception to the treatment of stock or securities as tainted assets where (i) the stock is in a foreign corporation organized under the laws of the same foreign country as the transferee, (ii) immediately after the exchange the foreign corporation is 80-percent owned (within the meaning of section 368(c) of the Code) by the transferee and has a substantial part of its business assets in the country in which the transferee is organized, and (iii) the transferee is 50-percent owned (as defined in section 954(d)(3) of the Code) by persons who, immediately before the exchange, controlled the transferor. A favorable ruling also ordinarily will be issued where stock of a domestic corporation is acquired in exchange for stock of a foreign corporation if immediately after the exchange the shareholders of the acquired domestic corporation do not own (directly or indirectly) more than 50 percent of the total combined voting power of the acquiring foreign corporation. However, a favorable ruling will not be issued under these latter circumstances if the assets of the acquired domestic corporation consist principally of stock or securities.

In *Kaiser Aluminium Chemical Corp.* v. *Commissioner* (76 T.C. 325 (1981), *acq.*, 1982-2 C.B. 1), the Tax Court overturned an adverse ruling that was based on the guideline principle that stock is generally a tainted asset. The Tax Court noted that the stock transferred was "closely akin to operating assets," that the taxpayer's stock interest was related to its manufacturing operations as a source of supply, that the stock was not liquid or readily marketable, and that the stock "was not a portfolio investment providing a 'passive' return on assets."

The facts of *Kaiser* illustrate the difficulty encountered by taxpayers who seek favorable rulings on stock transfers under circumstances not addressed by the guidelines. In the *Kaiser* case, a foreign corporation that supplied raw materials solely to its shareholders was owned 32.3 percent by the transferor-U.S. corporation, 13.8 percent by the transferee-foreign corporation, 12.5 percent by a subsidiary of another foreign corporation that also owned 45 percent of the transferee, and 41.4 percent by two other manufacturers. The transferor's U.S. parent corporation also owned a 45-percent interest in the transferee. There were substantial restrictions on the sale of the stock in the foreign corporation whose shares were transferred, pursuant to a consortium agreement and a general debenture trust deed. Because the transferee faced the loss of valuable development rights (granted by the Australian government) unless it could insure the availability of sufficient raw materials, four percent of the taxpayer's stock (along with the 12.5 percent interest of the transferee's other affiliate) was contributed to the capital of the transferee. The stock transfers increased the amount of raw materials to which the transferee was entitled. Although the IRS acknowledged that there were valid business reasons for the transfer, the IRS declined to issue a favorable ruling under the guidelines. *See* LTR. 7744001 (May 9, 1977). In contrast, on the same facts, the Tax Court concluded that the transferred stock interest was akin to a direct interest in producing assets, and that a favorable ruling should have been issued.

Other areas in which a favorable ruling is issued upon inclusion of a toll charge

A favorable ruling also ordinarily will be issued under the guidelines when assets of a domestic corporation are acquired by a foreign corporation in a corporate reorganization (Code secs. 354, 355, 356 and 361), provided the transferor agrees to include in its gross income an appropriate amount to reflect realization of income or gain on assets whose transfer would precipitate an unfavorable ruling in connection with a section 351 exchange. For example, if a foreign corporation acquires substantially all of the assets of a domestic corporation solely in exchange for voting stock of the foreign corporation (a type "C" reorganization) and the acquired assets include inventory (a tainted asset), a favorable ruling will be issued (and tax-free reorganization treatment obtained) only if the domestic corporation agrees to include in its gross income a toll charge reflecting the realization of income from the inventory.

Similarly, a favorable ruling ordinarily will be issued when a domestic corporation is liquidated into a foreign parent corporation, provided the domestic corporation agrees to include in its gross income an appropriate amount to reflect realization of income or gain on assets whose transfer would precipitate an unfavorable ruling in connection with a 351 exchange. In the case of both corporate reorganizations and liquidations into foreign parents, the character of the toll charge and any basis adjustments are determined as though the property were transferred in a taxable exchange.

Treatment of partnerships

The guidelines do not discuss outbound transfers by partnerships or outbound transfers of partnership interests. However, Treasury regulations proposed in 1982 (Prop. Treas. Regs. sec. 1.367(a)-1(b)(3)) provide that a transfer of property by a partnership to a foreign corporation is treated for purposes of section 367 as an indirect transfer of the property by the partners, with each partner transferring the portion of each asset that is attributable to that partner's partnership interest. The proposed regulations do not prescribe the substantive treatment of the transferred assets. Rather, the transferred assets are generally examined under the guidelines standards, e.g., an asset is considered to be tainted if it is an inventory item, leased property, or certain stock. The proposed regulations do not distinguish between limited and general partnership interests and do not provide rules for the transfer by partners of their partnership interests.

Use of closing agreements

Under present law, the IRS has the authority to issue a favorable ruling under section 367 when a transferor is willing to enter into a closing agreement with the IRS obligating the transferor to pay tax on any gain from a subsequent disposition of the transferred assets by the transferee within a certain number of years after the transfer. Currently, the IRS declines to exercise this authority because of the perceived administrative burden of concluding such agreements and possible difficulties in enforcing them.

In the *Kaiser* case, the Tax Court noted with apparent disapproval the unwillingness of the Service in that case to propose a closing agreement with the taxpayer that specified terms and conditions for a transfer of stock subject to section 367. The Court indicated that an agreement by the transferor to pay tax in that case on a subsequent disposition of the stock by the transferee would obviate any principal tax avoidance purpose.

Transfers of intangible assets

Research, experimentation, and development, if successful, generate valuable intangible assets, such as patents and know-how. U.S. tax rules contain tax incentives designed to encourage research, experimentation, and development. For instance, business expenditures to develop or create an asset with a useful life that extends beyond the taxable year is generally required to be capitalized. However, taxpayers may elect to deduct currently business "research or experimental expenditures" (sec. 174). Taxpayers may also currently claim a tax credit for 25 percent of certain incremental research expenses (sec. 44F). In addition, under temporary legislation enacted in 1981, all research and experimental expenditures paid or incurred for activities conducted in the United States are allocated to U.S. income for purposes of the foreign tax credit limitation, allowing taxpayers to increase the amount of foreign tax credits that may be claimed.

Under the guidelines, a toll charge must be included in income in order to obtain a favorable ruling with respect to an exchange involving a transfer to a foreign corporation of a U.S. patent, trademark, or other intangibles for use in connection with manufacturing for sale or consumption in the United States. Thus, the transfer of U.S.-developed know-how to a tax-haven subsidiary for use in manufacturing goods for the U.S. market is subject to tax. Otherwise, U.S. owners of know-how could shift income that arose from that know-how offshore.

Similarly, transfers to foreign corporations of U.S. patents, trademarks, and other intangibles for use in connection with a U.S. trade or business are subject to a toll charge under the guidelines. Thus, the U.S. holder of a trademark cannot transfer it tax-free to a foreign subsidiary (which could then charge the U.S. transferor a license fee). Otherwise, U.S. owners and users of trademarks could shift income offshore.

Under the guidelines, transfers of foreign patents, trademarks, and similar intangibles for use in connection with the sale of goods manufactured in the United States are subject to a toll charge. This rule also prevents shifting of income outside U.S. taxing jurisdiction.

By implication, transfers of intangibles for use in connection with a foreign trade or business for consumption outside the United States generally may not be taxable under these IRS procedures.[3] Thus, U.S. persons who take advantage of tax incentives for research may transfer the fruits of research (intangibles) to foreign corporations that may use the intangibles free of any U.S. tax.

In addition, some taxpayers have apparently taken the position that the transfer of foreign patents or know-how for use in foreign manufacturing for the U.S. market is not subject to tax under the guidelines.

In the Tax Equity and Fiscal Responsibility Act of 1982, Congress specified the extent to which income from intangibles could escape U.S. tax under the possessions corporations rules. That Act, which primarily benefits Puerto Rico, treats transfers of any possession-related intangibles to foreign jurisdictions as having a principal purpose of tax avoidance.

Incorporation of foreign loss branches

The transfer of the assets of a foreign branch of a U.S. corporation to a foreign corporation that otherwise qualifies as a tax-free contribution to the capital of the foreign corporation or as a tax-free organization is a transfer of assets from U.S. taxing jurisdiction. Thus, corporate status is denied to the foreign transferee corporation in the absence of an IRS determination that the exchange did not have the avoidance of Federal income taxes as one of its principal purposes.

Where a foreign branches recognizes a loss, that loss can result in a U.S. tax benefit either because it reduces U.S. tax on domestic source income or because it reduces U.S. tax on foreign-source income.

Where the branch whose losses have reduced U.S. tax on domestic source income is incorporated, the losses are later recaptured through the foreign tax credit limitation (sec. 904(f)). Where the losses reduced U.S. tax on foreign income the avoidance of Federal income tax is deemed to be a principal purpose of the transaction by the IRS (see Rev. Rul. 78-201, 1978-1 C.B. 91). Under IRS rulings, these losses are recaptured to the extent of the gain realized on the

[3] The Internal Revenue Service has frequently issued private letter rulings that such transfers do not have a principal purpose of tax avoidance. See, e.g., LTR 8404026 (October 31, 1983); LTR 8405004 (September 29, 1983); LTR 8405113 (November 4, 1983).

exchange (Rev. Rul. 80-246, 1980-2 C.B. 125; Rev. Rul. 82-146, 1982-2 C.B. 84).

The Tax Court, however, has held that the transfer of the assets of a foreign branch to a foreign corporation did not have a tax avoidance purpose. *Hershey Foods Corp.* v. *Commissioner*, 76 T.C. 312 (1981). In that case the branch losses had not resulted in a tax benefit to the U.S. corporation because the corporation had foreign tax credits that would have eliminated U.S. tax on foreign income in any event.

Judicial interpretation of the principal purpose test

The Tax Court has interpreted the statute's principal purpose test as allowing tax-free transfers of appreciated property to foreign corporations unless the exchange is "in pursuance of a plan having as one of its 'first-in-importance' purposes the avoidance of Federal income taxes." *Dittler Bros.* v. *Commissioner*, 72 T.C. 896, 915 (1979). In *Dittler*, a U.S. corporation owned know-how for the production of rub-off lottery tickets. It transferred that know-how for 50 percent of the stock of a corporation organized in the Netherlands Antilles. The Netherlands Antilles corporation, which operated through a subsidiary, was to use that know-how in connection with foreign manufacturing for foreign markets. The other 50 percent belonged to a United Kingdom corporation that contributed marketing intangibles. Related parties were to do the manufacturing and marketing of lottery tickets for that Netherlands Antilles corporation. The Netherlands Antilles corporation operated through independent contractors and had very little in the way of fixed assets.

The IRS denied the U.S. transferor's request for a ruling that the transfer of know-how did not have as one of its principal purposes the avoidance of Federal income tax. The IRS based its denial on the failure to satisfy the guideline requirement that the transferee devote the assets to the active conduct of a trade or business and that the transferee generally have need for fixed assets in that business. The Service's factual grounds for that denial included (1) the Netherlands Antilles corporation would not engage in any active business; rather, its income would arise from the know-how and other intangibles and rights that it received from related parties; and, (2) the arrangement created a potential for tax avoidance in that income from exploitation of the know-how was diverted to a passive recipient in a foreign tax-haven country.

The Tax Court found, despite the specific active trade or business standard in the guidelines, that the transfer fell within a more general rule in the guidelines—reflecting the statute's principal purpose test—that a taxpayer is free to establish that based on all the facts and circumstances of his case a favorable ruling should be issued, notwithstanding any contrary statements contained in the guidelines. The Court did not reach question whether transacting business through independent contractors constitutes an active trade or business.

The Tax Court concluded that this transfer did not have a principal purpose of tax avoidance. It based that conclusion on several factors, including that: (1) the U.S. transferor's United Kingdom co-owner of the Netherlands Antilles corporation demanded the Antilles location and the form of the transaction, and that (2) there was a business reason for retention of up to 25 percent of the transferee's profits in the Netherlands Antilles corporation. The Court found insubstantial evidence to support the conclusion that the U.S. transferor "controlled the form and structure of the transaction." Lacking control, the U.S. transferor did not make the transfer in pursuance of a plan having as one of its principal purposes the avoidance of Federal income tax.

Excise tax on certain transfers not subject to section 367

An excise tax generally is imposed on certain outbound transfers of property not described in section 367 when the transferor fails to establish to the satisfaction of the Secretary of the Treasury that the transfer is not in pursuance of a plan having as one of its principal purposes the avoidance of Federal income tax (Code secs. 1491-94). The excise tax generally applies to transfers of property, whether otherwise tax-free or taxable, by U.S. persons (including corporations and partnerships) to foreign corporations, foreign partnerships, and foreign estates and trusts. However, in the case of transfers of property to foreign corporations, the tax applies only to property treated as paid-in surplus or as a contribution to capital.

The excise tax is equal to 35 percent of the transferor's gain which is not recognized at the time of the transfer. But to the extent the transferor immediately recognizes gain on the transfer, the amount against which the tax is applied is reduced.

A transferor may elect to treat a transfer otherwise subject to excise tax as a sale or exchange of the property transferred and to recognize as gain (but not loss) in the year of the transfer the excess of the fair market value of the property over the transferor's adjusted basis for determining gain on the property (sec. 1057). To the extent that gain is recognized in the year of the transfer pursuant to this election, the transfer is not subject to the excise tax, and normal rules will apply to increase the transferred property's basis to the transferee by the amount of gain received. However, since the objective of the excise tax is to prevent a transfer from escaping tax which is in pursuance of a plan having as one of its principal purposes the avoidance of tax, an election which has such a principal purpose is not permitted.

Declaratory judgment procedure

The Tax Reform Act of 1976 established a declaratory judgment procedure allowing taxpayers to litigate in the Tax Court section 367 determinations in actual controversy (Code sec. 7477). Congress established this procedure because the ruling requirement prevented a taxpayer from going through with a transaction and then litigating in court the question of whether tax avoidance was one of the principal purposes of the transaction. While Congress generally approved of the standards applied by the IRS in issuing rulings, Congress believed that there may have been cases where these standards were inappropriate or were not being correctly applied.

Under the special declaratory judgment procedure, the Tax Court is empowered to review whether an IRS determination as to tax avoidance is reasonable, and whether the conditions imposed in making the determination are reasonable conditions in order to prevent the avoidance of tax.

Any such declaration has the force and effect of a final judgment or decree and is reviewable as such. The Tax Court is required to base its determination upon the reasons provided by the IRS in its notice to the party making the request for a determination. The facts that the IRS and, hence, the Tax Court must base its determination upon are generally those provided by the taxpayer in its ruling request; the IRS can request additional facts not provided in the initial ruling request but ultimately must issue a ruling regardless of whether the taxpayer provides additional facts. The Tax Court's judgment is limited to a scrutiny of the IRS's determination.

For a petitioner to receive a declaratory judgment from the Tax Court under this procedure, he must demonstrate that he has exhausted all administrative remedies available to him within the IRS. Thus, he must demonstrate that he has made a request to the IRS for a determination, that the IRS has either failed to act or has acted adversely, and that he has appealed any adverse determination.

Reasons for Change

The Congress originally enacted the special rules for non-recognition transactions involving foreign corporations (sec. 367) specifically to prevent avoidance of U.S. tax by transferring appreciated property outside the United States. While that provision has generally worked well over the years, a series of Tax Court cases has threatened to weaken it.

The current statutory provisions apply only to transfers pursuant to "a plan having as one of its principal purposes the avoidance of Federal income taxes" (sec. 367(a)). Interpreting this provision in the case of *Dittler Brothers, Inc.* v. *Commissioner*, the Tax Court referred to a "principal" purpose as being a purpose "first in rank, authority, importance, or degree." The implication of the case was that a tax avoidance purpose for a transfer must be greater in importance than any business purpose before section 367(a) will apply to prevent a tax-free outbound transfer of property. This narrow interpretation by the Tax Court of the principal purpose test has caused the IRS difficulty in administering section 367(a). The IRS cannot now restrict tax avoidance transfers that the provisions of that section were intended to combat.

The bill replaces the principal purpose test of present law with an "active trade or business" exception. Generally, a transfer of property by a U.S. person to a foreign corporation will be treated as a taxable exchange unless the property is transferred for use by the foreign corporation in the active conduct of a trade or business outside the United States.

Transfers of intangibles

In addition to the general problems associated with judicial interpretations of the principal purpose test of section 367(a), specific and unique problems exist with respect to applying section 367(a) to the transfer by U.S. persons of manufacturing intangibles to foreign corporations. Under its published ruling guidelines, the IRS generally has issued favorable rulings for transfers of patents and similar intangibles for use in an active trade or business of the foreign transferee corporation. The only exceptions are transfers of certain intangibles used in connection with a trade or business in the United States or in connection with goods to be manufactured, sold or consumed in the United States. In light of this favorable ruling policy, a number of U.S. companies have adopted a practice of developing patents or similar intangibles at their facilities in the United States. When these intangibles appear ready for profitable exploitation, they are transferred to a manufacturing subsidiary incorporated in a low-tax foreign jurisdiction (or in a high-tax jurisdiction that offers a tax holiday for specified local manufacturing operations). By engaging in such a practice, the transferor U.S. companies hope to reduce their U.S. taxable income by deducting substantial research and experimentation expenses associated with the development of the transferred intangible and, by transferring the intangible to a foreign corporation at the point of profitabilty, to ensure deferral of U.S. tax on the profits generated by the intangible. By incorporating the transferee in a low-tax jurisdiction, the U.S. companies also avoid any significant foreign tax on such profits.

Tainted assets

The committee generally approves of the current administrative practice of denying tax-free treatment to exchanges involving outbound transfers of liquid or passive investment assets unless the U.S. tax on the potential earnings from such assets is paid or preserved for future payment. Accordingly, the bill provides that, except as provided in regulations, tax-free treatment will be unavailable for exchanges involving certain assets ("tainted assets").

The bill generally codifies the tainted asset categories described in the IRS guidelines. However, the bill alters these categories in several respects. First, the bill does not treat stock and securities as tainted assets. Rather, all transfers of stock and securities will be tested under the active trade or business exception. Stock will be considered as transferred for use in an active trade or business when transferred under circumstances resembling those existing at the time of the transfer in the *Kaiser* case (where the stock was akin to a direct interest in producing assets) or under certain other limited circumstances.

Second, two other categories of assets treated as tainted under the guidelines are not so treated under the bill: assets whose sale by the transferee is a principal purpose of the transfer and assets likely to be leased or licensed by the transferee corporation. Similar to the treatment of exchanges involving transfers of stock, exchanges involving transfers of these assets will be tested under the active trade or business exception. Generally, these assets will not be considered to be transferred for use in the active conduct of a trade or business. However, the committee believes that the leasing of transferred tangible assets should not necessarily preclude tax-free treatment of the related exchange when the transferee is engaged in the active conduct of a leasing business involving such assets, the transferred assets will not be leased in the United

States, and the transferee has a need for a substantial investment in the type of assets transferred.

Third, foreign currency is defined as a tainted asset. The committee understands that foreign currency transfers by U.S. businesses have increased significantly in recent years due to the increased activities of U.S. businesses in foreign countries and the substitution of floating for fixed exchange rates in 1971. Because of the obvious liquidity of foreign currency, it can easily and quickly be disposed of by a foreign transferee. There should be U.S tax on gains attributable to exchange rate fluctuations.

Goodwill developed by a foreign branch

The committee does not anticipate that the transfer of goodwill or going concern value (or certain similar intangibles) developed by a foreign branch to a foreign corporation will result in abuse of the U.S. tax system (regardless of whether the foreign corporation is newly organized).

Transfers of partnership interests

The committee believes that a transfer of a partnership interest by the partner to a foreign corporation generally should receive the same tax treatment as a transfer of the partner's pro rata share of the partnership assets. Accordingly, under the bill, except as provided in regulations, U.S. persons who transfer partnership interests to foreign corporations in exchanges described in section 367 are treated as transferring their pro rata share of the partnership assets. This rule goes beyond the proposed regulations which deem partners to be the transferors of partnership assets for section 367 purposes only when the *partnership* transfers such assets.

Incorporation of foreign loss branches

In certain cases, a U.S. taxpayer's foreign branch has incurred losses prior to its incorporation that have been taken into account by the U.S. taxpayer and that have reduced the amount of the U.S. taxpayer's worldwide income subject to U.S. income tax. As a result of the incorporation of the foreign branch operations, the U.S. taxpayer will not currently take into account the income to be produced by these operations and that income will not increase the amount of the U.S. taxpayer's worldwide income that is subject to U.S. income tax. Thus, the transfer by the U.S. taxpayer of the assets of the branch to the foreign corporation has the effect of avoiding U.S. income tax (see Rev. Rul. 78-201, 1978-1 C.B. 91). The committee believes that the IRS position on this issue, as expressed in Rev. Rul. 78-201 as modified by subsequent rulings, is correct and is consistent with present law. The Tax Court, in *Hershey*, has taken the contrary view. The committee believes that it is important to clarify the law to prevent future tax avoidance.

Ruling requirement and declaratory judgment procedure

Standards for the issuance of favorable and adverse rulings have become relatively well-defined through continuing administrative interpretation and practice. The development of such standards, which the bill codifies in part, has imparted a substantial degree of regularity to the ruling process. Given certain facts, taxpayers can predict whether the IRS will issue a favorable or an adverse ruling. The elimination of the principal purpose test, the application of which primarily involves a factual determination, should further increase predictability of result under section 367. Many taxpayers consider the ruling requirement burdensome, and the requirement has placed a steadily increasing demand on IRS resources as outbound transfers have increased in number. The committee believes that the elimination of the principal purpose test renders the ruling requirement unnecessary. Accordingly, the bill eliminates the ruling requirement. Taxpayers will now be able to proceed freely with exchanges involving outbound transfers without advance or post-transaction clearance. The exchanges either will be tax-free or will involve the payment of an appropriate toll charge, in accordance with the substantive rules set forth in section 367, as amended by the bill. However, taxpayers planning a transfer subject to section 367 who seek the certainty of tax treatment that a ruling provides may request a discretionary ruling regarding the tax treatment of the transfer.

The special declaratory judgment procedure of present law, under which the Tax Court reviews section 367 rulings and considers ruling requests, was enacted because, under prior law, a taxpayer who received an adverse ruling, practically speaking, could not proceed with the transaction at issue (unless the taxpayer was willing to comply with the ruling and treat the transaction as fully taxable or accept a toll charge as the case may be). The committee believes that the declaratory judgment procedure is no longer necessary in light of the elimination of the ruling requirement. Accordingly, the bill repeals the declaratory judgment procedure for section 367 determinations.

With the elimination of the ruling requirement and the declaratory judgment procedure, there is also eliminated an unintended advantage presently conferred on taxpayers: full control over the nature of the factual evidence upon which an IRS determination or a declaratory judgment determination under section 367 is based. Under the mandatory ruling procedure of present law, the IRS must issue a ruling based on whatever facts the taxpayer provides. The IRS can request additional information but cannot compel its disclosure. A Tax Court declaratory judgment is generally based in turn on the administrative record and is limited to a declaration of whether the IRS acted reasonably. Under the new discretionary ruling procedure, the IRS will decline to rule if the taxpayer does not present facts that the IRS deems sufficient upon which to base a ruling. Moreover, judicial review of a section 367 determination will involve a trial and full development of a factual record. That factual record will be independent of the existing administrative record; it might include information about the manner in which the exchange at issue was actually carried out (as distinguished from information about the plan for the exchange) and information about how the transferred property was used and whether the transferee disposed of it after the transfer.

So that the IRS will continue to be informed of outbound transfers of property subject to section 367, the bill establishes a notification requirement and a set of penalties for failure to comply with the requirement. Without a mechanism for apprising the IRS of outbound transfers, the IRS generally would have to depend on audits to detect outbound transfers of property subject to section 367 and any instances of failure to pay tax due on such transfers. Because of the complexity of many corporate income tax returns and certain exchanges that corporations carry out, the audit process is not a reliable means of isolating exchanges subject to section 367.

Explanation of Provision

Overview

The bill restructures the rules governing transfers of property outside the United States. Under the general rule, a foreign corporation is not considered a corporation for purposes of determining the extent to which gain is recognized on the transfer. An exception is generally provided for transfers of property used abroad in the active conduct of a trade or business outside of the United States. Transfers of stock, securities, or partnership interests may qualify for the exception. The Secretary of the Treasury, by regulations, may none the less provide for recognition of gain in cases of transfers of property for use in the active conduct of a trade or business outside the United States. The committee intends that the Secretary use this regulatory authority to provide for recognition in cases of transfers involving the potential of tax avoidance. The bill authorizes the Secretary to designate other transfers that are excepted from the general rule of recognition. In addition, the bill imposes a notification requirement with respect to transfers of property outside the United States.

Certain categories of tainted assets (similar to those in the IRS guidelines) are ineligible for the active trade or business exception. The active trade or business exception to the general rule is also inapplicable to the incorporation of certain foreign branches in circumstances where the branch has operated at a loss. Special rules are provided for the transfer of intangibles (e.g., patents, know-how, or similar items), under which the taxpayer is treated as receiving income over the useful life of the intangible in an amount reflecting reasonable payments contigent upon the productivity, use, or disposition of the intangible.

The principles governing the imposition of section 367 toll charges and the 35 percent excise tax on outbound transfers not covered by section 367 are similar. To preserve the consistency between section 367 and the excise tax rules, the bill makes conforming changes in the excise tax provisions.

General rule

If, in connection with any exchange described in section 332, 351, 354, 355, 356, or 361, a U.S. person transfers property to a foreign corporation, such foreign corporation generally will not, for purposes of determining the extent to which gain will be recognized on such transfer, be considered to be a corporation. As under current law, except to the extent provided in regulations, this rule will not apply to the transfer of stock or securities of a foreign corporation which is a party to the exchange or a party to the reorganization. The term "party to the exchange" as used in this provision includes a party to the reorganization (as defined in section 368(b) of the Code) and the transferor and transferee in an exchange other than a reorganization.

Exception for property transferred for use in an active trade or business

Except as provided in regulations, the general rule does not apply to any property transferred to a foreign corporation for use by such foreign corporation in the active conduct of a trade or business. The committee believes that the activities engaged in by the corporation involved in the *Dittler* case did not constitute an active trade or business. Accordingly, under the new statutory standard (which does not look to tax avoidance), a transfer such as that in *Dittler* would be taxable. The committee contemplates that, ordinarily, no gain will be recognized on the transfer of goodwill or going concern value for use in an active trade or business. Similarly, it is expected that regulations will provide that gain will not be recognized on transfers of marketing intangibles (such as trademarks or trade names) in appropriate cases. The committee expects that, prior to January 1, 1985 (the effective date of the bill), the Secretary will issue regulations prescribing the standards to be used in determining whether property is transferred for use in the active conduct of a trade or business within the meaning of the bill. However, if the Secretary does not issue regulations before January 1, 1985, it is intended that taxpayers will continue to rely on the current IRS practice (as reflected in IRS ruling policy) in determining the existence of an active trade or business.

Treatment of stock or securities

Certain transfers of stock and securities by a U.S. person to a foreign corporation will fall within the active trade or business exception and will, therefore, be free of U.S. tax. The committee believes that transfers of stock such as that in the *Kaiser* case (where the stock was akin to a direct interest in producing assets), discussed above, should fall within the exception under the bill.

The regulations implementing the active trade or business exception are also to specify additional circumstances under which outbound transfers of stock may fall within the active trade or business exception. The bill contemplates that a transaction that constitutes a section 351 exchange as well as a type B reorganization will be treated as a section 351 exchange. Generally, additional circumstances which might\place a transfer of stock within the exception include substantial ownership by the transferee in the corporation whose stock is transferred, and integration of the business activities of that corporation with the business activities of the transferee.

The committee believes that the IRS should set forth regulations whereby, where appropriate, the IRS would not impose tax on the transfer of such stock, provided the transferor agrees that the stock will not be disposed of by the transferee (or any other person) for a substantial period of time following the year of the transfer. The transferor would be taxed on any income or gain from a disposition of the stock as if the disposition took place in the year of the original transfer at the fair market value of the stock at the time of the original transfer. Thus, interest would be added to the tax for the period from the initial transfer to the subsequent disposition.

The committee understands that enforcement of such regulations could, in some cases, present problems. However, it believes that the burdens of enforcing compliance would not outweigh the benefits of regulations in many cases. To promote compliance, the IRS might require in the regulations, for example, the transferor to certify annually for some period (*e.g.*, 15 years) following the transfer that the transferred property is still held by the transferee and to file annually a waiver of the statute of limitations on assessment. In addition, the IRS might require that the transferor furnish sufficient security to ensure that any tax will be paid.

In addition, the committee anticipates that regulations will provide an exception for transfers of stock of foreign corporations to transferees organized in the same country as the corporation whose stock is transferred under principles similar to those now embodied in the IRS guidelines.

Treatment of property likely to be leased

Certain transfers by a U.S. person to a foreign corporation of property likely to be leased by the transferee foreign corporation will fall within the active trade or business exception where the transfer does not involve potential tax avoidance. The transfer of tangible property of a type leased by the transferee in the active conduct of a leasing business should generally fall within the exception provided the property transferred is not to be leased in the United States and the transferee has a need for substantial investment in the type of property transferred. *Cf.* Rev. Proc. 80-14, 1980-1 C.B. 617.

Assets ineligible for active trade or business exception

Except as provided in regulations, the transfer of property falling in any of several enumerated categories of tainted assets will be treated as a taxable exchange. Where tainted assets and other assets are transferred to a foreign corporation for use in an active trade or business, no gain will be recognized on the transfer of assets other than the tainted assets.

The bill creates a new tainted asset category: foreign currency or other property denominated in foreign currency. "Other property denominated in foreign currency" includes installment obligations, accounts receivable, accounts payable, and other obligations entitling their owner to receive cash payments in other than U.S. dollars. Under the guidelines, such property (with the exception of accounts payable) has been considered to fall into the category of tainted assets. The bill also provides a special rule (discussed below) for transfers of certain intangibles to controlled foreign corporations (sec. 351) and in certain corporate reorganizations (sec. 361). Intangibles transferred to foreign corporations other than in transfers to controlled corporations. (sec. 351) or in certain corporate reorganizations (sec. 361) are treated as a separate category of tainted assets.

The following tainted asset categories enumerated in the bill are carried over from the guidelines: (1) stock in trade of the taxpayer or other property of a kind which would properly be included in the inventory of the taxpayer if on hand at the close of the taxable year, or property held by the taxpayer primarily for sale to customers in the ordinary course of his trade or business; (2) a letter or memorandum, or similar property held (a) by a taxpayer whose personal efforts created the property, (b) by a taxpayer for whom the property was prepared or produced, or (c) by a taxpayer in whose hands the basis of the property is determined, for purposes of determining gain from a sale or exchange, by reference to the basis of the property in the hands of a taxpayer described in (a) or (b); (3) installment obligations, accounts receivable (including both trade and service receivables) and similar property; and (4) property that, at the time of its transfer, is leased by the transferor to a person other than the transferee.

Partnerships

The bill contains a special rule for transfers of partnership interests. Except as provided in regulations to be prescribed by the Secretary, a transfer by a U.S. person of a partnership interest to a foreign corporation in a section 367 exchange is to be treated as a transfer of the U.S. person's pro rata share of the partnership assets. Under this rule, the tax consequences of an outbound transfer by a U.S. person of his partnership interest generally will depend upon whether the transfer of the underlying partnership assets would be tax-free or subject to a toll charge. For example, the transfer by a U.S. partner to a foreign corporation he controls of his interest in a general partnership engaged in leasing, some of whose assets are leased to other than the transferee (and are, therefore, tainted assets), will be subject to a toll charge with respect to those leased assets. On the other hand, if the general partnership and the transferee foreign corporation are actively engaged in similar manufacturing and the assets of the partnership are chiefly plant and equipment and are to be used by the foreign corporation in its business, then the transfer falls within the active trade or business exception and, therefore, will be tax-free.

Under regulations to be prescribed by the Secretary, this special rule will not apply to most transfers of limited partnership investments. Because limited partnership interests frequently represent passive, limited liability interests comparable to stock and securities, the committee believes that limited partnership interests generally should be treated like stock and securities for section 367 purposes. Thus, a transfer of a limited partnership interest to a foreign corporation generally will fall within the active trade or business exception only under the limited circumstances in which a transfer of comparable stock or securities would do so.

Special rules for transfers of intangibles

Except as provided in regulations to be prescribed by the Secretary, a transfer of intangible property to a controlled foreign corporation (sec. 351) or in certain corporate reorganizations (sec. 361) is treated as a sale made for payments that are contingent on productivity, use, or disposition. Intangible property is defined as any (i) patent, invention, formula, process, design, pattern, or know-how, (ii) copyright, literary, musical, or artistic composition, (iii) trademark, trade name, or brand name, (iv) franchise, license, or contract, (v) method, program, system, procedure, campaign, survey, study, forecast, estimate, customer list, or technical data, or (vi) any similar item, which property has substantial value independent of the services of any individual. This rule applies even if the intangible property is transferred along with tangible personal property eligible for the trade or business exception.

In general, upon the transfer of intangible property in a transaction that would otherwise fall within the general rule under the bill, the transferor is treated as receiving amounts that reasonably reflect the amounts that would have been received under an agreement providing for payments contingent on productivity, use, or disposition of the property. Amounts are treated as received over the useful life of the intangible property on an annual basis. The bill provides that earnings and profits of the transferee foreign corporation are reduced by the amount of income required to be included in income by the transferor. Any amounts included in gross income by reason of this special rule are treated as ordinary income from sources within the United States.

These special rules (including the sourcing rule) apply only to situations involving a transfer of the intangible property to a foreign corporation. In any case in which the IRS determines that an adjustment under section 482 (relating to the allocation of income and deductions among taxpayers) is appropriate because a foreign corporation obtained the use of the intangible property without sufficient compensation therefor, the special rule for transfers of intangibles will have no application to amounts included in the income of a U.S. taxpayer pursuant to such an adjustment. Thus, for example, the source of any adjustment to the income of a U.S. taxpayer under section 482 would be determined without regard to the sourcing rule in the bill.

The bill contemplates that gain on a disposition of stock in a foreign-transferee corporation will be treated as being attributable, in part, to the transferred intangible (and, therefore, U.S. source income); similarly, upon a disposition of the intangible by the foreign-transferee corporation, the U.S. transferor will be treated as receiving a payment with a U.S. source.

Incorporation of foreign loss branch

In the case of the transfer of the assets of a foreign branch of a U.S. person to a foreign corporation in an exchange described in section 332, 351, 354, 355, 356, or 361, the bill generally requires recognition of gain on the lesser of (1) any gain on the transfer and (2) the excess of losses (incurred by the foreign branch before the transfer and with respect to which a deduction was allowed to the taxpayer) over the amount of income that will be recognized by the taxpayer on account of the transfer pursuant to the rules requiring recognition on the disposition of certain foreign assets by taxpayers who have sustained overall foreign losses (sec. 904(f)(3)). As under current law, to the extent that the taxpayer has incurred an overall foreign loss in years prior to the incorporation that has not previously been recaptured, any gain on incorporation of the foreign branch is includible in gross income under these rules and is recharacterized as U.S. source income. In computing the tax imposed under this rule, gain on transfers of goodwill or going concern value will be taxable.

An example illustrates the operation of the bill's rule. A taxpayer's branch in country A incurred a $100 foreign loss in year 1; that loss offset $100 of U.S. source income in year 1. In year 2, the taxpayer's branch in country B earned $200 of foreign source income; the taxpayer treated $100 of that income as U.S. source income (sec. 904(f)). In year 3, the taxpayer incorporates the country A branch; that incorporation involves the transfer to a new country A corporation of assets with an excess of fair market value over basis of $85. In year 3, none of the gain on the incorporation is subject to recharacterization as U.S. source income (because of the previous recharacterization in year 2). Therefore, the taxpayer includes in income $85 (the lesser of the gain ($85) or the excess of the previously deducted losses ($100) over amounts subject to recharacterization as U.S. source income ($0 in this case)) as ordinary income from sources without the United States.

Excise tax rules

To preserve general consistency between the section 367 toll charge rules and the 35-percent excise tax rules, the bill provides that the excise tax will not apply to a transfer when the taxpayer establishes to the satisfaction of the Secretary that gain should not be recognized on the transfer under principles similar to the principles of section 367. The bill makes conforming amendments in the excise tax provision governing abatement and refund of excise tax. Regulations implementing these provisions are to be promulgated by the Secretary of the Treasury.

Elimination of ruling requirement and repeal of declaratory judgment procedure

The bill eliminates the requirement that taxpayers planning a transfer subject to section 367 obtain a ruling from the IRS regarding the tax treatment of the transfer. Taxpayers may now proceed with exchanges involving outbound transfers without advance or post-transaction IRS clearance. The exchanges will be tax-free or will involve the payment of an appropriate toll charge, in accordance with the substantive rules set forth in section 367, as amended by the bill.

Taxpayers planning a transfer subject to section 367 who seek the certainty of tax treatment that a ruling provides may continue to request a ruling regarding the tax treatment of the transfer. The issuance of such a ruling will be in the IRS's discretion. Although the bill repeals the present law rule that the IRS must issue a section 367 ruling when requested, the committee expects that when facts sufficient upon which to base a ruling are provided in a ruling request the IRS normally will issue a ruling. On the other hand, the committee hopes that the regularity of administrative practice under section 367 and the general codification under the bill of that practice provide sufficient certainty with respect to the tax treatment of exchanges subject to section 367 that in many or most cases taxpayers will not consider a ruling necessary.

The bill also repeals the special declaratory judgment procedure for Tax Court review of section 367 rulings and Tax Court consideration of ruling requests.

Notification requirement

The bill establishes a notification requirement for section 367 transfers and a set of penalties for failure to comply with the requirement. A U.S. person who transfers property to a foreign corporation in an exchange subject to section 367 is required to furnish to the Secretary such information with respect to the exchange as the Secretary may require in regulations. The information is to be furnished at the time and in the manner provided by the regulations. When a U.S. person fails for any reason to comply with the notification requirement, the bill generally will impose on that person a penalty equal to 25 percent of the amount of the gain which is realized on the exchange. However, no penalty is imposed if the U.S. person shows that his failure to give notice was due to reasonable cause and not to willful neglect.

The bill extends the general three-year limitation on assessment and collection with respect to any tax imposed under section 367 when a taxpayer fails for any reason to give the required notice. The bill provides that in such a case the time for assessment of the tax imposed under section 367 does not expire before the date three years after the date the Secretary is notified. Thus, if a taxpayer fails to notify the Secretary of an exchange subject to section 367, the time for assessment of any tax imposed on the exchange by reason of section 367 continues indefinitely.

Effective Date

The bill generally applies to transfers or exchanges made after December 31, 1984. However, a transition rule is provided for transfers or exchanges with respect to which a ruling request pursuant to section 367(a) (as in effect before enactment of the bill) was filed with the IRS before March 1, 1984.

Revenue Effect

This provision will increase fiscal year budget receipts by $12 million in 1986, $127 million in 1987, $324 million in 1988, and $540 million in 1989.

3. Gain From Sale or Exchange of Stock in Certain Foreign Corporations (sec. 123 of the bill and sec. 1248 of the Code)

Present Law

Gain recognized on the sale or exchange of stock in a foreign corporation by a U.S. person owning ten percent or more of the corporation's voting stock may be treated as a dividend (sec. 1248(a)). This rule is designed to prevent U.S. taxpayers from accumulating earnings free of U.S. tax in a controlled foreign corporation (generally, a foreign corporation more than 50 percent of the voting stock of which is owned by U.S. persons who own ten percent or more of such stock), and then (rather than repatriating the earnings in the form of dividends taxable as ordinary income) disposing of the stock at capital gain rates for a price that reflects the accumulated earnings. The statute recharacterizes gain as dividend income to the extent of the corporation's post-1962 earnings and profits attributable to the period the stock sold was held by the shareholder while the corporation was a controlled foreign corporation.

The Tax Reform Act of 1976 extended the rule for dispositions of stock in a foreign corporation to various nonrecognition transactions involving U.S. corporations. Under the 1976 amendment, a U.S. corporation that disposes of stock in a transaction governed by section 311, 336, or 337 (by distributing the stock as a dividend-in-kind or in the course of liquidation) is required to recognize its pro rata share of post-1962 earnings and profits as dividend income. The amount of dividend income required to be included in the U.S. corporation's income is equal to the difference between the fair market value of the stock and its basis, subject to the post-1962 earnings and profits limitation.

Reasons for Change

The purpose of the provision that recharacterizes gain upon the sale or exchange of stock in certain foreign corporations is to tax the accumulated profits of active foreign corporations upon repatriation. Although section 1248 has generally carried out this policy, it has come to the committee's attention that certain transactions may circumvent the statutory rules. For example, taxpayers have taken the position that section 1248 does not apply if a foreign corporation that is wholly owned by a widely held U.S. corporation issues new shares and pays a small amount of cash in exchange for shares representing a majority interest in the U.S. corporation. If this interpretation is sustained, the shareholders of the U.S. corporation might pay a capital gains tax on the difference between the value of the foreign corporation's stock (plus the cash) and their basis in the stock in the U.S. corporation, but no ordinary income tax would be paid on the accumulated earnings and profits of the foreign corporation at that time. Further, because the transaction would result in the foreign corporation ceasing to be a controlled foreign corporation, earnings accumulated prior to the exchange could be permanently exempt from U.S. corporate tax. The committee is aware that present law is unclear, and intends no inference that the transaction works as described.

In the view of the committee, the ability to avoid ordinary income tax by causing a foreign corporation to engage in a transaction with the shareholders of its U.S. parent corporation would make a mockery of the principle of taxing accumulated earnings and profits of foreign corporations upon repatriation. The committee believes that a U.S. corporation should be required to recognize dividend income upon the acquisition of its stock by its wholly owned foreign corporation, to the extent that the U.S. corporation's ownership interest in the foreign corporation is reduced. This treatment is also appropriate in certain cases where a U.S. corporation owns less than 100 percent of a foreign corporation that is or was a controlled foreign corporation.

Explanation of Provision

Under the bill, if shareholders of a U.S. corporation exchange stock in the U.S. corporation for newly issued stock (or treasury stock) of a foreign corporation ten percent or more of the voting stock of which is owned by the U.S. corporation, the transaction is recast. For purposes of applying section 1248, the foreign corporation is viewed as having issued the stock to the U.S. corporation and the U.S. corporation is treated as having distributed that stock to its shareholders. Under the rules of section 1248 provided in present law, the U.S. corporation is thereby required to recognize dividend income. The amount of dividend income is equal to the difference between the fair market value of the stock received by the shareholders of the U.S. corporation and the U.S. corporation's basis for its stock in the foreign corporation, subject to the post-1962 earnings and profits limitation.

The application of the provisions of the bill is illustrated by the following example:

Example.—M, a U.S. corporation, is and always has been the sole shareholder of P, a foreign corporation. P, which was organized in 1959, has previously untaxed post-1962 earnings and profits of $40 million. M, whose shares are widely held, has assets worth $100 million (including P shares representing $40 million of value). In recent years, while profits from M's operations have declined, P's foreign operations have generated substantial income. M has a zero basis in the P stock. In addition, many of M's shareholders have losses in their M stock. M's shareholders transfer all of their stock in M to P in exchange for newly issued P stock representing 90 percent of the total number of outstanding P stock plus a *de minimis* amount of cash. After the exchange, P owns all of the outstanding stock of M, and the former M shareholders own stock of P with a value approximating $100 million. The principal purpose of this transaction was to enable the corporate group to retain and reinvest P's accumulated and future foreign earnings free of U.S. tax. On the basis of public and private rulings issued by the Internal

Revenue Service and cases decided under the law in effect prior to enactment of the Internal Revenue Code of 1954, the parties to the transaction could take the position that the former M shareholders acquired all the P stock received by them in exchange for M stock worth $100 million, notwithstanding the fact that P's value was augmented by only $60 million dollars. *See* Rev. Rul. 84-30, 1984-9 I.R.B. 5; Rev. Rul. 57-465, 1957-2 C.B. 250; *Helvering* v. *Schoellkopf*, 100 F.2d 415 (2d Cir. 1938). *But see Bausch & Lomb Optical Co.* v. *Commissioner*, 267 F.2d 75 (2d Cir. 1959), *cert. denied*, 361 U.S. 835 (1959) (where a corporation that issued its stock in exchange for all the assets of its 79-percent owned subsidiary was treated as receiving the assets in consideration for its stock in the subsidiary by way of liquidation—to the extent of the 79-percent stock interest—rather than in a tax-free reorganization).

The bill taxes the transaction in accordance with its economic substance. The effect of the bill is to treat the excess of the value held by the former M shareholders after the exchange ($100 million) over the amount by which P's value was augmented ($60 million) as if M had distributed P shares equal to that difference ($40 million in the example) to its shareholders. Under the 1976 amendments to section 1248, M would recognize ordinary income of $40 million if the P stock were distributed as a dividend-in-kind or in liquidation. Similarly, under the bill, $40 million is includible in M's income as a dividend.

Effective Date

The provision to apply section 1248 to certain indirect transfers is effective for exchanges after the date of enactment.

Revenue Effect

This provision will have a negligible revenue effect on fiscal year budget receipts.

4. Original Issue Discount and Coupon Stripping—Foreign Investors (sec. 124 of the bill and secs. 871 and 881 of the Code)

Present Law

Background—foreign investors generally

In general, foreign corporations and nonresident aliens are subject to a flat 30-percent U.S. tax on certain U.S. source income not effectively connected with the conduct of a U.S. trade or business. Effectively connected income is taxed at the rates that apply to U.S. persons. In general, foreign investors are subject to the flat 30-percent tax on U.S. ordinary income, while their U.S. source capital gains (other than real estate gains) are not taxable. Amounts subject to the 30-percent tax in the hands of foreign investors include amounts received as dividends, rents, salaries, "interest (other than original issue discount as defined in section 1232(b)). . . and other fixed or determinable annual or periodical gains, profits, and income" (secs. 871(a)(1)(A), 881(a)(1)).

Original issue discount

Corporate and government obligations

Foreign investors may be able to defer tax on certain original issue discount (OID) on obligations of corporations and governments until disposition of the debt instrument. To the extent that deferral is not available, however, these foreign investors may be subject to the accelerated recognition rules that caused front-end loading of income of U.S. persons prior to the Tax Equity and Fiscal Responsibility Act of 1982 (TEFRA).

Although interest on which foreign investors are taxable does not include "original issue discount as defined in section 1232(b)," this exclusion of OID from interest does not exclude all OID from tax. The tax rules governing OID differentiate between pre-April 1, 1972, issues and post-March 31, 1972, issues (secs 871(a)(1)(C), 881(a)(3)).

Deferral on pre-April 1, 1972, issues

Foreign investors generally defer the 30-percent tax on OID on debt issued before April 1, 1972, until disposition (sec. 871(a)(1)(C)(i)). This result occurs because the Code generally treats foreign investors like U.S. persons holding pre-May 27, 1969, debt (sec. 1232(a)(2)(B)). That is, this OID is not subject to the 30-percent tax until sale, exchange, or surrender at maturity. There is no current taxation on ratable amounts of OID (see S. Rpt. 92–437, 92d Cong., 1st Sess., 1972–1 C.B. 559, 601).

Post-March 31, 1972 issues

Foreign investors who acquire debt issued after March 31, 1972, and payable more than 6 months [4] from the date of issue are subject to tax on such debt in three ways.

First, they are subject to tax on the actual interest they receive (on the coupons they clip) (see sec. 871(a)(1)(A)).

Second, when they receive a periodic interest payment (clip a coupon), they are subject to tax on the OID "accrued" between the immediately preceding interest payment and the date of the interest payment in question, but "the total amount withheld is not to exceed the amount of interest paid" (S. Rep. No. 92-437, above) (see sec. 871(a)(1)(C)(iii)).

Third, on sale or surrender, the foreign investor is subject to tax on the OID not previously taxed (secs. 871(a)(1)(C)(ii), 1232(a)(2)(B); S. Rpt. 92-437, above). Therefore, if the foreign investor buys a zero coupon bond and keeps it until maturity, he is not liable for any U.S. tax until that time. Low-coupon discount bonds will yield partial tax deferral.

Obligations of partnerships, etc.

OID on noncorporate debt is taxable no later than the time of disposition. The Internal Revenue Service proposed in 1976 to treat OID on "obligations not issued by a corporation or by a government or political subdivision thereof" like OID on post-March 31, 1972, corporate debt. Proposed Reg. sec. 1.871-7(c)(4)(i). That is, according to the proposed regulation, foreign investors are subject to tax on OID on debt issued by partnerships, individuals and other entities that are not corporations or governments ("noncorporate" issuers) upon receipt of coupon interest to the extent of net after-30-percent-tax interest. Any excess tax is due at the time of disposition.

Coupon stripping

Coupons.—Receipt of an interest payment upon surrender of a stripped coupon is taxable at the 30-percent rate. If the foreign investor can establish basis for the surrendered coupon by showing that he or she had purchased it, he or she should, under normal concepts, reduce the taxable income. The treatment of a sale of a stripped coupon before maturity is unclear. Foreign investors are not taxed on OID "as defined in section 1232(b)" (section 871(a)(1)(A)). They are taxed on "interest," however. The increased value of stripped bonds and stripped coupons may not be "OID as defined in section 1232(b)". This additional value may be an "amount received . . . as . . . interest (other than original issue discount as defined in section 1232(b)" on which such investors are subject to tax.[5]

[4] These persons pay no tax on OID on debt payable 6 months or less from the issue date. This result was deliberate. S. Rpt. 92-437, above.

[5] Arguably, this additional value is instead "other fixed or determinable annual or periodical income" subject to tax. *Cf.* Subcommittee on OID of the N.Y. State Bar, "Taxation and Withholding for OID Realized by Nonresident, Aliens and Foreign Corporations," 25 Tax Lawyer 201, 213 (1972), arguing, prior to the 1972 statutory changes, that much OID was such income.

If sale of a stripped coupon resulted in capital gain for U.S. persons,[6] however, a similar sale by a foreign investor may not be taxable under the general rule that foreign investors pay no tax on capital gains.

Bonds.—Surrender of a stripped bond at maturity or sale of such a bond may generate an "amount received . . . as . . . interest (other than original issue discount as defined in section 1232(b)" or "other fixed or determinable annual or periodical income," either of which would be subject to the U.S. 30-percent withholding tax. This treatment would parallel the treatment of stripped coupons, discussed above. Surrender of a stripped bond at maturity or sale of such a bond is free of tax to the extent that the gain is capital.

Reasons for Change

The committee intends generally to make the rules governing income from original issue discount debt and income from stripped bonds and coupons consistent for U.S. persons and foreign investors. To this end, the committee intends to make technical corrections to rules that Congress enacted in the Revenue Act of 1971. In addition, the committee seeks to fulfill Congress' intent in enacting TEFRA that the TEFRA modifications of the coupon-stripping rules and the OID rules that applied to U.S. persons also apply to foreign investors. Finally, the committee intends to coordinate the changes that this bill makes with respect to U.S. investors so that those changes generally apply to foreign investors as well.

The committee recognizes that this legislation does not end mismatching of (1) an accrual basis U.S. OID debt issuer's tax deductions and (2) a foreign investor's income inclusion. The committee believes that an end to such mismatching would be desirable, but that current inclusion of OID income of foreign investors might present practical enforcement problems. The committee believes that further study of current inclusion is in order.

Explanation of Provisions

Original issue discount

When a nonresident alien individual or a foreign corporation receives an interest payment on an OID obligation, an amount equal to the OID accrued on the obligation since the last payment of interest thereon will generally be subject to U.S. tax. However, such OID will be taken into account for this purpose only to the extent that the tax on the OID does not exceed the interest payment less the (30-percent or lower treaty rate) tax imposed on the interest payment. The bill thus makes it clear that the entire amount of the interest payment may be used to satisfy U.S. income tax. On the sale, exchange, or retirement of an OID obligation, the amount of any gain not in excess of the OID accruing while the foreign investor held the obligation is subject to tax (to the extent that such discount was not theretofore taken into account upon a payment of interest). These rules will apply to OID regardless of whether the instrument is a capital asset in the hands of its holder, regardless

[6] Certain sales of stripped coupons before maturity arguably yielded capital gains treatment (see Rev. Rul. 54-251, 1954-2 C.B. 172). Such sales could have yielded interest income, however.

of the period that the foreign investor holds it, and regardless of the identity of the issuer. Interest other than original issue discount (as defined in new section 1273) will be taxable under the rules that now govern interest "other than originial issue discount as defined in sec. 1232(b). "

As under present law, the bill generally defines original issue discount obligation to mean any bond or other evidence of indebtedness having original issue discount. Generally, original issue discount means the difference between the issue price and the stated redemption price at maturity (proposed sec. 1273). That term does not include, however, any obligation payable 183 days or less from the date of original issue (without regard to the period held by the taxpayer) or any obligation that is tax-exempt under section 103 or under any other provision of law without regard to the identity of the holder.

The bill determines the amount of the OID which accrues during any period under the new rules generally applicable to U.S. persons (proposed sec. 1274) or under the corresponding provisions of prior law (without regard to exemptions in any of those rules or any provisions for short-term obligations). Thus, for example, with respect to instruments issued after July 1, 1982, OID generally accrues on the basis of a constant interest rate. As for debt issued by natural persons, however, OID accrues on the basis of a constant interest rate only for post-March 1, 1984, issues. For debt issued before July 2, 1982, OID accrues on a front-end loaded basis.

Except to the extent provided in regulations prescribed by the Secretary, the determination of whether any amount taxable under this OID provision is from sources within the United States is to be made at the time of payment (of sale or exchange or retirement) as if the payment (or sale or exchange or retirement) involved the payment of interest. The committee has provided regulatory authority because the bill's general source rule may not always produce the proper source of OID income. For instance, an obligor issues a 20-year zero-coupon bond to a foreign investor. On the same day, the U.S. obligor issues a 20-year interest-bearing bond to a second foreign investor. For 19 of the 20 years of the interest-bearing bond's term most or all of the interest that the obligor pays on the interest-bearing bond is U.S.-source interest. In the twentieth year, interest that the obligor pays on the interest-bearing bond is foreign-source interest (because, for example, the obligor is an individual who has changed his or her residence or a corporation whose income is no longer effectively connected with a U.S. trade or business). The committee anticipates that regulations could provide that the bulk of the income that arises from the OID on the zero coupon bond in this case is U.S.-source income.

Stripped instruments

The bill provides that the rules treating stripped bonds and stripped coupons purchased after July 1, 1982, as obligations with original issue discount in the hands of U.S. persons (proposed sec. 1286) shall apply to foreign investors. Thus, foreign investors will generally treat stripped coupons and stripped bonds acquired after July 1, 1982, as OID instruments. This treatment generally conforms the treatment of foreign investors to that of U.S. investors, except that foreign investors are not subject to tax until actual receipt of payment.

Effective Date

The bill will generally apply to payments sales, exchanges, or retirements on or after the 60th day after the date of enactment and with respect to obligations issued after March 31, 1972. As noted in the discussion of present law, the bill does not affect the computation of the accrual of OID of pre-July 2, 1982 debt, and it does not affect stripped instruments acquired before July 2, 1982.

Revenue Effect

These provisions will have a negligible effect on revenues.

5. Source of Transportation Income (sec. 125 of the bill and sec. 863 of the Code)

Present Law and Background

U.S. taxation of U.S. persons

The United States generally taxes the worldwide income of U.S. persons,[7] but a dollar-for-dollar credit for foreign income taxes is allowed.[8] The credit is limited so that it cannot reduce U.S. tax on U.S. income, *i.e.*, it is limited to the amount of pre-credit U.S. tax on foreign income (foreign tax credit limitation).

The foreign tax credit limitation presently applies on an overall basis to most taxpayers: taxpayers combine income and losses from all foreign operations in all foreign countries to determine their foreign tax credit limitations. This allows taxpayers effectively to credit income taxes paid on income from one foreign country against U.S. tax on income from other foreign sources, so long as total income characterized as from foreign sources is high enough.

U.S. taxation of foreign persons

In general, the United States taxes foreign corporations and nonresident alien individuals on their U.S. source income and on foreign source income that is effectively connected with the conduct of a U.S. trade or business carried on by the foreigner. Income that is effectively connected with a U.S. trade or business generally is taxed in the same manner and at the same rates to foreign persons as to U.S. persons.

Sourcing of income generally

The Internal Revenue Code provides rules for determining whether income is from U.S. sources or from foreign sources. U.S. source income generally includes, for example, income from sales of property manufactured in the United States and sold in the United States, income from services performed in the United States, dividends paid by U.S. corporations, and interest paid by U.S. persons (sec. 861). Foreign source income includes income from the sale outside the United States of property manufactured outside the United States, income from services performed outside the United States, dividends paid by other than U.S. corporations, interest paid by other than U.S. persons, and royalties from the use outside the United States of patents, secret processes, and similar properties (sec. 862). Some income generally is treated as partially U.S. source and partially foreign source (sec. 863).

[7] U.S. persons are U.S. citizens, U.S. residents, U.S. partnerships, U.S. corporations, and, generally, U.S. trusts and estates (Code sec. 7701(a)(30)).

[8] Foreign income taxes include income, war profits, and excess profits taxes paid or accrued during the taxable year to any foreign country (or possession of the United States).

Sourcing of transportation income

The Code provides generally that rental income from property located in the United States is U.S. source income and rental income from property located outside the United States is foreign source income (secs. 861(a)(4) and 862(a)(4)). Further, income from transportation or other services rendered partly within and partly without the United States is partly U.S. source income and partly foreign source income (sec. 863(b)(1)). Treasury regulations (Treas. Reg. secs. 1.861-5, 1.862-1(a)(4), and 1.863-4) and rulings provide more detailed sourcing rules for transportation income.

Under the regulations and rulings, the source of transportation income depends on whether the income is rental income (bareboat charter hire) or transportation service income (e.g., time or voyage charter hire). If the income is rental income, it is foreign source income to the extent allocable to periods when the vessel is outside the United States and its territorial waters (the three-mile limit), whether that voyage is between two U.S. ports or a U.S. port and a foreign port (Rev. Rul. 75-483, 1975-2 C.B. 286). If the income is a payment for transportation services between two U.S. ports or a U.S. port and a foreign port, the income is allocated between U.S. and foreign sources by comparing costs incurred within the United States' territorial limits and costs incurred outside the United States' territorial limits (IRS Private Letter Ruling 8229005, March 30, 1982).

Whether income attributable to transportation of cargo between two U.S. ports (or a U.S. port and a foreign port) is rental income or services income, the income will be mostly foreign source income provided the route of transport lies primarily beyond the three-mile limit. Thus, for example, persons who transport crude oil from Alaska to West Coast points or, by way of the Panamanian pipeline, to East Coast points, may treat income earned from such transportation as deriving from foreign sources to the extent allocable to periods when the transporting vessel was outside the U.S. territorial limit.

Reasons for Change

The purpose of the foreign tax credit is to mitigate double taxation. Treating transportation income attributable to transportation beginning and ending in the United States as foreign source income increases the foreign tax credit limitation of the carrier and affiliates by income that does not have a nexus with any foreign country. If the carrier or its affiliates have excess foreign tax credits as a result of unrelated foreign operations, this increase in the foreign tax credit limitation effectively enables the carrier to use the excess credits to offset all or part of any U.S. tax that should be imposed on the transportation income. The result is an inflating of the limitation by a shifting of what are economically U.S. earnings to foreign sources.

Moreover, foreign persons who earn income from transportation that begins and ends in the United States (such as foreign lessors of containers that travel between Alaska and the West Coast) should be fully subject to U.S. tax on such income.

Consistent with this policy, the committee believes that all transportation income attributable to transportation which begins and ends in the United States (or any of its possessions) should be U.S. source income. Under the present sourcing rules, carriers operating between points in the United States can obtain predominantly foreign sourcing for transportation income earned from their U.S. routes by routing their vessels or aircraft outside the three-mile limit. The transaction rarely has any connection with any country other than the United States.

Explanation of Provision

The bill provides that all transportation income attributable to transportation which begins and ends in the United States (including, for this purpose, in any possession of the United States) is to be treated as U.S. source income. This treatment will apply to both U.S. and foreign persons. For these purposes, transportation income is defined as any income derived from or in connection with the use, or hiring or leasing for use, of a vessel or aircraft or the performance of services directly related to the use of such vessel or aircraft. Thus, the bill applies to transportation income attributable to both rentals and the provision of transportation services. Also, the provision applies both to companies earning transportation income and their employees. Transportation income includes income from transporting persons as well as income from shipping. The bill states that the term "vessel or aircraft" includes any container used in connection with a vessel or aircraft.

Under the bill, transportation of oil, for example, from U.S. points to other U.S. points, either directly or by way of the Panamanian pipeline, is transportation "which begins and ends in the United States" and thus, transportation income from such transportation is U.S. source income.

The new sourcing rule is to be applied in accordance with regulations prescribed by the Secretary of the Treasury. Generally, transportation of cargo will not be considered to "begin and end in the United States" (and thus, the new sourcing rule will not cause income from such transportation to be U.S. source income) when, en route to a delivery point elsewhere in the United States, a stop at a U.S. intermediate point is made for refueling, maintenance, loading or unloading of other cargo, or other business reasons, if the transporting vessel or aircraft took on the cargo in a foreign country. Similarly, transportation of cargo will not be considered to begin and end in the United States when it involves transportation from one U.S. point to another intermediate U.S. point where refueling, maintenance, etc., takes place before ultimate delivery of the cargo to a point in foreign country. Repackaging, recontainerization, or any other activity involving the unloading of the cargo at the U.S. intermediate point will not change these results under the sourcing rule provided the cargo is transported to its ultimate destination on the same aircraft or vessel that carried it to the intermediate U.S. point. If the cargo is transported to its ultimate destination on another aircraft or vessel, its transportation between the U.S. points will be considered to begin and end in the United States.

Transportation of persons will not be considered to "begin and end in the United States" when, en route to a destination elsewhere in the United States, a stop at a U.S. intermediate point is made for refueling, maintenance, or other business reasons, if the persons begin the trip in a foreign country and do not change aircraft or vessels at the U.S. intermediate point. Similarly, transportation of persons will not be considered to begin and end in the United States when it involves transportation from one U.S. point to an intermediate U.S. point like that just noted en route to the persons' destination in a foreign country provided, again, the persons do not change aircraft or vessels at the U.S. intermediate point. Round-trip travel from the United States to a foreign country by persons is not transportation which begins and ends in the United States under the bill and, thus, the new sourcing rule will not cause carrier transportation income attributable to such round-trip transportation to be U.S. source income.

Effective date

The new sourcing rule for transportation income will apply to transportation beginning after the bill's date of enactment in taxable years ending after that date.

Revenue Effect

This provision will increase fiscal year budget receipts by $5 million in 1984, $13 million in 1985, $17 million in 1986, $18 million in 1987, $19 million in 1988, and $20 million in 1989.

6. Insurance of Related Parties by a Controlled Foreign Corporation (sec. 136 of the bill and sec. 954(e) of the Code)

Present Law

Under present law, the income derived from the insurance of U.S. risks by a controlled foreign corporation is currently taxable to its U.S. shareholders, if the premiums and other consideration received by it with respect to the U.S. risks exceed 5 percent of the total premiums and other consideration received during the year with respect to all risks. Generally, income derived from the insurance of non-U.S. risks is not currently taxable.

U.S. shareholders of controlled foreign corporations are also currently taxable on foreign base company services income for the taxable year. Foreign base company services income means any income (whether in the form of compensation, commissions, fees, or otherwise) derived in connection with the performance of technical, managerial, engineering, architectural, scientific, skilled, industrial, commercial, or like services that are performed for or on behalf of any related person and are performed outside the country under the laws of which the controlled foreign corporation is organized. Treasury regulations indicate that the place of performance will depend on the facts and circumstances of each case. However, in general, under those regulations, the place of performance will be where the persons performing the services are physically located when they perform their duties.

Generally, the issuing of insurance or annuity contracts, or the reinsurance thereof, is considered to be the sale of services rather than goods or property.

Reasons for Change

The committee believes that present-law provisions on related party insurance may allow foreign corporations controlled by U.S. shareholders improperly to shift income to tax havens. As a result, there could be deferral of current tax on that income, or generation of low-taxed foreign-source income available to absorb otherwise unusable foreign tax credits. The committee believes that the essential service performed under an insurance contract is the indemnity coverage for the risk of loss against which a party is insured. Administrative or investment services performed by a related insurer under the contract generally are incidental to this coverage. Accordingly, the committee believes that insurance services should be treated as performed in the country in which the risk is located.

In adopting this change, the committee recognizes that it is not directly addressing all the problems associated with the use of controlled foreign corporations as captive insurance companies in sophisticated self-insurance arrangements for related persons. The committee does not intend that the provision be construed as affecting any determination as to whether a payment made to a related insurer constitutes self-insurance, the "premium" for which is nondeductible.[9]

Explanation of Provision

The definition of foreign base company services income is amended to provide specifically that any services performed with respect to any policy of insurance or reinsurance, if the primary insured is a related person, will be treated as having been performed in the country in which the risk of loss against which the related person is insured is located. Accordingly, income from the insurance or reinsurance of non-U.S. risks of a related person that arise outside the country under whose laws the insurer is created or organized will be currently taxable to U.S. shareholders of controlled foreign corporations as foreign base company services income.

For example, assume that a U.S. corporation owns 10 percent or more of the stock of an insurance company incorporated in a tax haven. The insurance company insures risks of unrelated parties as well as risks of foreign subsidiaries of the U.S. corporation. Under the bill, the foreign insurance company's income from the insurance of risks of those foreign subsidiaries (including associated investment income) will be foreign base company services income that is currently taxable to its U.S. shareholders, subject to the rules of subpart F (secs. 951-964). Income that is attributable to the insurance or reinsurance of risks of unrelated parties will ordinarily not be currently taxable to the U.S. shareholders of the controlled foreign corporation, unless its foreign base company income exceeds 70 percent of gross income.

This provision will apply only if a valid insurance arrangement is found to exist, and only if the insured related party is the primary insured. For example, if a Bermuda insurance subsidiary of a U.S. corporation validly insures the French plant of the French subsidiary of that U.S. corporation, its income from that insurance contract will be foreign base company services income. By contrast, if a Bermuda insurance subsidiary of a U.S. corporation validly reinsures a risk of an unrelated party that is covered by an insurance contract issued by U.K. insurance subsidiary of that U.S. corporation, its income from that insurance contract will not be foreign base company services income.

Effective Date

The provision will apply for taxable years beginning after the date of enactment.

Revenue Effect

This provision is estimated to increase budget receipts by less than $5 million annually.

[9] For discussions of the captive insurance issues, see Rev. Rul. 77-316, 1977-2 C.B. 53; and *Carnation Co.* v. *United States,* 640 F. 2d 1010 (9th Cir. 1981) cert. denied. 454 U.S. 965.

7. Foreign Collapsible Corporations (sec. 126 of the bill and sec. 341 of the Code)

Present Law

Section 341 generally requires a shareholder's gain on the sale or liquidation of a collapsible corporation to be reported as ordinary income rather than capital gain. However, section 341(f)(1) permits a shareholder to obtain capital-gain treatment on the disposition of stock if the corporation consents to recognize gain on disposition of its "subsection (f) assets" (generally, noncapital assets) when realized.

Section 341(f)(2) provides for recognition of gain at the corporate level on the disposition of subsection (f) assets, even in a transaction that would otherwise qualify for nonrecognition of gain. However, section 341(f)(3) provides an exception from this rule for certain tax-free corporate organizations, reorganizations, and liquidations, where the transferee makes a section 341(f) consent. This exception may also present opportunities for tax avoidance.

Reasons for Change

It may be possible to circumvent section 341 by causing a foreign corporation to give a section 341(f) consent under circumstances that render enforcement of the consent impractical (*e.g.* if the foreign corporation is not to be engaged in a U.S. trade or business and the stock is sold to a foreign person). The committee recognizes that there may be cases in which it is appropriate to give effect to a section 341(f) consent given by a foreign corporation.

Explanation of Provisions

The bill provides that, to the extent provided in regulations, a section 341(f) consent will not be given effect where the consent is given by a foreign corporation. The bill also provides regulatory authority to limit the effect of a section 314(f) consent in the case of certain tax-free corporate transactions.

Effective Date

This provision is effective on the date of enactment.

Revenue Effect

This provision will have a negligible effect on fiscal year budget receipts.

8. Recharacterization of U.S. Income as Foreign Income (sec. 128 of the bill and sec. 904 of the Code)

Present Law

In general, the United States taxes U.S. corporation on their worldwide income, but grants a credit for foreign income taxes paid or accrued. The credit is limited to ensure that foreign taxes can offset only U.S. tax on foreign source taxable income. The limitation is determined by using a simple ratio of foreign source taxable income to worldwide taxable income. The limitation is computed on a worldwide or overall basis so that taxes paid to one foreign country in excess of the U.S. rate can offset U.S. tax that would be imposed on other low-taxed or untaxed foreign income.

In addition to a credit for taxes paid directly, a credit is also permitted for certain taxes paid by foreign corporations at least 10 percent of the voting stock of which is owned by a U.S. corporation (sec. 902). Dividends to these U.S. corporations carry with them a proportionate amount of the foreign taxes paid by the foreign corporation.

The Code defines U.S. and foreign source income. U.S. source income includes, generally, dividends and interest paid by U.S persons. It also includes income from insuring U.S. risks.

Dividends and interest that a foreign corporation (not doing business in the United States) pays are foreign source income. However, a pro rata portion of dividends and interest paid by a foreign corporation is U.S. source income when half or more of the foreign corporation's gross income over a three-year period is effectively connected with a U.S. trade or business.

Under current law, U.S. source income paid to a foreign corporation may become foreign source income either as a dividend to U.S. shareholders or as an inclusion in their income under subpart F. For example, a U.S. corporation may own 100 percent of a tax-haven insurance company. That foreign insurance company earns all its income from reinsuring U.S. risks of unrelated U.S. companies. The income of the insurance company is U.S. source income, but that income, so long as the insurance company avoids becoming engaged in a U.S. business, is not subject to the regular graduated-rate U.S. income tax. The Code imposes at most a 1-percent excise tax on certain premiums received by foreign insurance companies not doing business in the United States to reinsure U.S. risks. The tax haven where the insurance company operates imposes no tax on its income. If the insurance company were a U.S. corporation, it would be subject to the regular graduated-rate U.S. tax.

The Code contains rules intended to prevent the shifting of income to low-tax jurisdictions having no natural economic nexus with the transaction (subpart F). Subpart F treats U.S. shareholders in controlled foreign corporations that earn defined categories of income (such as income from insuring U.S. risks) as if they had received distributions from the controlled foreign corporations. That is, the U.S. shareholders are currently taxable on the tax-haven type income of the controlled foreign corporations. In this case, subpart F generally treats the U.S. owner of a tax-haven insurance company as if it had received a distribution from the insurance company in the amount of the income that the insurance company earned. That subpart F inclusion, even though wholly attributable to U.S. source income, is treated as foreign source income. Even though the insurance company's income was subject to no tax in the country of its incorporation, it may escape U.S. tax on the subpart F inclusion to the U.S. corporation. This result may occur because the subpart F inclusion, as foreign source income, may absorb foreign tax credits that arise from taxes imposed by countries other than the tax haven. This result occurs because foreign taxes from one country can offset U.S. tax on income from another country. That is, high foreign taxes on income from foreign business operations could shelter this tax-haven income from U.S. tax.[10]

Reasons for Change

A fundamental premise of the foreign tax credit is that it should not offset the U.S. tax on U.S. source income. Because present law determines the source of dividend and interest income by reference to the payor, resourcing (and the inflation of the foreign tax credit limitation) can be achieved by the simple device of having a foreign corporation that pays a dividend (or the income of which is taxed to the U.S. shareholders) receive income from U.S. sources.

The United States should receive the full U.S. tax (unreduced by foreign tax credits) on income of U.S. persons that arises within the United States. The committee intends to proscribe devices that artificially convert U.S. income to foreign income, or other devices that create artificial foreign income. Such devices circumvent the foreign tax credit limitation and erode the U.S. tax base. They give U.S. taxpayers an incentive to use high foreign taxes to shelter income that is really U.S. source income but whose source taxpayers have artifically converted to foreign. The ability to create artificially foreign low-taxed income that can absorb foreign tax credits that arise from unrelated high-taxed foreign income passes the cost of high foreign taxes from the U.S. taxpayer to the U.S. Government.

Explanation of Provision

Under the bill, the United States-connected percentage of a distribution or interest payment made by a United States-owned foreign corporation will be treated as U.S. source income. This rule will apply only for the purpose of the foreign tax credit limitation; it will not apply for purposes of the rules that tax foreign persons

[10] A variation on this tax plan involves receipt by the tax-haven corporation of premiums covering risks of related parties. The committee does not express a view as to whether such a payment to a related person constitutes nondeductible self-insurance.

on income that is not effectively connected with the conduct of a U.S. trade or business.

The United States-connected percentage is generally the percentage of the gross income of the foreign corporation for a three-year base period that is either derived from sources within the United States, or effectively connected with the conduct of a trade or business within the United States. However, if that percentage for the three-year base period is less than 10 percent, the United States-connected percentage will be zero. The base period with respect to any taxable year is generally the period of three taxable years preceding that taxable year (or so much of such period as the corporation is in existence). If the distributing corporation has no gross income from any source for the three-year period (or part thereof) for any reason (including business inactivity or the fact that the corporation is newly created or organized), the 10-percent test will apply solely with respect to the taxable year of the distributing corporation in which the distribution occurs.

For example, assume that 10 percent of a United States-owned foreign corporation's gross income for the base period is U.S. source income that is effectively connected with the conduct of a U.S. trade or business, 20 percent of its gross income is U.S. source income that is not effectively connected with the conduct of a U.S. trade or business, 30 percent of its gross income is foreign source income that is effectively connected with the conduct of a U.S. trade or business, and 40 percent of its gross income is foreign source income that is not effectively connected with the conduct of a U.S. trade or business. The applicable percentage for this corporation is 60 percent (10 plus 20 plus 30). Therefore, 60 percent of a distribution or interest payment with respect to a taxable year governed by this base period from this foreign corporation to a U.S. shareholder is treated as U.S. source income, while 40 percent is treated as foreign source income.

The bill defines United States-owned foreign corporation to mean any foreign corporation if 50 percent or more of either the total combined voting power of all classes of its voting stock or the total value of all classes of its stock is held directly or indirectly by United States persons.

The bill defines distribution to include any amount required to be included in income under section 951. That is, distributions include Subpart F inclusions as well as dividends.

The Secretary is to prescribe regulations for the application of this rule in cases of distributions or payments made through one or more entities. The committee intends that the regulations trace the source of income through entities to prevent abuse of this provision.

Effective Date

These provisions apply generally to distributions, subpart F inclusions, and interest payments made by U.S.-owned foreign corporations after the date of enactment, in taxable years ending after that date, to the extent attributable to income received or accrued by such corporations after that date. However, the bill provides two transitional rules. The purpose of these transitional rules is to retain prior tax treatment for taxpayers receiving distributions, etc. from corporations that borrowed pursuant to fixed-term arrangements before committee action. The committee does not intend that any inferences should be drawn from these transitional rules regarding the correct tax treatment, under current law, of transactions involving international finance subsidiaries in the Netherlands Antilles.

Under the first transitional rule, certain interest received or accrued by applicable controlled foreign corporations (CFCs) will not be taken into account in computing the U.S.-connected percentage of any distribution or interest payment by the CFC if the interest is allocable to certain CFC obligations outstanding, or CFC equity, as of March 31, 1984. Applicable CFCs are those in existence on March 31, 1984, substantially all of the activities of which consist of issuing obligations and lending the proceeds to affiliates.

Interest received or accrued prior to 1992 on U.S.-affiliate obligations held by an applicable CFC and allocable to that CFC's capitalization on March 31, 1984, qualifies for this treatment. For this purpose, an applicable CFC's capitalization on March 31, 1984, is equal to the sum of the CFC's obligations (issued by the CFC) and equity outstanding on March 31, 1984. Obligations outstanding on March 31, 1984, are not counted for this purpose if they were not issued before March 8, 1984, unless a binding commitment by the CFC to issue them was in effect on March 7, 1984. (This transitional rule does not apply in determining whether the U.S.-connected percentage is less than 10 percent.)

Qualified interest in a given taxable year is determined by multiplying the interest received or accrued in that year on an applicable CFC's loans to its U.S. affiliates by a limiting fraction. The limiting fraction is equal to (1) the aggregate principal amount of U.S.-affiliate obligations held by the CFC on March 31, 1984 (but not in excess of the CFC's March 31, 1984, capitalization (described above)), divided by (2) the average daily principal balance of U.S.-affiliate obligations held by the CFC during the taxable year. The numerator of the limiting fraction is adjusted downward to reflect (1) retirements in that taxable year of any obligations issued by the CFC that are included in the March 31, 1984, capitalization and (2) a pro rata portion of the CFC's equity allocable to these retired obligations. (When all of the CFC obligations included in the March 31, 1984, capitalization have been retired, the limiting fraction must equal zero. Thus, the amount of interest received or accrued therafter allocable to such CFC obligations and equity will be zero and this transitional rule will no longer apply.) The committee intends that the numerator of the limiting fraction in a given taxable year be adjusted upward by the amount of accrued original issue discount (OID) on any OID obligations included in an applicable CFC's March 31, 1984, capitalization. In no event may the limiting fraction exceed one.

For purposes of this transitional rule, the principal amount of any obligation with OID is the obligation's issue price. However, the committee intends that the principal *balance* of any obligation with OID will equal the issue price plus accrued OID.

Under the second transitional rule (which may apply only to taxpayers not availing themselves of the first transitional rule), these provisions of the bill will not apply to distributions, deemed distributions, or interest payments to the extent attributable to interest received by foreign corporations, other than applicable CFCs, on any term obligations held by such corporations on March 7, 1984.

Revenue Effect

This provision will increase fiscal year budget receipts by $13 million in 1984, $60 million in 1985, $64 million in 1986, $70 million in 1987, $76 million in 1988, and $82 million in 1989.

9. Recharacterization of Interest Income as Dividend Income (sec. 129 of the bill and sec. 904 of the Code)

Present Law

In general, the United States taxes U.S. corporations on their worldwide income, but grants a credit for foreign income taxes paid or accrued. The credit is limited to ensure that foreign taxes can offset only U.S. tax on foreign source taxable income. The limitation is determined by using a simple ratio of foreign source taxable income to worldwide taxable income. The limitation is computed on a worldwide or overall basis so that taxes paid to one foreign country in excess of the U.S. rate can offset U.S. tax that would be imposed on other low-taxed or untaxed foreign income.

In addition to a credit for taxes paid directly, a credit is also permitted for certain taxes paid by foreign corporations at least 10 percent of the voting stock of which is owned by a U.S. corporation (sec. 902). Dividends to these U.S. corporations carry with them a proportionate amount of the foreign taxes paid by the foreign corporation.

Many foreign countries do not tax interest that their residents pay to U.S. lenders—including interest that their banks pay to U.S. depositors. Therefore, frequently, U.S. persons can earn foreign interest income free of foreign tax.

In general, taxes paid on one kind of foreign source income in excess of the U.S. rate can offset U.S. tax that would be imposed on other kinds of low-taxed or untaxed foreign source income. However, if a U.S. person pays no foreign tax on foreign interest income, the U.S. person generally must pay U.S. tax on that foreign interest income because there is a separate foreign tax credit limitation for interest income. Interest income to which the separate limitation applies does not include interest derived from a transaction that is directly related to the active conduct by the taxpayer of a trade or business in a foreign country or U.S. possession (or derived from disposition of such a trade or business), interest derived in the conduct by the taxpayer of a banking, financing, or similar business, interest received from 10-percent owned corporations, or interest received on disposition of certain securities in 10-percent owned corporations (sec. 904(d)(2)). Thus, foreign taxes on non-interest income generally will not offset the U.S. tax on foreign interest income, no matter how high the foreign taxes on foreign non-interest income.[11] This rule preserves the U.S. tax on untaxed interest income of U.S. persons, wherever earned. Its primary purpose is to

[11] Similarly, foreign taxes on foreign interest income generally cannot offset U.S. tax on foreign non-interest income. In general, the total (U.S. and foreign) tax on a U.S. person's foreign interest income is the higher of the U.S. tax or the foreign tax on foreign interest.

prevent generation of low-taxed foreign interest income that can absorb excess foreign ;ax credits.

A U.S. person may circumvent this special rule, however. Instead of lending money and earning interest income directly, a U.S. person may own a foreign corporation that accumulates earnings and lends money (for example, through a bank deposit) and earns interest income. The use of the foreign corporation, however, may convert the character of the interest income to non-interest (*e.g.*, dividend) income. This conversion may remove the income from the separate foreign tax credit limitation and allow it to absorb foreign tax credits attributable to non-interest income. This interest income may escape all U.S. and foreign tax.

Similarly, a U.S. person may invest in a U.S. corporation (such as a mutual fund) that buys foreign interest-bearing investments. There may be little or no foreign tax on the income from these investments. The U.S. corporation's dividends may be foreign income under a special rule that recharacterizes payments from a U.S. corporation as foreign if 80 percent or more of its income is foreign. These dividends, under current law, may absorb excess foreign tax credits and thus escape U.S. tax.

Reasons for Change

In 1962, Congress enacted the separate foreign tax credit limitation for interest to prevent taxpayers from artificially converting U.S. source income to foreign source low taxed interest income and thus inflating the foreign tax credit limitation. It has come to the attention of the committee that under the current Treasury interpretation of the separate foreign tax credit limitation, the same result can be achieved by having interest paid to a foreign subsidiary rather than directly to the taxpayer and then by distributing that interest as a dividend. In either case, there is artificial inflation of the foreign tax credit limitation, as a result of an easily manipulable financial transaction. The committee seeks to insure the integrity of the separate foreign tax credit limitation for interest income, and to prevent U.S. taxpayers from using artificial devices to convert interest income into non-interest income.

Current law, by encouraging U.S. taxpayers to invest capital outside the United States, erodes the U.S. tax base. If taxpayers can convert low-taxed foreign interest income to non-interest income, they circumvent the foreign tax credit limitation. Then, the U.S. Treasury, and not the U.S. taxpayer, bears the burden of foreign taxes on non-interest income.

Explanation of Provision

Under the bill, any distribution made by a United States-owned foreign corporation or by a regulated investment company out of that portion of its earnings and profits which is attributable to certain interest will be treated as interest. This rule will apply only for the purpose of the foreign tax credit limitation; it will not apply for other purposes of the Code.

The interest to which this provision applies is generally interest that would now be subject to the separate foreign tax credit limitation for interest if the United States-owned foreign corporation were currently subject to U.S. tax on it (or if the regulated investment company failed to distribute it). For example, a dividend from United States-owned foreign corporation that derived all its earnings and profits from interest in the conduct of a banking, financing, or similar business (as defined in sec. 904(d)(2)(B)) will not be subject to recharacterization as interest. A foreign corporation that derives all or a substantial portion of its earnings from lending money to related parties will not qualify for the banking or financing exception (or the active trade or business exception or, generally, any other exception) to interest treatment.

The determination of earnings and profits attributable to interest will involve the allocation and apportionment of deductions. For this purpose, the only items of expense allocable or apportionable against gross interest income (other than expenses definitely related to gross interest income) will be interest expenses. The committee intends that the apportionment of interest expenses (that cannot be allocated to specific property) follow the asset method described in Treasury Regulation sec. 1.861-8(e)(2)(v).

The bill will not apply, however, to any distribution made by a corporation during a taxable year if less than 10 percent of the earnings and profits of the distributing corporation for a three-year base period is attributable to interest income (of the kind to which the provision applies). The base period with respect to any taxable year is generally the period of three taxable years preceding that taxable year (or so much of such period as the corporation is in existence). If the distributing corporation has no gross income from any source for the three-year period (or part thereof) for any reason (including business inactivity or the fact that the corporation is newly created or organized), the 10-percent test will apply solely with respect to the taxable year of the distributing corporation in which the distribution occurs.

For example, after the provision is fully effective, if 20 percent of a foreign corporation's earnings and profits for the three years preceding the taxable year of a distribution is attributable to interest, while 15 percent of current year earnings and profits is attributable to interest, 15 percent of a distribution out of current year earnings and profits will be treated as interest. The same result will occur (after the provision is fully effective) if the three-year period figure in the above example is 10 percent. By contrast (again after the provision is fully effective), if 2 percent of a foreign corporation's earnings and profits for the three years preceding the taxable year of a distribution is attributable to interest, while 15 percent of current year earnings and profits is attributable to interest, none of the current year distribution will be treated as interest.

The bill defines United States-owned foreign corporation to mean any foreign corporation if 50 percent or more of either the total combined voting power of all classes of its voting stock or the total value of all classes of its stock is held directly or indirectly by United States persons.

The bill defines distribution to include any amount required to be included in income under section 951. That is, distributions include Subpart F inclusions as well as dividends.

Foreign taxes on interest that is subject to recharacterization under this provision will be creditable taxes if they meet the Code's standards for creditability. They will be subject to the separate foreign tax credit limitation for interest. For example, foreign taxes on U.S. source interest that is earned by a United States-owned foreign corporation and that (after a dividend or a deemed distribution) is subsequently treated as U.S. source income in the hands of a U.S. person under another provision of the bill—if they are creditable taxes—may bo credited subject to the application of the taxpayer's foreign tax credit limitation for interest income.

The Secretary is to prescribe regulations for the application of this rule in cases of distributions or payments made through one or more entities. The committee intends that the regulations trace the character of income through entities to prevent abuse of this provision.

Effective Date

The provision will generally apply to payments and deemed distributions from corporations that are attributable to interest received or accrued in taxable years of paying corporations (or corporations that are deemed to make distributions) beginning after the date of enactment. However, this provision will not apply to payments and deemed distributions (by certain paying corporations (or corporations that are deemed to make distributions)) to the extent attributable to interest received (by such paying corporations (or corporations that are deemed to make distributions)) on term obligations held by such corporations on March 7, 1984.

This transitional rule will not apply to payments and deemed distributions by controlled foreign corporations in existence on March 31, 1984, substantially all of the activities of which consist of issuing obligations and lending the proceeds to affiliates.

The base period for determining whether a paying (or deemed distributing) corporation has met the 10-percent test will begin no sooner than the first taxable year beginning after the date of enactment. Thus, the 10-percent test will apply—for the first taxable year of the distributing corporation beginning after the date of enactment—solely with respect to the taxable year of the distributing corporation in which the distribution occurs.

Revenue Effect

This provision of the bill is estimated to increase fiscal year budget receipts by $67 million in 1985, $118 million in 1986, $129 million in 1987, $142 million in 1988, and $157 million in 1989.

10. Excise Tax on Insurance Premiums Paid to Foreign Insurers and Reinsurers (sec. 135 of the bill and sec. 4371-74 of the Code)

Present Law

Under present law, an excise tax is imposed (sec. 4371) on each policy of insurance, indemnity bond, annuity contract, or policy of reinsurance issued by any foreign insurer or reinsurer to or for or in the name of a domestic corporation or partnership, or a U.S. resident individual with respect to risks wholly or partly within the United States, or to or for or in the name of any foreign person engaged in business within the United States with respect to risks within the United States. The excise tax is imposed at the rate of: (1) 4 cents on each dollar (or fraction thereof) of the premium paid on a policy of casualty insurance or the indemnity bond; (2) 1 cent on each dollar (or fraction thereof) of the premium paid on a policy of a life, sickness, or accident insurance, or annuity contract on the life or hazards to the person of a U.S. citizen or resident, unless the insurer is subject to tax under section 819 (relating to the taxation of foreign life insurance companies); and (3) 1 cent on each dollar (or fraction thereof) of the premium paid on a policy of reinsurance covering any of the contracts taxable under (1) or (2).

Present law (sec. 4373) provides exemptions from the excise tax in the case of (1) policies signed or countersigned by an officer or agent of the insurer in a State or the District of Columbia, within which such insurer is authorized to do business, or (2) any indemnity bond required to be filed by any person to secure payment of any pension, allowance, allotment, relief, or insurance by the United States, or to secure a duplicate for, or the payment of, any bond, note, certificate of indebtedness, war-saving certificate, warrant, or check issued by the United States.

Thus, present law imposes a tax on any direct insurance transaction with a foreign insurer (not subject to U.S. income tax), and an additional tax on any reinsurance transaction with a foreign insurer, if the transaction involves the insurance or reinsurance of a U.S. risk. A policy of reinsurance issued by a foreign insurer covering U.S. casualty risks or U.S. life risks is subject to the tax imposed on reinsurance policies, whether the primary insurer is a domestic or foreign insurer. Rev. Rul. 58-612, 1958-2 C.B. 850. See also *American Bankers Insurance Co. of Florida* v. *United States,* 388 F.2d 304 (5th Cir. 1968).

The excise tax also may be waived under certain recent U.S. tax treaties, such as it is in the United States-United Kingdom Income Tax Treaty or in the United States-France Income Tax Treaty. Although premiums received by certain persons may be exempt from the excise tax (whether by treaty or by statutory exception), such exceptions generally do not waive the excise tax for subsequent reinsurance transactions covering insurance of U.S. risks under which premiums are paid to and received by a nonexempt person.

Section 4374, as amended by the Tax Reform Act of 1976, provides that the excise tax imposed by section 4371 shall be paid, on the basis of a return, by any person who makes, signs, issues, or sells any of the documents and instruments subject to the taxes, or for whose use or benefit the same are made, signed, issued, or sold. Thus, the liability for the tax falls jointly on all the parties to the insurance transaction.

Treasury regulations (Treas. Reg. sec. 46.4374-1) (which do not reflect the changes made by the Tax Reform Act of 1976) provide that the tax is to be remitted by the U.S. person who actually transfers the premium to the foreign insurer or reinsurer or to any nonresident agent, solicitor, or broker. There is no provision that requires the U.S. person to withhold any excise tax owed by a foreign insurer or reinsurer.

Reasons for Change

The committee believes that the present-law excise tax system consisting of one tax on the direct insurance of a U.S. risk with a foreign insurer, and another tax, which generally is in addition to the first, on the reinsurance of a U.S. risk with a foreign insurer, should be replaced with a more administrable system. The new system will ensure that an excise tax is collected in all events to the extent a U.S. risk is insured, whether directly or indirectly, by a foreign insurer that is not subject to U.S. income tax or otherwise exempt from the excise tax. The committee believes that the policy of imposing an excise tax on insurers and reinsurers that are not subject to the net income tax will be better served by this new system under which the foreign insurer (or its agent) will be liable for the excise tax and the U.S. insured or broker that is obligated to transmit the premiums will be required to withhold the tax.

The committee is also concerned that the present tax rate differentiation between direct insurance and reinsurance of U.S. casualty risks allows U.S. insureds to avoid the proper level of excise tax by careful structuring of insurance and reinsurance transactions. In light of the bill's restructuring of the application of the excise tax, as well as concern over cases of tax avoidance, the committee believes that the excise tax rate applicable to a reinsurance transaction should reflect the character or class of the contracts issued by the primary insurer.

Explanation of Provisions

Excise tax rate

Generally, the bill conforms the excise tax rate imposed on a policy of reinsurance covering any policy of casualty insurance or the indemnity bond for a U.S. risk, if the policy of reinsurance is issued by a foreign insurer or reinsurer, to that imposed on a policy of direct insurance covering the same class of risks. The excise tax imposed on the insurance or reinsurance of U.S. casualty risks will be 4 percent of the premium received by a foreign insurer on the policy of insurance or reinsurance; the excise tax on the insurance or reinsurance of U.S. life risks will be 1 percent of the premiums received by a foreign insurer on the policy of insurance or reinsurance. The change to a tax rate expressed as a percentage of premiums paid from the present-law rate of cents per dollar of premium (or fractional part thereof) conforms the language of the imposition of tax provision to the change made by the Tax Reform Act of 1976 to the tax liability provision that the tax be paid by return rather than by stamps.

The bill eliminates the potential additive impact of the present-law provision for excise taxes on direct insurance and reinsurance with foreign insurers. In general, it provides that, to the extent an excise tax has been paid with respect to the U.S. risk under a contract of direct insurance with a foreign insurer, no excise tax will be due upon any subsequent reinsurance of such U.S. risk. Also, the bill provides generally that the foreign insurer or reinsurer is liable for the excise tax on the policy of insurance and that the amount of tax will be determined on the basis of the premiums retained by the foreign insurer or reinsurer. For these purposes, premiums retained means gross premiums and other consideration received by the foreign insurer with respect to the risks covered by the policy, reduced by premiums paid by such insurer for reinsurance ceded with respect to such risks.

For example, assume that a U.S. person insures its home office building with a U.K. insurer for a premium of $100x, that the U.K. insurer cedes a portion of the covered risk to a Bermuda reinsurer for a premium of $30x, and that the Bermuda reinsurer does not cede the risk further. To the extent the premiums for the U.S. risk are retained by the U.K. insurer ($70x), no excise tax is due because of a treaty exemption; to the extent premiums for the reinsurance of the U.S. risk are retained by the Bermuda reinsurer, an excise tax of $1.2x is due ($30x multiplied by .04). For comparison, assume that the U.S. person had insured directly with a Bermuda insurer (for a premium of $100x), which in turn ceded a portion of the U.S. risk to a U.K. reinsurer (for a premium of $30x). An excise tax of $2.8x is due from the Bermuda insurer and none is due on the reinsurance contract from the U.K. reinsurer.

Withholding for excise tax

Finally, the bill adopts a withholding provision to aid in the administration and collection of the excise tax with respect to subsequent reinsurance of U.S. risks in transactions between exempt foreign insurers and nonexempt foreign insurers or reinsurers. Generally, when a foreign insurer or reinsurer issues a policy or contract that would be subject to the excise tax, the person who controls, receives, has custody of, disposes of, or pays the premiums to the foreign insurer or reinsurer must withhold from those premiums, an amount to cover any excise tax that will be imposed upon premiums paid and retained by the foreign insurer or a reinsurer in a subsequent reinsurance of the covered U.S. risks. Because the amount of the reinsurance premiums may be unknown to the person responsible for withholding the excise tax on the premiums, the amount of the withholding will be based on the amount of the premiums being paid to the foreign insurer or reinsurer with respect to the directly covered U.S. risks. Treasury will have general authority to provide, by regulations, for the proper refund of any overwithholding or for the exemption from this withholding requirement. For example, Treasury might waive the withholding requirement if an exempt foreign insurer agrees to act as the withholding agent for the U.S. excise tax due because of subsequent reinsurance transactions.

Effective Date

The provisions will apply for premiums paid after the date of enactment.

Revenue Effect

This provision is estimated to increase fiscal year budget receipts by $21 million in 1985, $34 million in 1986, $39 million in 1987, $44 million in 1988, and $49 million in 1989.

11. Provisions Relating to Foreign Personal Holding Companies (sec. 131 of the bill and secs. 551, 552, 553, 554, and 951 of the Code)

Present Law

Foreign personal holding companies in general

Congress enacted the foreign personal holding company rules to prevent U.S. taxpayers from accumulating income tax-free in foreign "incorporated pocketbooks." If five or fewer U.S. citizens or residents own, directly or indirectly, more than half of the outstanding stock (in value) of a foreign corporation that has primarily foreign personal holding company income (generally passive income such as dividends, interest, royalties, and rents (if rental income does not amount to 50 percent of gross income)), that corporation will be a foreign personal holding company. In that case, the foreign corporation's U.S. shareholders, including U.S. citizens, residents and corporations, are subject to U.S. tax on their pro rata share of the corporation's undistributed foreign personal holding company income. That is, though only individuals count in the determination of foreign personal holding company status, persons other than individuals may be subject to foreign personal holding company tax.

Attribution for characterization as a foreign personal holding company

The foreign personal holding company provisions contain constructive ownership rules that determine whether a foreign corporation is more than 50 percent owned by five or fewer United States citizens or residents. These rules treat an individual as owning stock owned, directly or indirectly, by or for his or her partners, brothers and sisters (whether by the whole or half blood), spouse, ancestors, and lineal descendants. One case, however, casts doubt on the operation of these constructive ownership rules when nonresident aliens are the only family members who own stock in a foreign corporation.[12]

These constructive ownership rules also apply to deem income to be foreign personal holding company income in two cases: (1) when a foreign corporation has contracted to furnish personal services that an individual who owns (or who owns constructively) 25 percent or more in value of the outstanding stock of the corporation has performed, is to perform, or may be designated to perform; and

[12] In *Estate of Nettie S. Miller* v. *Commissioner*, 43 T.C. 760 (1965), nonacq., 1966-1 C.B. 4, two Canadian sisters owned over half the stock of a Canadian corporation. A divided Tax Court, despite the language of the statute, declined to attribute their stock to their brother, a U.S. citizen and resident, who owned none of the stock. Therefore, the corporation was not a foreign personal holding company, so its U.S. shareholders, who were unrelated to the Canadian sisters, were not subject to tax.

(2) when an individual who owns (or who owns constructively) 25 percent or more in value of the outstanding stock of the corporation is entitled to use corporate property and when the corporation in any way receives compensation for use of that property. This latter rule prevents foreign corporations from avoiding fo.eign personal holding company status by generating what appear to be large amounts of rental income.

Income inclusion through foreign entity

Shareholders in a foreign personal holding company who are U.S. citizens or residents, U.S. corporations, U.S. partnerships, or estates and trusts (other than estates and trusts whose gross income includes only income from sources within the United States)[13] must include their share of undistributed foreign personal holding company income in their gross income. These shareholders are called "United States shareholders". If a foreign personal holding company is a shareholder in another foreign personal holding company, the first company includes in its gross income, as a dividend, its share of the undistributed foreign personal holding company income of the second foreign personal holding company.

Interposition of a foreign partnership, a foreign corporation other than a foreign personal holding company, or an estate or a trust whose gross income includes only income from sources within the United States between a taxpayer and a foreign personal holding company, however, arguably may allow avoidance of the foreign personal holding company rules. Although stock owned, directly or indirectly, by or for a corporation, partnership, estate, or trust is considered as being owned proportionately by its shareholders, partners, or beneficiaries for the purpose of determining whether a corporation is a foreign personal holding company, some taxpayers have taken the position that these tracing rules do not necessarily apply to impose a tax on the ultimate owners of a foreign personal holding company.

Coordination of subpart F with foreign personal holding company provisions

In 1962, to supplement the foreign personal holding company rules, Congress imposed tax on the U.S. shareholders of controlled foreign corporations engaging in certain tax-haven type activities by adding the Subpart F rules to the Internal Revenue Code. The Subpart F rules, as amended, impose tax when a controlled foreign corporation has "Subpart F income," and in other circumstances.

Subpart F income includes income from related party sales and services transactions through tax haven-type base companies, from insurance of U.S. risks, from shipping operations (unless the income is reinvested), from foreign oil related activities, and from passive investments. Some of this income may also be taxable under the 1937 foreign personal holding company rules as amended. Subpart F imposes a tax (although not on "Subpart F income")

[13] This excluded category of estates and trusts corresponds generally to the definition of "foreign estate or trust" in Internal Revenue Code section 7701(a)(31). Therefore, in general, estates or trusts that are United States persons are subject to the same treatment as U.S. citizens or corporations.

in other circumstances, such as investment by a controlled foreign corporation of its earnings in U.S. property, and a controlled foreign corporation's withdrawal of its previously excluded income from shipping operations.

Where the foreign personal holding company rules and the Subpart F rules overlap, the foreign personal holding company rules generally take priority (sec. 951(d)). A taxpayer who is subject to tax under the foreign personal holding company rules may contend that it is not subject to the Subpart F rules that year. For instance, taxpayers (who are shareholders in a foreign corporation that is both a foreign personal holding company and a controlled foreign corporation) have taken the position that being subject to foreign personal holding company tax for a taxable year exempts them from taxation under Subpart F on investment that year in U.S. property of earnings of the foreign corporation. Because historical earnings invested in U.S. property, for example, might be substantially greater than current income taxed under the foreign personal holding company rules, such a position, if sustained, could undercut much of Subpart F. Courts have split on this issue. *Compare Whitlock* v. *Commissioner*, 494 F.2d 1297 (10th Cir. 1974), *cert. denied*, 419 U.S. 839 (holding the taxpayer liable for tax under Subpart F), *with Lovett* v. *United States*, 621 F.2d 1130 (Ct. Cl. 1980) (holding that no Subpart F tax was due).

Same country dividend and interest rule

The controlled foreign corporation rules of Subpart F tax U.S. shareholders of controlled foreign corporations on foreign personal holding company income, with some modifications. Those rules, however, exclude from the foreign personal holding company income that is subject to Subpart F dividends and interest received from a corporation (1) related to the recipient, (2) organized in the same country as the recipient corporation, and (3) having a substantial part of its assets used in its trade or business located in that same country, as income other than investment income. This "same country exception" has no counterpart in the foreign personal holding company rules, so those rules can apply to any dividends or interest. However, a threshold test applies, so that, in some cases, so long as less than 60 percent of a foreign corporation's income is foreign personal holding company income, it will not be a foreign personal holding company.

Reasons for Change

The foreign personal holding company provisions have been in the law since 1937 and serve an important purpose in removing the tax incentive to shift assets offshore, often to tax havens. Several technical problems have come to the committee's attention. First, the committee believes that attribution of ownership from a nonresident blood relative for the purpose of determining whether a foreign corporation is a foreign personal holding company is generally inappropriate, particularly where the U.S. person to whom the stock is attributed owns no stock. Similarly, there should be no such attribution from a nonresident alien partner in a partnership in which no U.S. shareholder is a partner (so long as the alien's partners do not include members of a U.S. shareholder's family). In addition, the committee is aware that the present rules have allowed taxpayers to take the position that they can circumvent the foreign personal holding company rules by interposing foreign entities between themselves and foreign personal holding companies. This abuse of the system was not intended and should be stopped.

Moreover, the Code provision governing the overlap of Subpart F and the foreign personal holding company rules has produced uncertainty and some questionable results. The committee believes that U.S. taxpayers should be subject to tax on the full amount of the tainted earnings of their foreign corporations, not more and not less. However, no inference as to the proper result under present law is intended.

Finally, the committee believes, because there appears to be no shifting of income to a tax haven when a foreign personal holding company receives interest or dividends from a related corporation organized and operating in the same country, that such income should not be foreign personal holding company income. The committee does not believe, however, that such income should count as non-foreign personal holding company income, because such treatment could sometimes insulate other passive income from tax by avoiding the threshold for foreign personal holding company status.

Explanation of Provisions

Attribution for characterization as a foreign personal holding company

The bill repeals, for the purpose of determining whether five or fewer U.S. citizens or residents own, directly or indirectly, more than half of the outstanding stock (in value) of a foreign corporation, the rules that attribute ownership of stock actually owned by a nonresident alien to the alien's U.S. brothers and sisters (whether by the whole or half blood), ancestors, and lineal descendants. It also repeals the rules that attribute ownership of stock actually owned by a nonresident alien to the alien's U.S. partners, so long as the alien's U.S. partners do not own, directly or indirectly, stock in the foreign corporation and so long as the alien's partners do not include members of the same family as a U.S. citizen or resident who owns, directly or indirectly, stock in the foreign corporation. For example, if the nonresident alien partner of a U.S. citizen owns 60 percent of a foreign corporation, while a second U.S. citizen (who is wholly unrelated to the first U.S. citizen and to the nonresident alien) owns the remaining 40 percent, the foreign corporation will not be a foreign personal holding company. The bill will not affect the current attribution rules that operate to treat certain income from personal services and income from certain use of corporate property as foreign personal holding company income.

Income inclusion through foreign entity

The bill adds a tracing rule that makes it clear that taxpayers cannot interpose foreign corporations (other than foreign personal holding companies), foreign partnerships, estates or trusts whose gross income includes only income from sources within the United

States, or other entities between themselves and the foreign corporation to avoid the foreign personal holding company rules. The bill provides that stock of a foreign personal holding company that is owned by a partnership, estate, or trust that is not a U.S. shareholder, or by a foreign corporation that is not a foreign personal holding company, will be considered (for income inclusion purposes) as being owned proportionately by its partners, beneficiaries, or shareholders. This rule will apply to trace ownership and attribute income through tiers of such entities. The bill grants regulatory authority to the Secretary of the Treasury to provide for such adjustments in the foreign personal holding company rules as may be necessary to carry out the purposes of this rule. Such an adjustment could be necessary, for example, to prevent double taxation of foreign personal holding company income.

This situation could arise in a case where a U.S. person owns shares in a foreign corporation which is not a foreign personal holding company which in turn owns stock in a foreign corporation that is a foreign personal holding company. Under the bill, the U.S. person could be subject to tax on his pro rata share of the income of the foreign personal holding company and, unless an adjustment were made, could be subject to tax again upon a dividend distribution from the same earnings from the foreign personal holding company which, in turn, is redistributed as a dividend by the foreign corporation to the U.S. shareholder. The committee intends that rules similar to those contained in section 959 apply.

Coordination of subpart F with foreign personal holding company provisions

The bill repeals the rule of section 951(d) that taxation under the foreign personal holding company rules precludes taxation under the Subpart F rules. It substitutes a new mechanism for the avoidance of double taxation by providing that a controlled foreign corporation's Subpart F income is taxed under Subpart F—but not under the foreign personal holding company rules—to the extent that it would otherwise be taxable under both Subpart F and the foreign personal holding company rules. Therefore, the existence of income subject to tax under the foreign personal holding company rules will not preclude taxation under Subpart F. Income includible under only one set of rules (foreign personal holding company rules or Subpart F rules) will be includible under that set of rules. A taxpayer taxable under Subpart F on amounts other than Subpart F income (on such items as withdrawals from foreign base company shipping income and investments in U.S. property) will be taxable under Subpart F whether or not its foreign corporation subjected it to foreign personal holding company tax.

Same country dividend and interest rule

For purposes of the foreign personal holding company rules, dividends and interest received from a corporation (1) related to the recipient, (2) organized in the same country as the recipient corporation, and (3) having a substantial part of its assets used it its trade or business located in that same country will not count in determining whether a foreign corporation is a foreign personal holding company—either as foreign personal holding company income or as non-foreign personal holding company income. That is, such income will not enter into the numerator or the denominator of the threshold fraction. In addition, such dividends and interest will not be treated as foreign personal holding company income that is taxable to the U.S. shareholder of a foreign personal holding company.

Effective Date

The provisions relating solely to foreign personal holding companies will apply to taxable years of foreign corporations beginning after March 15, 1984. The provisions governing the overlap of the Subpart F rules and the foreign personal holding company rules will apply to taxable years of U.S. shareholders beginning after the date of enactment.

Revenue Effect

These provisions will result in a revenue gain of less than $5 million annually.

12. Withholding on Dispositions by Foreigners of United States Real Property Interests (sec. 141 of the bill and sec. 6039C and new sec. 1444 of the Code)*

Present Law

In 1980, the Congress adopted the Foreign Investment in Real Property Tax Act, requiring that foreign persons who dispose of U.S. real property interests pay tax on any gain realized on the disposition. The interests on whose disposition recognition occurs include real estate and shares in certain corporations owning primarily real estate. The intent of the legislation was to treat foreign investors the same as U.S. persons by removing certain preferential tax treatment previously accorded them.

The Act provides for enforcement of the tax on foreigners through a system of information reporting designed to identify foreign owners (rather than sellers) of U.S. real property interests.

Reasons for Change

A major problem with the Foreign Investment in Real Property Tax Act is that it can often be easily evaded. Since the tax is not due until a tax return is filed after the end of the year, a foreign person can sell his U.S. real estate, take the proceeds out of the United States, and since he is beyond the jurisidiction of the United States, not pay any tax to the United States on the sale. Moreover, through nominees and foreign corporations established in tax havens, he can reinvest these untaxed proceeds back in the United States with impunity.

The Senate version of the 1980 legislation sought to deal with this problem by requiring that the purchaser of the U.S. real estate or other persons with control over the amount paid withhold the tax that would be due on the sale. This is the method used to insure collection of tax on other payments of income to foreign persons, and is used by almost all countries.

The conference on the 1980 legislation dropped the withholding provision. The conferees were concerned about protecting withholding agents who might not know that a seller is a foreign person. The conferees agreed that it would be necessary to structure withholding provisions carefully to insure that they would not inadvertently disrupt the U.S. real estate market or expose U.S. buyers or U.S. agents of foreign sellers of U.S. real estate to liability where such liability is not appropriate. The Senate voted again in 1981 and 1982 to impose withholding on sales of U.S. real property to foreigners, but in each case the conference committee failed to agree to withholding.

* This provision was contained in S. 2062, reported by the Senate Committee on the Budget on November 4, 1983.

In lieu of withholding, the provisions of the Foreign Investment in Real Property Tax Act are currently to be enforced through information reporting. The Act requires the Secretary of the Treasury to issue regulations providing for reporting. However, the Treasury has had difficulty in developing such regulations; it has not yet issued final regulations to require information reporting, so none is now required.

Enforcement through withholding has several advantages over enforcement through information reporting. Most importantly, withholding should prove more effective than information reporting, and will eliminate the problem of identifying owners of bearer shares. It will also relieve U.S. persons of significant paperwork because the bill authorizes the Treasury to relax or eliminate the information reporting requirements. In addition, the relaxation or elimination of information reporting could reassure legitimate foreign investors who may fear disclosure of their holdings to their potential political adversaries in their home countries.

Explanation of Provision

The bill requires withholding by a transferee of U.S. real estate, any agent of a transferee, or any settlement officer or transferor's agent (hereinafter collectively referred to as "withholding agent") where a U.S. real property interest is acquired from a foreign person.

Withholding rate

The amount to be withheld is the smallest of: first, in the case of a corporate transferor, 28 percent of the sales price, or in the case of a noncorporate transferor, 20 percent of the sales price; second, the transferor's maximum tax liability, discussed below; or third, the fair market value of that portion of the sale proceeds which is within the withholding agent's control. In determining the amount within the withholding agent's control, the withholding agent may be deemed to control certain debts incurred within two years of the transfer for which the transferee or the property is liable. This last rule, designed to prevent mortgaging out of gain, is to be subject to such exceptions as the Secretary may provide by regulations.

The transferor's maximum tax liability consists of two elements: first, the maximum amount that the Treasury (upon request of the transferor or the withholding agent) determines that the transferor could owe on his gain on the sale, discussed below, and second, any unsatisfied prior withholding tax liabilities caused by prior foreign ownership with respect to the transferred property that, under the bill, were previously required to be withheld but were not withheld. The first element, the maximum tax that the transferor could owe on the sale, is to be calculated on a transaction by transaction basis at the highest possible tax rate for that transaction. For example, if a nonresident alien purchased unimproved land on January 1, 1985 for $100,000, and sold the land on September 1, 1985, for $110,000, his maximum tax liability for that sale would be $2,000, i.e., 20 percent, the highest marginal tax rate for long-term capital gains of an individual, times $10,000, his net gain. Neither offsetting transactions (completed or anticipated) nor the presumed abence of other income during the taxable year would enter into the calculation of the maximum tax that the transferor could owe on the sale.

Withholding agent

While the bill generally places an obligation to withhold when a U.S. real property interest is acquired from a foreign person, the withholding requirement applies to a transferee, a transferee's agent, or a settlement officer only if he knows or has received notice from either the transferor or any agent of the transferor that the transferor is a foreign person. The transferor is required to notify the transferee, the transferee's agent, and the settlement officer that the transferor is a foreign person. A transferor's agent is also required to notify the transferee that the transferor may be a foreign person if the agent has reason to believe that the transferor may be a foreign person. If the transferor's agent fails to make a reasonable inquiry about the transferor's status, he is required to notify the transferee that the transferor may be foreign. However, the transferor's agent is relieved of any responsibility to give notice to a transferee if he relies in good faith on a written statement of the transferor—or, in the case of a transferor's agent retained by another agent of the transferor, a written statement by that other agent of the transferor—that the transferor is a U.S. person. A transferor's agent who does not carry out his obligation to provide notice is required to withhold the appropriate amount from any of the transferee's consideration he has within his control, including any compensation received by him in connection with the transaction.

The bill defines transferor's agent as a person who actually represents a foreign transferor in negotiations preceding the transaction or at settlement of the transaction. The definition also includes a person who, in negotiations or at settlement, represents the transferor indirectly through a subagency relationship. A person who, at the transferor's request, procures the services of an agent for negotiations or settlement, is also an agent of the transferor. The bill specifies certain actions that a person might take, even on behalf of the transferor, without automatically coming within the definition of an agent of the transferor. Receipt or disbursement of any of the consideration for the transaction (for instance, by an escrow agent) does not automatically cause agency status; neither does recording of documents involved in the transaction.

Exemptions from withholding

The bill provides for exemptions from withholding in three cases. First, withholding is not required if the transferee is to use the real property as his principal residence and the purchase price is $200,000 or less. Second, withholding is not required if the transferor obtains a qualifying statement from the Treasury that he is exempt from tax or has provided adequate security for payment of the tax, or has otherwise made arrangements with Treasury for the payment of the tax. Third, withholding is not required if the property being transferred is stock of a corporation and the transfer takes place on an established U.S. securities market.

Miscellaneous

Provision is made for the Treasury, upon request of the transferor or any withholding agent, to reduce the amount of withholding otherwise required. Any such request, as well as a request for a qualifying statement, must be acted upon within 30 days of receipt of the request.

The bill provides special rules for withholding by a domestic partnership, a trustee of a domestic trust, or an executor of a domestic estate. These persons are required (pursuant to such terms and conditions as regulations may require) to withhold from amounts which such entities have in their custody and which are attributable to the disposition of a U.S. real property interest, but only if the amounts are income of a nonresident alien individual or foreign corporation, partnership, trust, or estate.

Withholding is also required where a U.S. real property interest is distributed by a foreign corporation or is disposed of in certain transactions on which gain is recognized under the U.S. real property rules but that, under the Code's general rules, would be nonrecognition transactions. For example, when a liquidating foreign corporation distributes a U.S. real property interest to its shareholders, it is required to withhold a tax equal to 28 percent of the fair market value of the property reduced by the adjusted basis of the property.

Effective Date

The withholding requirements of this provision apply to payments of consideration with respect to the acquisition of a United States real property interest that are made more than 30 days after the date of the bill's enactment.

Revenue Effect

This provision will increase fiscal year budget receipts by $44 million in 1984, $40 million in 1985, $10 million in 1986, $10 million in 1987, $11 million in 1988, and $14 million in 1989.

13. Foreign Investment Companies (secs. 127 and 130 of the bill and secs. 535 and 1246 of the Code) *

Present Law

U.S. taxation of foreign persons

Although U.S. corporations are subject to current U.S. taxation on worldwide income, foreign corporations are generally subject to U.S. taxation on only their U.S. source income and income from a U.S. business. Foreign corporations are generally exempt from U.S. taxation on foreign source income. A special rule applies, however, to income from the sale of commodities and futures contracts. Foreign corporations are taxable on their gains from the sale of commodities and futures contracts only when those sales are effectively connected with a trade or business in the United States. In general, by avoiding contacts with the United States, a company purchasing and selling commodities and futures contracts on U.S. markets may be able to avoid conducting a business in the United States and thus avoid U.S. tax (sec. 864(b)(2)(B)). In that event, gains from sales of commodities and futures contracts are exempt even though they have a U.S. source.

Dividends from one foreign corporation to another foreign corporation are taxable only if 50 percent or more of the paying foreign corporation's income from the last three years is U.S. business income, in which case the dividends are U.S. source income (in the same proportion as the gross income is U.S. business income) (sec. 861(a)(2)(B)).

Taxation of U.S. shareholders of foreign corporations

The United States generally imposes tax on the U.S. shareholder of a foreign corporation only when that shareholder receives the foreign corporation's earnings in the form of a dividend. That is, the U.S. shareholder of a foreign corporation generally may defer tax on that income until receipt of dividends.

The Subpart F provisions of the Code provide an exception to this general rule of deferral. Under these provisions, income from certain "tax haven" type activities conducted by corporations controlled by U.S. shareholders is currently taxed to them before they actually receive the income in the form of a dividend. For this purpose, tax haven activities generally include gains from trading in futures contracts in commodities. However, the Subpart F rules apply only if more than fifty percent of the voting power in the foreign corporation is owned by U.S. persons who own (directly or indirectly) at least ten percent interests in the corporation. (Even if ownership is so concentrated that the Subpart F rules apply, the

* This provision was contained in S. 2062, reported by the Senate Committee on the Budget, on November 4, 1983.

rules apply only to those U.S. persons who are considered to own ten percent or more of the voting power in the foreign corporation.)

Two other, similar sets of rules, the personal holding company rules and the foreign personal holding company rules, could also subject foreign corporations or their U.S. shareholders to current taxation on passive investment income or futures trading income, but these rules apply only if five or fewer U.S. individuals own (directly or indirectly) more than fifty percent in value of the stock of a foreign corporation. In general, only one of these three sets of rules will apply to tax that income.

The accumulated earnings tax

The accumulated earnings tax is aimed at corporations accumulating income for the purpose of avoiding tax at the shareholder level. The accumulated earnings tax (which reaches a maximum rate of 38.5%) generally applies to a U.S. or foreign corporation formed or availed of for the purpose of avoiding the U.S. income tax on shareholders by accumulating earnings at the corporate level rather than distributing earnings.

Under Treasury Regulations, the tax does not apply to foreign source income (Treas. Reg. sec. 1.532-1(c)). It may be unclear whether a foreign parent corporation and a foreign subsidiary corporation (earning U.S. source income) from which the foreign parent receives dividends are subject to this tax, however. If the subsidiary distributes all its U.S. source earnings as dividends to its parent, those dividends are generally deductible from accumulated earnings. Therefore, there may be no accumulated earnings at the level of the subsidiary to which the accumulated earnings tax can apply. The parent corporation may avoid the accumulated earnings tax because all of its income is foreign source income (such as dividends from its subsidiary) not effectively connected with a U.S. trade or business.

The Internal Revenue Service may argue in such a case that imposition of an accumulated earnings tax on the earnings of either foreign corporation is appropriate. First, the statute and the Regulations allow imposition of the accumulated earnings tax if the avoidance of tax at the shareholder level is accomplished through the use of a chain of corporations. (See Treas. reg. sec. 1.532-1(a)(2).) Second, the Code gives the Secretary authority to disregard certain tax benefits associated with a corporation if the corporation was acquired for the principal purpose of evading or avoiding Federal income tax (sec. 269).

Shareholder level tax on disposition of the investment

Code rules attempt to prevent U.S. taxpayers from repatriating foreign earnings at the lower capital gains rates after deferring tax on those earnings. Gains of a U.S. person who was a ten-percent shareholder (during a five-year period) in a controlled foreign corporation on the disposition of that corporation's stock are subject to ordinary income (dividend) treatment rather than capital gains treatment to the extent of that person's share of the post-1962 earnings and profits of the controlled foreign corporation (sec. 1248). Wide dispersal of a foreign corporation's stock ownership can avoid controlled corporation status.

Another provision, the foreign investment company provision (sec. 1246), generally applies to any foreign corporation that is either (1) registered under the Investment Company Act of 1940 or (2) engaged primarily in the business of investing or trading in securities (as generally defined in that Act) when more than 50 percent of the corporation's stock (by value or by voting power) is held (directly or indirectly) by U.S. persons. When a U.S. person disposes of stock in a foreign investment company, that person is subject to ordinary income treatment to the extent of his share of the foreign investment company's earnings and profits. A foreign corporation that does not register under the Investment Company Act avoids the first of these criteria. In addition, certain case law holds that commodities do not constitute securities for purposes of that Act, so that a company that is engaged primarily in the business of investing or trading in commodities may avoid the second criterion.

Marking-to-market of futures trading income

The Economic Recovery Tax Act of 1981, Public Law 97-34, adopted a mark-to-market rule for the taxation of certain commodity futures contracts (Code sec. 1256(a)). Thus, each such regulated futures contract held by a taxpayer is treated as if it were sold or otherwise liquidated for fair market value on the last business day of the year. A maximum rate of 32 percent applies to this income. U.S. taxpayers investing through a pass-through entity (such as a limited partnership) organized in the United States in such futures contracts would be subject to this mark-to-market rule.

Foreign corporations not engaged in U.S. trade or business are not subject to the mark-to-market rule.

Reasons for Change

Background

A mutual fund may, using some of the rules described above, attempt to defer U.S. tax and to convert trading income (ordinarily taxed as 60 percent long-term gain and 40 percent short-term gain) to 100 percent long-term capital gain through the use of two foreign corporations, one of which ("the Parent") owns all the shares of the other ("the Subsidiary"). The fund establishes and operates these foreign corporations in tax haven jurisdictions, which impose no tax on their operations.

U.S. taxation of foreign persons

The Parent may trade in non-U.S. commodity markets (and will avoid having any U.S. source income), while the Subsidiary will trade in U.S. commodity markets (and will earn all the U.S. source income that either corporation earns). In general, by carefully structuring its activities, the Subsidiary may be able to avoid having a business in the United States and thus avoid U.S. tax on gains from commodity trading activities (sec. 864(b)(2)(B)).

The Parent may be able to avoid U.S. tax if it is a foreign corporation with no U.S. source income. Its income will consist mainly of (1) dividends from the Subsidiary, which should not be U.S. source, and (2) gains from trading on non-U.S. commodities markets, which will result in foreign source income.

Taxation of U.S. shareholders of foreign corporations

The fund may plan to avoid U.S. shareholder level tax on the earnings of the Parent and the Subsidiary by having the Parent distribute no dividends. Shareholders will have to dispose of their shares to receive any income.

To decontrol these corporations for purposes of anti-tax avoidance rules including the controlled foreign coporation rules, the Parent will restrict transfers of its shares, and it will attempt to spread ownership of its shares by U.S. persons among many such persons.

Accumulated earnings tax

The fund may plan its operations so as to try to avoid the accumulated earnings tax. It may try to benefit from the general rule that the tax does not apply to foreign source income. This is one of the primary reasons to set up two foreign corporations (the Parent and the Subsidiary) rather than one. The parties involved will argue that the Subsidiary will not be subject to the tax because it will distribute all its U.S. source earnings as dividends to the Parent. The fund will argue that there are no accumulated earnings at the level of the Subsidiary to which the accumulated earning tax can apply. The fund seeks to avoid the accumulated earning tax at the level of the Parent by having all the Parent's income be foreign source income.

The validity of these positions under current law, however, is unclear, and the Internal Revenue Service may argue that imposition of an accumulated earnings tax on the earnings of the Parent or the Subsidiary is appropriate.

To avoid potential challenges to its position on the accumulated earnings tax, the fund may allege that its corporate structure has no tax avoidance purpose. The issue would be one of intent.

Shareholder level tax on disposition of the investment

Under this plan, the shareholder realizes income from the investment by disposing of the interest in the offshore corporation rather than by being paid the earnings. A major element in this plan is to permit U.S. investors in the fund to realize capital rather than ordinary gain from their investment when they sell. Such treatment would circumvent the Code's rules that attempt to prevent U.S. taxpayers from repatriating foreign earnings at the lower long-term capital gains rates after deferring tax on those earnings. The fund would plan to avoid this rule by causing such wide dispersal of the Parent's stock ownership as to avoid controlled foreign corporation status.

The fund would plan to avoid the foreign investment company provision (sec. 1246) by failing to register the Parent or the Subsidiary under the Investment Company Act and by relying on case law that holds that commodities do not constitute securities for purposes of that Act.

Marking-to-market of futures trading income

U.S. investors could avoid the mark-to-market rule by interposing corporations between themselves and the investments. A similar result could be achieved though the use of a domestic corporation at the investor's level, but the corporation would be subject to the mark-to-market rules.

Committee concerns

The committee is concerned that the abusive use of tax havens by U.S. persons through transactions like those described above poses a significant threat to the U.S. tax base. While the committee recognizes legitimate uses of tax haven entities, it also recognizes that any use of tax haven entities must be carefully scruntinized. Particularly troublesome are those cases in which U.S. taxpayers seek to use a foreign entity, which is not much more than a conduit, to shield U.S. income from U.S. tax.

Such a situation has come to the attention of the committee with the result that the committee has reviewed certain anti-abuse provisions of the Code and has found uncertainties that should be clarifed. In particular, the committee believes that for purposes of insuring that investment income of a U.S.-controlled foreign investment company cannot be converted to capital gain, no distinction should be made between security transactions and other investment transactions. Accordingly, the committee expanded the scope of the foreign investment company rules.

Also the committee believes it inappropriate to defer U.S. tax on the U.S. earnings of a foreign company, or to permit mere receipt of U.S.-source income by a foreign corporation and its payment to another foreign corporation controlled by U.S. persons to change the source of that income. Accordingly, the committee has amended the accumulated earnings tax rules to insure U.S. tax in such cases.

The committee believes that the tax haven plans described above may not yield the results that taxpayers seek under current law. Nonetheless, the committee believes that legislation is appropriate to clarify the law in this area.

Explanation of Provisions

a. Definition of foreign investment company (sec. 1246 of the Code)

The bill expands the definition of "foreign investment company" (sec. 1246), for purposes of determining when gain on the sale of shares of that stock will be ordinary rather than capital. A foreign investment company will include any foreign corporation that is engaged (or holding itself out as being engaged) primarily in the business of investing, reinvesting, or trading in securities, commodities, or any interest (including a futures or forward contract or option) in commodities or securities, at a time when 50 percent or more of the total combined voting power of all classes of stock entitled to vote, or the total value of all classes of stock, is held directly or indirectly by U.S. persons. For this purpose, "securities" are defined in section 2(a)(36) of the Investment Company Act of 1940, as amended. If that definition in the Investment Company Act is amended in the future, then the definition for Internal Revenue Code purposes will also change. A primary effect of this provision is to bring commodity trading companies within the definition of foreign investment company. The bill will generally not affect the treatment of foreign corporations registered under the 1940 Act.

Effective date.—The provision will generally apply to sales and exchanges (and distributions) after October 31, 1983. In the case of shares held on October 31, 1983, and held continuously thereafter by one taxpayer until sale, exchange, or distribution, however, the bill will apply to sales and exchanges (and distributions) made after the date that is one year after the date of enactment.

b. Extension of accumulated earnings tax to U.S.-owned foreign corporations (sec. 535 of the Code)

The bill makes it clear that U.S. persons cannot use two or more tiers of foreign corporations to avoid the accumulated earnings tax on certain U.S. earnings. For purposes of the accumulated earnings tax rules (secs. 531–537), if more than 10 percent of the earnings and profits of any foreign corporation for any taxable year are derived from sources within the United States or are effectively connected with the conduct of a trade or business within the United States, then any distribution received (directly or indirectly) by a United States-owned foreign corporation out of those earnings and profits will be treated as derived by the receiving corporation from sources within the United States. That is, the earnings retain their U.S. source or U.S. connection in the hands of the receiving (upper-tier) corporation, so that they will be subject to the accumulated earnings tax. A similar rule applies to interest paid by a foreign corporation. If the paying corporation meets the 10-percent earnings and and profits threshold, all interest it pays to a U.S.-owned foreign corporation is U.S. source income for the purpose of the accumulated earnings tax.

The committee intends that the accumulated earnings tax apply in appropriate cases to U.S. source income in the hands of a United States-owned foreign corporation whether or not those earnings are effectively connected with the conduct of a U.S. trade or business, and whether or not those earnings in the hands of the United States-owned foreign corporation are attributable to earnings that are effectively connected with the conduct of a U.S. trade or business.

The bill defines the term "United States-owned foreign corporation" to mean any foreign corporation if 50 percent or more of the total combined voting power of all classes of stock entitled to vote, or the total value of all classes of stock, is held directly or indirectly by U.S. persons. It will apply to closely held and publicly held foreign corporations alike.

Effective date.—This provision will apply to distributions received by a United States-owned foreign corporation on or after May 23, 1983. In the case of a foreign corporation that was a United States-owned foreign corporation on May 23, 1983, however, the provision will first apply in the first taxable year of the foreign corporation that begins after December 31, 1984.

Effective Date

The effective dates for these provisions are included above in the "Explanation of Provision."

Revenue Effect

These provisions will increase budget receipts by less than $10 million annually.

14. Repeal of 30-Percent Withholding Tax on Certain Interest Paid to Foreign Persons (sec. 142 of the bill and secs. 864, 871, 881, 1441, 1442 and 2105 of the Code)

Present Law

In general

The United States taxes the worldwide income of U.S. citizens, residents, and corporations (in the case of foreign source income, however, a dollar-for-dollar credit is allowed for any foreign income tax paid). Nonresident aliens and foreign corporations, however, are generally taxed on only their income which is from U.S. sources or which is effectively connected with a business conducted by them in the United States.

Withholding tax on foreign persons

In situations where the U.S. source income received by a nonresident alien or foreign corporation is interest, dividends, or other similar types of investment income, the United States imposes a flat 30-percent tax on the gross amount paid (subject to reduction in rate or exemption by U.S. tax treaties, as described below) if such income or gain is not effectively connected with the conduct of a trade or business by the taxpayer within the United States (Code secs. 871(a) and 881). This tax is generally collected by means of withholding by the person making the payment to the foreign recipient of the income (secs. 1441 and 1442) and, accordingly, the tax is generally referred to as a withholding tax. In most instances, the amount withheld by the U.S. payor is the final tax liability of the foreign recipient and thus the foreign recipient files no U.S. tax return with respect to this income.

If the interest, dividend, or other similar income is effectively connected with a U.S. trade or business of the foreign investor, that income is not subject to the flat 30-percent withholding tax, but instead is included in the U.S. income tax return which must be filed for the business and is taxed at the ordinary graduated rates.

Exemptions from the withholding tax

The tax law provides some exemptions from the 30-percent tax on gross income both directly and by the treatment of certain income as foreign source income rather than U.S. source income. Interest from deposits with persons carrying on the banking business and similar institutions is exempt (secs. 861(a)(1)(A) and 861(c)). Original issue discount on obligations maturing in six months or less is exempt (secs. 871(a)(1) (A) and (C) and 881(a) (1) and (3)). Any interest and dividends paid by a domestic corporation which earns less than 20 percent of its gross income from sources within the United States (an "80/20 company") is also exempt from the 30-percent tax (secs. 861(a)(1)(B) and 861(a)(2)(A)). Also, interest on certain debt obligations which were part of a debt issue with respect to which an election had been made for purposes of the expired Interest Equalization Tax is exempt (secs. 861(a)(1)(G) and 4912(c)).

The income of foreign governments from investments in the United States in bonds, stocks and other securities, or from interest on bank deposits, is generally exempt from U.S. tax (sec. 892). Treasury regulations deny the exemption for income which the foreign government receives from commercial activities in the United States or income which inures to the benefit of any private person.

Individuals who are neither citizens nor domiciliaries of the United States are not subject to estate tax liability with respect to stock or debt obligations of a foreign corporation or debt obligations or bank deposits yielding interest that would not be subject to the 30-percent withholding tax if the decedent received it at the time of his death (secs. 2104 and 2105). Under present law, there is no estate tax liability in the case of an obligation of a U.S. corporation's foreign finance subsidiary, or in the case of a foreign corporation established to hold U.S. assets.

Tax treaty exemptions

In addition to the statutory exemptions listed above, various income tax treaties of the United States provide either for an exemption or a reduced rate of tax for U.S. source interest paid to foreign persons covered by these treaties. The exemption or reduced rate applies only if the income is not attributable to a trade or business conducted in the United States through a permanent establishment or fixed base located in the United States. The U.S income tax treaty with the Netherlands (as extended to the Netherlands Antilles) generally exempts U.S. source interest paid to Netherlands Antilles persons from withholding tax.

Background—Eurobond market and international finance subsidiaries

A major capital market outside the United States is the Eurobond market. It is not an organized exchange, but rather a network of underwriters and financial institutions that market bonds issued by private corporations (including but not limited to finance subsidiaries of U.S. companies), foreign governments and government agencies, and other borrowers.

In addition to individuals, purchasers of the bonds include institutions such as banks (frequently purchasing on behalf of investors with custodial accounts managed by the banks), investment companies, insurance companies, and pension funds. There is a liquid and well-capitalized secondary market for the bonds with rules of fair practice enforced by the Association of International Bond Dealers. Although a majority of the bond issues in the Eurobond market are denominated in dollars (whether or not the issuer is a U.S. corporation), bonds issued in the Eurobond market are also frequently denominated in other currencies (even at times when issued by U.S. multinationals).

In general, debt securities in the Eurobond market are free of taxes withheld at source, and the form of bond, debenture, or note sold in the Eurobond market puts the risk of such a tax on the issuer by requiring the issuer to pay interest, premiums, and principal net of any tax which might be withheld at source (subject to a right of the issuer to call the obligations in the event that a withholding tax is imposed as a result of a change in law or interpretation occurring after the obligations are issued). Because the Eurobond market is generally comprised of bonds not subject to withholding tax by the country of source, an issuer may not be able to compete easily for funds in the Eurobond market solely on the basis of price if its interest payments are subject to a substantial tax. U.S. corporations currently issue bonds in the Eurobond market free of U.S. withholding tax through the use of international finance subsidiaries, almost all of which are incorporated in the Netherlands Antilles.

Finance subsidiaries of U.S. corporations are usually paper corporations, often without employees or fixed assets, which are organized to make one or more offerings in the Eurobond market, with the proceeds to be relent to the U.S. parent or to domestic or foreign affiliates. The finance subsidiary's indebtedness to the foreign bondholders is guaranteed by the U.S. parent (or other affiliates). Alternatively, the subsidiary's indebtedness is secured by notes of the U.S. parent (or other affiliates) issued to the Antilles subsidiary in exchange for the loan proceeds of the bond issue. Under this arrangement, the U.S. parent (or other U.S. affiliate) receives the cash proceeds of the bond issue but pays the interest to the Antilles finance subsidiary rather than directly to the foreign bondholders.

Some have argued that the U.S. withholding tax is avoided by claiming the benefits of the tax treaty between the United States and the Netherlands, as extended to the Netherlands Antilles.[1] Pursuant to Article VIII of the treaty, an exemption is claimed from the U.S. withholding tax on the interest payments by the U.S. parent and affiliates to the Antilles finance subsidiary. The interest payments which the Antilles subsidiary in turn pays to the foreign bondholders are not subject to tax by the Antilles. Although most or all of the income of the Antilles finance subsidiary consists of interest payments from its U.S. parent and affiliates, that interest income would not ordinarily be treated as effectively connected with a U.S. trade or business of the Antilles subsidiary.

Consequently, since less than 50 percent of the gross income of the Antilles finance subsidiary is effectively connected with a U.S. trade or business, no part of the interest paid by the Antilles finance subsidiary to the foreign bondholders would be considered to be from U.S. sources and, accordingly, no U.S. second-tier withholding tax would be imposed (sec. 861(a)(1)(C)).[2] Thus, no tax is paid on

[1] The committee does not intend to create any inference regarding the operation of the relevant treaty and Code provisions in this situation.

[2] Even if the income of the finance subsidiary (the interest it receives from its U.S. parent and affiliates) were treated as effectively connected with a U.S. trade or business, the interest paid by the Antilles finance subsidiary would nevertheless be exempt from U.S. tax under Article XII of the treaty. This situation is advantageous when the taxpayer is in an excess foreign tax credit position because, while subject to U.S. tax on its net income (the spread between the interest it receives and the amounts it pays to the foreign bondholders), the finance subsidiary is not required to make an election to be subject to Netherlands Antilles tax in order to be free of the U.S. withholding tax.

the interest paid by the U.S. company to its Antilles finance subsidiary, or on the interest paid by the Antilles finance subsidiary to the foreign bondholders, either to the United States or to the Netherlands Antilles.

Because of a finance subsidiary's limited activities, the lack of any significant earning power other than in connection with the parent guarantee and the notes of the parent and other affiliates, and the absence of any substantial business purpose other than the avoidance of U.S. withholding tax, offerings by finance subsidiaries involve difficult U.S. tax issues in the absence of favorable IRS rulings. Since the marketing of a bond offering is based upon the reputation and earning power of the parent, and since the foreign investor is ultimately looking to the U.S. parent for payment of principal and interest, there is a risk that the bonds might be treated as, in substance, debt of the parent, rather than the subsidiary, and thus withholding could be required.[3]

Alternatively, the creation of the finance subsidiary might be viewed as having as its principal purpose the avoidance of the withholding tax, which becomes an obligation of the U.S. parent by virtue of its status as a withholding agent (sec. 1461), with the result that the exemption might not apply (sec. 269). Nevertheless, these finance subsidiary arrangements do in form satisfy the requirements for an exemption from the withholding tax and a number of legal arguments would support the taxation of these arrangements in accordance with their form. In any event, notwithstanding the refusal of the IRS since 1974 to issue rulings with respect to Antilles finance subsidiaries, many bond issues have been issued since 1974 (with the number of issues increasing in recent years) on the basis of opinions of counsel.

In recent years, however, field agents of the IRS have challenged certain arrangements involving Antilles finance subsidiaries.[4] The outcome to these challenges is not yet clear. In addition, the United States and the Netherlands Antilles are now in the process of renegotiating the existing treaty.

Typically, the U.S. parent and the finance subsidiary agree to indemnify the foreign bondholder against all U.S. withholding taxes (including interest and penalties) should the IRS successfully attack the claimed exemption from U.S. withholding tax or should U.S. tax law or the tax treaty with the Netherlands Antilles be changed to eliminate the basis for the claimed exemption. Also, the bonds typically provide that if U.S. withholding tax is imposed, the bonds are immediately callable.

Reasons for Change

The committee believes it important that U.S. businesses have access to the Eurobond market as a source of capital. The commit-

[3] *Compare, e.g., Aiken Industries, Inc.*, 56 T.C. 925 (1971), and *Plantation Patterns, Inc.* v. *Commissioner*, 462 F.2d 712 (5th Cir. 1972), 72-2 U.S.T.C. Paragraph 9494, *cert. denied*, 406 U.S. 1076, *with Moline Properties*, 319 U.S. 436 (1943), 43-1 U.S.T.C. Paragraph 9464 and *Perry R. Bass*, 50 T.C. 595 (1968).

[4] According to one source, there have been challenges to at least 25 of these arrangements. *See* 46 Taxes International 13 (August 1983). At least one company, Texas International Airlines, has disclosed such an audit in a proxy statement. Fialka, "*Closing a Loophole*," Wall Street Journal, Oct. 11, 1982, at 17, col. 2.

tee believes that the imposition of a withholding tax on portfolio interest paid on debt obligations issued by U.S. persons may impair the ability of U.S. corporations to raise capital in the Eurobond market. International bond issues are often exempt from withholding taxes and estate taxes imposed by foreign governments. By contrast, U.S. bond issues generally are not exempt from U.S. withholding tax, although as indicated above there is a patchwork of statutory exceptions to the withholding tax and the tax is frequently reduced or eliminated by treaty.

As explained above, to avoid the withholding tax, U.S. corporations seeking access to the Eurobond market generally establish international finance subsidiaries that issue Eurobonds, almost all of which are incorporated in the Netherlands Antilles. Exemption from withholding tax is claimed under the U.S. income tax treaty with the Netherlands, as extended to the Netherland Antilles.

The committee believes that if tax-free access to the Eurobond market is important, such access should be direct. In the committee's view, the current practice by U.S. corporations of issuing Eurobonds through finance subsidiaries located in the Netherlands Antilles, rather than directly from the United States, is neither economical nor indicative of sound tax policy. The committee is informed that the current practice imposes ·additional cost burdens on the issuing corporations and, in many cases, provides incomplete access to the Eurobond market. The cost of Eurobond borrowing to U.S. corporations would probably be lower were Eurobonds issued directly from the United States, utilizing existing U.S. office resources and personnel.

At the same time, the risk that U.S. withholding tax could be imposed on interest paid on Eurobonds issued by U.S. corporations sometimes makes it difficult to trade U.S. obligations in international bond markets since holders of international obligations desire assurance that there will be no withholding tax on any interest income which they may derive. To satisfy this desire of foreign lenders, U.S. corporate borrowers, as explained above, typically indemnify the foreign bondholders against all U.S. withholding tax should the IRS successfully attack the claimed exemption or the Netherlands Antilles tax treaty be changed to eliminate the basis for the claimed exemption. This also raises the cost which a U.S. borrower must incur when it goes into foreign markets to raise capital.

For these reasons, the committee believes that the 30-percent withholding tax on interest paid to foreign corporations and nonresident alien individuals by a U.S. borrower on portfolio debt investments generally should be repealed. This will allow U.S. corporations direct access to the Eurōbond market.

The committee is concerned, however, that repeal of the withholding tax, without a transitional period, may have a substantial negative impact on the economy of the Netherland Antilles. Because repeal of the withholding requirement will make it unnecessary for U.S. corporations to route borrowings through the Antilles, the use of the Antilles as a financial center is likely to be substantially reduced. The committee is informed that offshore financing activities currently generate a large portion of the Antilles budget. The committee believes that while tax treaties should not be used as a basis for establishing conduits whose existence results in a transfer of revenues from the U.S. Treasury, the Antilles should have some time to adjust to tax law changes that will affect its economy.

Therefore, the committee bill provides for a gradual phase-out, rather than immediate repeal, of the withholding tax on interest paid to foreign corporations and nonresident alien individuals on portfolio debt investments. The bill reduces the rate of tax on such interest from 30 percent to five percent on the date of enactment. The rate of tax is then gradually reduced to zero over a four-year period. Because some corporations will continue to have an incentive to issue Eurobonds through international finance subsidiaries during the phase-out period, the committee expects that the phase-out will promote a gradual and orderly reduction of international financing activity in the Netherlands Antilles and thus substantially mitigate any economic hardship that the withholding tax repeal might indirectly impose on that country.

The committee is aware that other provisions of the bill may also indirectly affect the Antilles economy. The committee believes, however, that any such effect is likely to be less pronounced than that withholding tax repeal may have; also, the provisions in question address tax abuses while the repeal of the 30-percent tax is intended to rationalize and clarify the tax rules affecting overseas borrowing by U.S. businesses.

Explanation of Provision

Phase-out of withholding tax

The bill generally provides for a phase-out of the 30-percent tax on interest paid by a U.S. borrower on portfolio debt investments where the interest is received by a nonresident alien individual or a foreign corporation. The rate of tax on that interest will be reduced to five percent for interest received after the date of enactment. The rate of tax will be reduced to four percent in 1985, three percent in 1986, two percent in 1987, and one percent for the period January 1 to June 30, 1988. Effective July 1, 1988, the withholding tax on interest received by foreign corporations and nonresident alien individuals on portfolio debt investments generally will be repealed.

The phase-out of the tax applies to interest paid on three categories of portfolio debt investments. First, interest paid on certain obligations not in registered form, i.e., payable to the person who has physical possession of the paper debt instrument ("bearer debt") is eligible for the phase-out. For the interest to be eligible, there must be arrangements reasonably designed to ensure that the obligation will be sold (or resold in connection with the original issue) only to non-U.S. persons, the interest must be payable only outside the United States and its possessions, and on the face of the obligation there must be a statement that any U.S. person who holds it will be subject to limitations under the U.S. income tax laws. Debt of any U.S. issuer, not just debt of U.S. corporations, may fall in this category. Therefore, obligations of the United States and its agencies may qualify.

Second, interest is eligible for the phase-out of tax where paid on an obligation in registered form, provided the U.S. payor (or U.S. person whose duty it would otherwise be to withhold tax) has received a statement that the beneficial owner of the obligation is not a U.S. person ("registered debt"). The statement must either be made by (1) the beneficial owner of the obligation or (2) a securities clearing organization, a bank, or other financial institution that holds customers' securities in the ordinary course of its business. The statement does not have to identify the owner, but simply state that the owner is not a U.S. person. The Secretary of the Treasury will have authority to publish a determination to the effect that statements from a securities clearing organization, bank, or other financial institution, or any class of such persons, are not adequate to qualify an obligation for this category. Interest paid one month or more after publication of a notice of inadequacy would be subject to the 30-percent tax, and the agent paying interest in such a case would have a duty to deduct and withhold U.S. tax at the 30-percent rate. Like bearer debt, registered debt may include debt of any U.S. issuer.

Third, interest paid on certain obligations assumed by U.S. corporations after the date of enactment ("assumed debt") is eligible for the phase-out. For the interest to be eligible, the U.S. corporation must have assumed an obligation that was issued on or before the date of enactment. At the time of its issuance, the later-assumed obligation must have been guaranteed by a U.S. corporation and must have been issued pursuant to arrangements reasonably designed to ensure that it would be sold (or resold in connection with the original issue) only to non-U.S. persons. In addition, the assuming U.S. corporation must meet, with respect to the assumed obligation (under regulations prescribed by the Secretary of the Treasury), reporting and other compliance requirements that would be imposed on the corporation from which the obligation is assumed were the latter corporation to continue to hold the obligation. The phase-out of tax on interest paid on assumed debt generally will allow U.S. corporations that assume debt of Netherlands Antilles financing subsidiaries to pay tax-exempt interest on that debt. Many contractual arrangements among U.S. borrowers, Netherlands Antilles financing subsidiaries and foreign lenders contemplate assumption by the U.S. borrower in the event of repeal of the 30-percent U.S. tax. The bill will also generally allow U.S. corporations that assume debt of "80/20" companies to use the proceeds of those borrowings to generate U.S. source income.

Not all interest on instruments in these three categories will be eligible for the phase-out of withholding tax. Interest will not be eligible for the phase-out if it is effectively connected with the conduct by the foreign recipient of a trade or business within the United States and thus will be taxed at the regular graduated rates. Also, interest on bearer debt or registered debt otherwise eligible for the phase-out will not be eligible if paid to a foreign person having a direct ownership interest in the U.S. payor. In the case of payments from domestic corporations, direct ownership exists if the recipient of the interest owns or is considered as owning or constructively owning 10 percent or more of the total combined voting power of all classes of stock entitled to vote of that corporation. In the case of interest paid by a domestic partnership, direct ownership exists if the recipient of the interest owns or is considered as owning or constructively owning 10 percent or more of the capital or profits interest in the partnership.

Foreign banks will generally not be eligible for the phase-out of withholding tax with respect to interest they receive on either bearer debt or registered debt on an extension of credit pursuant to a loan agreement entered into in the ordinary course of their banking business. Foreign banks will, however, be eligible for the phase-out with respect to interest paid on bearer or registered obligations of the United States.

To prevent U.S. persons from indirectly taking advantage of this provision, the bill provides that a foreign corporation which is a controlled foreign corporation (within the meaning of sec. 957) is not to be entitled to the phase-out of the withholding tax with respect to interest on bearer debt or registered debt received from U.S. persons.

Interest on assumed debt will be eligible for the phase-out of tax even in the hands of foreign persons having direct ownership interest in the U.S. payor, in the hands of a foreign bank, or in the hands of controlled foreign corporations.

Estate tax

The bill will eliminate any potential U.S. estate tax liability of nonresident alien individuals, in the case of obligations the income from which, if received by the decedent at the time of his death, would be eligible for the phase-out of withholding tax.

Prevention of tax evasion

Under the bill, if the Secretary of the Treasury determines that the United States is not receiving adequate information from a foreign country to prevent evasion of U.S. income tax by U.S. persons, the Secretary may provide in writing (and publish a statement) that the phase-out of withholding tax will not apply to payments of interest addressed to or for the account of persons within that country for issuances of debt obligations after the date of publication of the Secretary's determination. The termination will continue until the Secretary determines that the exchange of information between the United States and that country is adequate to prevent the evasion of U.S. income tax by U.S. persons. Any termination for interest will also automatically terminate the exemption from the estate tax on debt obligations.

Under the bill, an explicit duty to deduct and withhold tax at the 30-percent rate will arise only if the person otherwise subject to the duty knows, or has reason to know, that the interest is subject to tax at the 30-percent rate because the recipient is a controlled foreign corporation, has a direct ownership interest in the U.S. payor, or (except in the case of interest paid on a U.S. obligation) is a bank and the interest is received on an extension of credit made pursuant to a loan agreement entered into in the ordinary course of the bank's business. The bill will not affect the authority of the Secretary to require a payor to withhold in cases where the payor does not know the identity of the beneficial owner of the securities with respect to which the interest or original issue discount is paid.

The present regulations require withholding where the ultimate recipient of the interest is unknown.

Effective Date

The amendments providing for the phase-out of the 30-percent tax on portfolio interest will take effect for portfolio interest received after the date of enactment. The amendments providing for an estate tax exclusion for debt obligations will apply to estates of decedents dying after the date of enactment.

Revenue Effect

This provision is estimated to reduce fiscal year budget receipts by $38 million in 1985, $67 million in 1986, $100 million in 1987, $150 million in 1988, and $188 million in 1989.

K. Taxpayer Compliance Provisions

1. Promoter Lists of Syndicate Participants, and Tax Shelter Registration (secs. 145 and 146 of the bill and new secs. 6111 and 6112 of the Code)

Present Law

Under present law, there is no explicit requirement that promoters of syndicated investments sold directly to investors maintain customer lists that may be examined by the Internal Revenue Service. As a result, promoters may not keep customer lists or the Internal Revenue Service may have to rely on its summons authority to obtain such lists.

In other contexts, present law provides means for the Internal Revenue Service to pursue taxpayers who were led into a questionable tax position through the representations of a promoter or other third party. For example, the partnership audit provisions of TEFRA enable the Internal Revenue Service to examine partnership issues in a single proceeding and to make appropriate adjustments in the individual partners' returns automatically. Elsewhere, the Code requires that income tax return preparers retain for 3 years either the returns prepared by them or a list of taxpayers for whom returns were prepared. This provision enables the Service to examine, for example, the returns prepared by a particular person if it finds a pattern of improper return preparation by that preparer.

The requirement that securities be registered with either the Securities and Exchange Commission (SEC) or a State agency, or both, applies to many tax shelters. It is unlawful to make use of any means or instruments of transportation or communication in interstate commerce or the mails in connection with the sale of any security unless that security is registered as provided in 15 U.S.C. sec. 77f. Classes of securities exempt from this requirement are listed in 15 U.S.C. sec. 77c and transactions exempt from this requirement are listed in 15 U.S.C. sec. 77d.

Any security that is part of an issue offered and sold only to residents of a single State by an issuer within that State is also exempt from registration under 15 U.S.C. sec. 77c(a)(11). A number of States also require registration of securities. There is no requirement that securities or tax shelters be registered with the IRS.

Reasons for Change

The committee is concerned that promoters of and investors in syndicated investments and tax shelters are profiting from the inability of the Treasury to effectively examine every return. These promoters know that even if a tax scheme they market is clearly faulty, some investors' incorrect returns will escape detection and many will enjoy a substantial deferral of tax while the Treasury searches for their returns and coordinates its handling of similar cases.

The new requirement that promoters keep lists of customers and investments will enable the Treasury to identify quickly all of the participants in related tax-shelter investments. As a result, taxpayers claiming improper treatment will not escape detection and investors in similar schemes will receive more uniform treatment.

The requirement that tax shelters must register with the IRS will apply to a smaller number of investment arrangements than the new list requirement will. Registration will provide the IRS with basic information when tax shelters are first offered for sale that will be useful in detecting trends in tax shelter promotions. The requirement that taxpayers include the registration number on their tax returns will enable the IRS to process these returns more efficiently and will enable the IRS to treat similarly situated taxpayers in the same manner.

Explanation of Provision

Customer lists

The bill requires that any person organizing any investment plan or arrangement, or any other plan or arrangement, or selling any interest in such a plan or arrangement, with respect to which the person makes or furnishes any statement with respect to the allowability of any deduction or credit, the excludability of any income, or the securing of any other tax benefit by reason of holding an interest in the entity or participating in the plan or arrangement, must maintain customer lists. These lists must show the name, address, and taxpayer identification number of each person investing in each plan or arrangement which the person organizes or sells. In addition, the Secretary is given authority to require such other information as he finds necessary. These lists must enable the Secretary to identify every purchaser of a given type of investment scheme. To this end, the Secretary may require the promoter to maintain these lists by reference to specific identifying characteristics relating to their purported tax treatment. These requirements do not apply with respect to partnership interests or subchapter S share ownership because such arrangements are already subject to special audit rules under the Code. Information must be retained for seven years after it is first required to be listed.

If the Secretary determines that the list requirements of this new provision are inconsistent with, or redundant, vis-a-vis any other provision of the Code, he may provide appropriate exceptions to the list requirement. Similarly, he may provide rules to eliminate maintenance of duplicate lists under this provision.

Any promoter or salesman who is required to maintain lists under the new provicions of the bill will be subject to a penalty comparable to that imposed on income tax return preparers who fail to maintain required lists. Thus, each failure to retain a record of any particular purchaser of an investment will be subject to a $50 penalty except when the failure results from reasonable cause and not from willful neglect. Unlike the return preparer penalty, however, the penalty for failure to maintain required promoter lists is not subject to an aggrngate annual limitation.

Registration of shelter investments

The bill also requires tax shelter promoters to register their promotions with the Internal Revenue Service. Promoters must disclose the projected tax benefits of the investment. In addition, the Secretary is given authority to determine the additional information that must be supplied by the promoter in order to register the promotion. The committee anticipates that the Secretary will require disclosure on a simple form and that the promoter will be required to disclose identifying information about the promoter and promotion, the dollar value of the entire offering, the cost per unit, the number of units anticipated to be sold, the highest ratio of tax benefits to aggregate investment in any of the first five years, the method of accounting, and any other information the Secretary determines to be useful. The Secretary's present law authority to require that returns be filed on magnetic media or in other machine-readable form includes the authority to require this registration form to be filed in machine-readable format. The committee anticipates that the Secretary will require this form to be filed in machine-readable format. Promoters will be assigned a number by the IRS that they will be required to supply to investors, who will be required to include the number on their returns.

A tax shelter will have to meet several tests to be subject to registration. First, the shelter will have to be subject to either Federal or State securities registration requirements. The committee intends that any offering required to be filed with, or with respect to which notice is required to be given to a Federal or State agency, be considered subject to either Federal or State securities registration requirements. In addition, transactions that are not required to be registered under a Federal or State law regulating securities will be required to register with the Internal Revenue Service if the aggregate amount invested exceeds $200,000 and the aggregate investment is made by 10 or more investors. In determining whether registration is required under this rule, all transactions involving the same promoter, whether or not in conjunction with other promoters, which offer substantially similar investments and tax benefits, are to be aggregated in the manner provided in regulations. The Secretary may also provide exclusions from the registration requirement by regulations.

Second, the shelter would have to be an investment with respect to which representations are made in connection with the offering of the investment that in any of the first five years of operation the investment will result in deductions in excess of the income from the investment or credits in excess of one-half of the income attributable to the investment.

The bill also provides that a promoter is liable for a penalty of $100 for each failure to provide a registration number to an investor. An investor who fails (without reasonable cause) to include a registration number on his return is subject to a $50 penalty. A promoter who fails to register with the IRS is liable for a penalty for failure to register of $500 plus one percent of the aggregate amount invested that exceeds $1,000,000.

Effective Date

The list requirement applies to investments sold after December 31, 1984.

The registration requirement becomes effective September 1, 1984 with respect to interests sold on or after that date. The Secretary is given authority to postpone this effective date.

2. Reporting with Respect to Cash Transactions and Mortgagε Interest (sec. 147 of the bill and new sec. 6050H of the Code)

Present Law

Cash transactions.—In addition to the information reporting required by the Code, the Bank Secrecy Act authorizes the Secretary to require reporting of certain financial transactions. Under these rules, certain banks and other financial institutions are required to report cash transactions (including deposits and withdrawals) of more than $10,000. The Treasury regulations provide a number of exceptions to this reporting requirement. Also, persons who bring or send more than $5,000 in cash or other bearer instruments into or out of the United States must report the event to the United States Customs Service. Finally, a United States taxpayer who files a tax return is required to notify the Internal Revenue Service, where provided for on the tax return, of the existence of a foreign bank account or other foreign financial account that he controls or in which he has an interest. If the amount in the account exceeds $1,000, then the amount must be reported on a separate form to the Treasury Department.

Bank Secrecy Act information is compiled by the Treasury Department, and made available to agents of the Internal Revenue Service.

Mortgage interest.—Under present law, interest paid on a mortgage is deductible in computing taxable income. There is, however, no requirement that the recipients of such interest provide information with respect to the payment to the Internal Revenue Service.

Reasons for Change

The committee is concerned that approximately 80 percent of the revenue lost through noncompliance is attributable to the underreporting of income. For 1981, the Internal Revenue Service estimates that taxpayers filing returns failed to report $134 billion of income and nonfilers failed to report $115 billion. This $250 billion of unaerreporting reduced tax receipts by an estimated $55 billion. Unreported income connected with illegal activities was estimated to result in an additional $9 billion of lost revenue. The committee believes that reporting on the spending of large amounts of cash will enable the Internal Revenue Service to identify taxpayers with large cash incomes.

In addition, the committee believes that a provision requiring recipients of mortgage interest payments in excess of $2,300 to report the interest received to the Internal Revenue Service (with a copy to the payor) will materially assist the Internal Revenue Service in verifying the accuracy of claimed mortgage interest deductions. Internal Revenue Service studies indicate that a significant percentage of all overstated deductions involves overstatement of interest deductions.

Explanation of Provision

Cash transactions.—Under the bill, any person who receives (for his own account or the account of another) cash in connection with a trade or business will be required to report on any transaction in which the amount of this cash received is $10,000 or more. A transaction subject to reporting is any receipt of cash including receipt in connection with the purchase of goods or services, the purchase or exchange of property, the opening of a deposit or credit account, the purchase of gambling chips, or any similar transaction. For this purpose, a series of related transactions will be treated as a single transaction.

This new reporting requirement is imposed with respect to any receipt of cash in connection with a trade or business whether or not the receipt constitutes income in the trade or business. Thus reporting is required whether or not consideration is returned for the cash and whether or not the cash is received for the recipients' account or for the account of another. An exception is provided in the case of transactions subject to reporting under the Bank Secrecy Act.

The recipient of the cash will be required to report the name, address, and identifying number of the payor, the date and nature of the transaction and such other information as the Secretary may require. In addition to furnishing reports on each cash transaction to the Internal Revenue Service, the recipient of the cash must furnish each payor an annual statement aggregating the amounts of cash received from him. Such statement must be furnished on or before January 31 of the year following the year of the reportable event.

The bill defines cash for purposes of this provision as including only U.S. and foreign currency.

Mortgage interest.—Under the bill, any person who, in connection with a trade or business, receives $2,300 or more of mortgage interest payments from any person during the calendar year will be required to report the payor's, name, address, and taxpayer identification number and such other information as the Secretary may prescribe. This reporting requirement applies not only to the person entitled to the interest, but also to persons (such as service companies) who receive interest payments on behalf of another. For this purpose, mortgage interest is any interest on an obligation secured by an interest in real property (including, however, interest payable under a contract for deed) and amounts paid in lieu of interest for which a deduction is allowed. In addition to furnishing reports on mortgage interest receipts of $2,300 or more for any calendar year to the Internal Revenue Service, the payment recipient must furnish to each payor an annual statement of the amount of mortgage interest received from that payor in the calendar year. Such statements are due on or before January 31 of the year following the calendar year for which the return is made.

The committee decided to require reporting only where the amount of interest exceeds $2,300 because payments in excess of that amount generally allow individual payors to claim itemized deductions.

Penalties.—The penalty for failure to make required reports and to furnish statements to taxpayers will be similar to that imposed on failures to make other information reports and statements. Thus, the penalty will be $50 per failure, subject to a maximum of $50,000 for any calendar year. The penalty is not applicable if the failure is due to reasonable cause and not to willful neglect. If, however, the failure to file required reports is due to intentional disregard of the filing requirements, the penalty is not less than 10 percent of the aggregate amount not properly reported and the $50,000 limitation will not apply.

Effective Date

This new reporting requirement will apply to amounts received after December 31, 1984.

3. Reporting on Discharge of Indebtedness (sec. 148 of the bill and new sec. 6050I of the Code)

Present Law

The acquisition by a creditor of property which served as security for a loan may be a taxable event to both the lender and the borrower. The tax effects vary depending upon whether the loan is thereby discharged in whole or in part, whether the debt was recourse or nonrecourse, whether the acquisition was by way of a foreclosure sale or abandonment, or otherwise.

In general, foreclosure events are treated as sales or exchanges between the parties to the extent of the fair market value in the case of recourse debt, and to the extent of the debt in the case of nonrecourse debt. In addition, the foreclosure or other acquisition by a lender of property which was security for a loan in full or part satisfaction of the loan, or the abandonment of the property, may (in certain cases), give rise to discharge of indebtedness income to the borrower.

Special rules apply with respect to foreclosures, or other acquisitions of security, by thrift institutions and certain reacquisitions by sellers of real property when the seller took back a purchase money obligation.

Reasons for Change

Under present law, there is no reporting requirement designed to encourage consistent treatment by the lender and the borrower on a foreclosure, or to encourage the correct treatment of discharge of indebtedness income in recourse debt cases. Thus, gain on foreclosure events and discharge of indebtedness income may go unreported. In addition, these events are difficult to detect on audit.

Explanation of Provision

Under the bill, any person (including the United States, a State or any agency or instrumentality of either) who, in connection with a trade or business, lends money secured by property, must report to the Secretary any foreclosure or other acquisition of property in full or partial satisfaction of a debt secured by that property. In addition, the lender must report the abandonment by the borrower of any property which is security for a loan by the lender when the property is first determined to have been abandoned.

In addition, a second reporting requirement arises whenever the lender claims a bad debt deduction or charges a bad debt reserve with respect to all or a portion of any debt secured by property. These reports must include the name, address, and taxpayer identification number of the borrower, the original amount of the debt, the type of security for the debt, the method of reacquisition, the amount charged to a reserve (or charged off), the recourse or nonrecourse character of the debt and such other information as the Secretary may prescribe. In each case, a duplicate report must be provided to the debtor by January 31 of the year following the year of the reportable event.

The penalty for failure to make required reports will be similar to that imposed on failures to make other information reports. Thus, the penalty will be $50 per failure, subject to a maximum of $50,000 for any calendar year. The penalty is not applicable if the failure is due to reasonable cause and not to willful neglect. If, however, the failure to file is due to intentional disregard of the filing requirements, the penalty is not less than 10 percent of the aggregate amount not properly reported and the $50,000 limitation will not apply.

Effective Date

This reporting requirement applies with respect to acquisitions, abandonments, or deductions after December 31, 1984.

4. Penalty for Promoting Abusive Tax Shelters (sec. 149 of the bill and sec. 6700 of the Code)

Present Law

Any person who organizes, assists in the organization of, or participates in the sale of any interest in a partnership or other entity, any investment plan or arrangement, or any other plan or arrangement and who makes or furnishes (in connection with such organization or sale), (1) a statement with respect to the allowability of any tax benefit by reason of participating in the entity, plan or arrangement which the person knows or has reason to know is false or fraudulent as to any material matter, or (2) a gross valuation overstatement with respect to any matter material to the entity, plan or arrangement (whether or not the accuracy of the statement of valuation is disclaimed) is subject to a civil penalty. Thus, persons subject to the penalty may include not only the promoter of a tax shelter partnership but also any other person who organizes or sells a plan or arrangement with respect to which there are material misrepresentations or valuation errors affecting the tax benefits to be derived from participation in the arrangement.

The penalty for promoting an abusive tax shelter is an assessable penalty equal to the greater of $1,000 or 10 percent of the gross income derived, or to be derived, from the activity. There need not be reliance by the purchasing taxpayer or actual underreporting of tax.

The Secretary is given authority to waive all or part of any penalty resulting from a gross valuation overstatement, upon a showing that there was a reasonable basis for the valuation and the valuation was made in good faith.

Section 7408 authorizes an action to enjoin any person from engaging in conduct subject to the penalty under section 6700.

Reasons for Change

The attention of the committee has been drawn to evidence that the $1,000 or 10-percent penalty enacted in TEFRA is inadequate in amount since promoters of tax shelters operate on a large margin.

The committee is concerned that section 6700 may be read narrowly to preclude application of the sectior 6700 penalty to conduct by promoters after the shelter has been organized, such as providing false partnership returns. If this activity were not subject to penalty under section 6700, it would not be subject to injunction under section 7408. The committee believes that abusive activities of promoters conducted after the organization or sale of the shelter should also be subject to injunction.

Explanation of Provision

The bill increases the penalty for promoting abusive tax shelters to the greater of $2,000 or 20 percent of the gross income derived, or to be derived, from the activity.

The bill amends section 6700 to provide that making or furnishing a statement or a gross valuation overstatement incidental to the activities of an abusive tax shelter is subject to penalty. Amending section 6700 in this manner will mean that promoters will be subject to injunction under section 7408. No inference should be drawn from this provision regarding the scope of the section 6700 penalty and the power of the District Courts of the United States to issue injunctions against promoter conduct under present law.

Effective Date

The amendments to the promoter penalty will take effect on the date of enactment.

5. Interest Rate on Tax-Shelter Syndicate Items (sec. 150 of the bill and sec. 6621 of the Code)

Present Law

Under present law, if a tax is not paid on or before the last date prescribed for payment, interest must be paid by the taxpayer on the unpaid amount for the period from the last date prescribed for payment to the date of payment at an annual rate established under section 6621. In general, the last date prescribed for payment is the due date of the return determined without regard to any extension of time for payment and without regard to any notice and demand for payment issued by reason of a jeopardy assessment (but not later than the date notice and demand for the tax is made by the Secretary).

Under present law, interest is paid by the United States on the overpayment of any tax at the annual rate established under section 6621. Generally, interest is paid with respect to a credit from the date of overpayment (generally the due date of the return) to the due date of the amount against which the credit is taken. In the case of a refund, interest is generally paid from the date of overpayment to the date (to be determined by the Secretary) preceding the date of the refund check by not more than 30 days. However, if the credit or refund is claimed in a late return, no interest is allowed or paid for the period before the date the return is filed. No interest is allowed on an overpayment of income tax if such overpayment is refunded within 45 days after the last date prescribed for filing the return of such tax (without regard to any filing extensions) or, if later, within 45 days after the date the return is filed.

Both the taxpayer and the United States must pay interest compounded at the annual rate established under section 6621. Under present law, interest rates are redetermined twice a year on the basis of the average adjusted prime rate charged by commercial banks during the six-month period ending September 30 (effective January 1 of the succeeding calendar year), and March 31 (effective July 1 of the same calendar year). Currently, the annual rate is set at 11 percent.

Reasons for Change

The committee is concerned by the continued rise in the backlog of cases with respect to pre-1983 years which involve tax shelter issues. The number of tax shelter cases in examination at the Internal Revenue Service was 195,000 at the end of fiscal year 1980, 250,000 at the end of 1981, and 285,000 at the end of 1982. Over the same period, the backlog of pending cases in the Tax Court increased from 34,776 to 53,440.

Explanation of Provision

Under the bill, the otherwise applicable interest rate for periods after 1983 will be increased by 50 percent with respect to tax-shelter items arising with respect to any year. Thus, under the bill a taxpayer who invests in a transaction motivated by a desire to evade or avoid Federal income taxes will have to pay a higher rate of interest if he is found to have underpaid his tax but will be entitled to larger interest payments from the United States if he overpays his taxes and later obtains a refund.

A tax-shelter item is any item giving rise to a deficiency or overpayment if the item arises in connection with any partnership or other entity, any investment plan or arrangement of any other plan or arrangement, if the principal purpose of the partnership, plan, or arrangement is the avoidance or evasion of Federal income tax and more than 34 persons participate in the plan or an arrangement, etc.

To determine the amount of any deficiency or overpayment attributable to a tax-shelter syndicate item, it will be necessary to compare the deficiency or overpayment as finally determined to the deficiency or overpayment that would have existed if the taxpayer's treatment of the items had been determined to be correct. The difference is the overpayment or deficiency attributable to the tax-shelter syndicate items.

Effective Date

The amendment applies to interest with respect to periods after 1984.

6. Regulation of Appraisers Practicing Before the Internal Revenue Service (sec. 151 of the bill and new sec. 330 of Title 31)

Present Law

Under present law, the Secretary of the Treasury may prescribe rules governing the admission of lawyers and accountants to practice before the Internal Revenue Service and may bar individuals from practice if he finds them to be incompetent, disreputable or grossly negligent. Present law does not provide any comparable authority with respect to the appearance of professional appraisers in proceedings at the Internal Revenue Service.

Reasons for Change

The committee believes that professional appraisers who seek to present evidence to the Internal Revenue Service should be subject to the same type of professional regulation that applies to attorneys and accountants practicing before the Internal Revenue Service and to attorneys appearing in court proceedings.

Explanation of Provision

Under the bill, the Secretary of the Treasury is authorized to bar from appearing before the Internal Revenue Service for the purpose of offering opinion evidence on the value of property or an interest in property, any individual who has violated the provisions of section 6701 of the Internal Revenue Code. Thus, an appraiser who aids or assists in the preparation or presentation of an appraisal in connection with the tax laws will be subject to disciplinary action if the appraiser knows that the appraisal will be used in connection with the tax laws and will result in an understatement of the tax liability of another person if so used.

Effective Date

The provision will apply upon enactment.

7. Provisions Relating to Individual Retirement Accounts (sec. 152 of the bill and secs. 408 and 6693 of the Code)

Present Law

An individual may deduct amounts contributed to an individual retirement account (IRA). A contribution for a taxable year is considered as having been made on the last day of the taxable year, if the contribution is made not later than the time prescribed for filing the return for the taxable year (including extensions). In the case of a calendar year taxpayer who is not granted an extension in the due date for filing his or her return, this means that a contribution made to an IRA for 1983 may be deducted on the 1983 tax return as long as the conntribution in made by April 15, 1984.

The trustee of an individual retirement account or individual retirement annuity is required to report to the Secretary of the Treasury and the individual for whom the IRA is maintained on contributions, distributions and other relevent matters required under regulations issued by the Secretary. The regulations are required to prescribe the time and manner in which the reports will be filed with the Secretary and furnished to the individual.

In the event of a failure to file a report regarding an IRA at the time and in the manner required, the person responsible for making the reports will pay a penalty of $10 for each failure, unless it is shown that the failure to file is due to reasonable cause.

Reasons for Change

The committee has learned that the annual IRA reports are not being filed in the time and manner that is desired. When reports are filed, the information concerning contributions made during the course of a year is stated as a single total and does not distinguish between contributions that may have been made for different years. As a result of these shortcomings, the committee decided to reaffirm the Secretary's authority in present law to require reporting as to each year for which contributions are made and to increase the penalty for failure to file in the manner and by the time required.

Additionally, the committee is concerned that the ability of taxpayers to make contributions between the time (without extensions) prescribed for filing the return for the taxable year and that time with extensions impedes the Secretary's ability to monitor deductions for these contributions.

Explanation of Provision

Section 408(i) which requires that the trustee of an IRA make required reports is amended to require that the report show both the total amount contributed each year and the taxable years to which the contributions relate.

Section 408 is also amended to require that all contributions relating to a taxable year must be made no later than the due date (without extensions) for filing the return for the taxable year. For most taxpayers, this date is April 15.

The penalty for failure to provide reports on individual retirement accounts and annuities is increased from $10 to $50 for each failure.

Effective Dates

The amendment to require that reports indicate the year to which a contribution relates shall apply to contributions made after 30 days after the date of enactment, for taxable year beginning after December 31, 1983.

The amendment to require that contributions relating to a taxable year must be made no later than the due date (without extensions) for filing the return for that taxable year would apply to contributions made after 30 days after the date of enactment, for taxable years beginning after December 31, 1983. Consequently, this amendment does not affect, for example, a taxpayer who obtains an extension to file from April 15, 1984, to August 15, 1984, who makes a contribution on July 31, 1984, and who deducts the contribution on his tax return for 1983.

The amendment to increase the penalty shall apply to failures occurring after the date of enactment.

8. Statements Required in Case of Certain Substitute Payments (sec. 153 of the bill and sec. 6045 of the Code)

Present Law

A broker who holds stock in street name for a customer may lend that stock to another customer for use in a short sale. The short-seller sells the borrowed stock with the expectation that the price of the stock will decline and expects to be able to purchase stock to return to the lending broker at a price below the proceeds of the sale. If a dividend is paid on the borrowed stock, the short-seller must pay the lender an amount in lieu of the dividend. The actual dividend is received by the purchaser in the short sale. If the borrowed stock belonged to a corporate client of the broker, the corporation is not entitled to the dividends received deduction on the amount of the payment received in lieu of the dividend.

A broker may engage in a similar transaction with tax-exempt bonds. Payments of interest on the bonds are tax-exempt to the purchaser in the short sale, while the interest-substitute payments to the client of the broker are not tax-exempt.

Reasons for Change

The committee understands that the inadequacy of the reporting requirements under present law has led to situations in which the dividends received deduction is being claimed twice with respect to the same stock because corporations who have deposited stock with their broker are unaware that the stock has been lent out in connection with a short sale and that the payment they have received is not a dividend but a dividend-substitute payment. A similar situation exists with respect to interest on tax-exempt bonds. The committee decided that a change in broker reporting requirements is needed so that customers of brokers can be informed of the action on the short sale so that they will not take improperly the dividend received deduction or the exemption for interest on tax-exempt bonds.

Explanation of Provision

The Secretary will be authorized to require that any broker who lends stock of a corporate customer for use in a short sale, and receives (on behalf of the customer) a payment in lieu of a dividend on such stock during the period the short sale is open, will furnish the corporate customer a written statement identifying the payment as being in lieu of a dividend payment.

The Secretary would also be authorized to require that any broker who lends tax-exempt bonds for use in a short sale, and receives (on behalf of the customer) a payment in lieu of the tax-exempt interest on the bonds during the period the short sale is open, will furnish to the customer a written statement identifying the payment as being in lieu of tax-exempt interest. The Secretary is authorized to promulgate regulations containing similar rules for other items if he determines this type of reporting would improve compliance. The Secretary is also authorized to require that brokers make a return to the IRS containing the information provided the customer.

The regulations shall prescribe the time and manner for furnishing the statement to the customer.

Effective Date

The amendment made by this section shall apply to payments received after December 31, 1984.

9. Charitable Contribution Valuation Rules; Modifications to Incorrect Valuation Penalties (sec. 154 of the bill and secs. 170, 6050, and 6659 of the Code)

Present Law

Substantiation

Present law provides that a charitable contribution is allowable as a deduction only if verified under Treasury regulations (Code sec. 170(a)(1)). Certain substantiation requirements are set forth in Treas. Reg. sec. 1.170A-1(a)(2), including additional information which must be attached to the donor's return in the case of donations of property for which a deduction exceeding $200 is claimed. While a taxpayer who obtains an appraisal is required by the regulations to attach a copy of the appraisal to the return, there is no specific requirement under present law that any appraisal must be obtained before claiming a deduction for gifts of property.

Overvaluation penalty

Present law imposes a graduated penalty for valuation overstatements by individuals, closely held corporations, and personal service corporations, subject to certain exceptions and a waiver provision. If the value (or basis) of property claimed on a return is 150 percent or more but not more than 200 percent of the correct amount, an addition to tax is imposed equal to 10 percent of the understatement attributable to the overvaluation. This penalty increases to 20 percent if the value (or basis) claimed is more than 200 but not more than 250 percent of the correct amount, and to 30 percent if the value (or basis) claimed is more than 250 percent of the correct amount (sec. 6659).[1]

Under present law, there are two exceptions to the section 6659 penalty. First, the penalty does not apply if the underpayment for a taxable year attributable to the valuation overstatement is less than $1,000. Second, the penalty is inapplicable to any property which, as of the close of a taxable year for which there is a valuation overstatement, had been held by the taxpayer for more than five years.

In addition, the IRS has discretionary authority to waive all or part of the penalty on a showing by a taxpayer that there was a

[1] For example, assume that a painting, which has been valued by a taxpayer (with a 50-percent marginal rate) at $500,000 for income tax purposes, is finally determined to have a value of $100,000. As a result of overstating the value of the painting, the taxpayer had claimed a $500,000 charitable contribution deduction for the year she donated it to a university museum, thereby reducing her tax liability by $250,000. Had the taxpayer claimed only the charitable deduction to which she was entitled ($100,000), her tax liability would have been reduced by only $50,000. Thus, because of the valuation overstatement, the taxpayer underpaid her income tax liability by $200,000. Accordingly, the addition to tax applicable to the valuation overstatement would be $60,000 (i.e., 30 percent of $200,000).

reasonable basis for the valuation (or basis) claimed on the return and that the claim was made in good faith.

Reasons for Change

The committee recognizes that the tax benefits provided to taxpayers who contribute appreciated property to charities create opportunities for overvaluations because the donor is entitled to deduct the fair market value of the property, but does not realize taxable gain equal to the appreciation. One way to reduce these opportunities to overvalue would be to eliminate the advantage that charitable gifts of appreciated property have over gifts of cash. The committee recognizes, however, that many charitable organizations depend on this tax benefit for fund-raising and as a means of acquiring valuable property.

At the same time, the committee understands that in recent years, opportunities to offset income through inflated valuations of donated property have been increasingly exploited by tax shelter promoters. Under typical tax shelter promotions, individuals acquire objects such as limited edition lithographs, books, gems, and the like, hold the property for at least the capital gains holding period, and then contribute the items to a museum, library, educational institution, or other qualified donee at their "appreciated" fair market value. The shelter package may include an "independent" appraisal, and the potential donor may be assured that his or her subsequent gift will be accepted by a charitable organization.

Also, the committee is concerned with other situations where individuals buy items on their own initiative specifically for contribution after expiration of the one-year capital gains holding period, or overvalue items which they have held for long periods before donating them to a charity. While some of the most flagrant overvaluation cases which have come to attention have involved gems donated to museums, deductions denied by the IRS on the basis of overvaluation also have involved contributions of other types of property, such as interests in real estate, and contributions made to other types of donees, such as educational institutions.

The committee is aware that in various instances, the IRS has succeeded in challenging overvaluations claimed by donors, and that the IRS has initiated a special audit program to combat charitable contribution tax shelters. However, it is not possible to detect all or even most instances of excessive deductions. Because of the subjective nature of valuation, taxpayers may continue to play the "audit lottery" and claim excessive charitable deductions. The committee is also concerned that the publicity given to the extent of gross overvaluations by some donors encourages other taxpayers, who are not in a position to claim inflated deductions for donations of property such as art works, gemstones, antiques, rare books, real estate, etc., to have disrespect for the tax law.

Because of these concerns, the committee believes that stronger substantiation and overvaluation provisions should be made applicable to charitable contributions of property. Further, the committee believes that the present-law incorrrect valuation penalty should apply whether the property is held for fewer or more than five years, and that it is equally important to deter incorrect valuations for estate and gift tax purposes. Accordingly, the committee believes that the section 6659 penalty should be generally modified in certain respects, including applying the penalty to incorrect valuations in the case of estate and gift tax returns. The committee believes that these provisions of the bill will be effective in deterring incorrect valuations and will assist the IRS in administering the law.

Explanation of Provisions

Substantiation requirements

General rule

The bill imposes appraisal and information reporting requirements where the claimed value exceeds certain dollar amounts for a charitable contribution of property, other than contributions of securities for which (as of the date of the contribution) market quotations are readily available on an established securities market. These requirements apply to charitable deductions claimed under Code section 170 by an individual,[2] a closely held corporation, or a personal service corporation.

Under the bill, the appraisal and information reporting requirements apply (1) if the claimed value of donated property in a year exceeds $2,000 for any single item of such property or for any collection or group of similar items of such property (such as a set of lithographs) donated during the year to a particular charity, or (2) if the total claimed value of all such property other than gifts described in (1) given to one or more charities exceeds $5,000 in the aggregate for the year. Deductions for other donations of property continue to be subject to substantiation requirements pursuant to regulations issued under section 170.

Appraisal

Where these rules apply, the donor must obtain a written appraisal stating the property's fair market value on the date of contribution. (As reflected by the requirements below, the appraisal must be received by the donor before filing of the return on which the deduction is first claimed.) Appraisals for which the fee is based on a percentage of the appraised value cannot qualify, but appraisals are not disqualified where all or a portion of the fee is based on a sliding scale if the portion of the fee based on a sliding scale is paid to any generally recognized association which regulates appraisers.

The appraisal must be made by a person who is qualified to make appraisals of the type of property donated. The appraisal cannot be made by the taxpayer, a party to the transaction in which the taxpayer acquired the property, the donee, or any person related to or regularly employed by any of the foregoing. Thus, for example, a taxpayer who acquired a painting from an art dealer could not use an appraisal from that dealer, persons regularly em-

[2] In the case of partnerships or S corporations, the requirements apply where a partner or S corporation shareholder includes a deduction on his or her return on account of a charitable contribution of such property by the partnership or S corporation.

ployed by the dealer, or related persons (within the meaning of sec. 267(b)).[3]

The bill also requires that the appraisal must include a description of the donated property, the fair market value of the property on the date of contribution, the specific basis for the valuation (e.g., comparable sales), and the qualifications of the appraiser. Also, the appraisal must state that it is being prepared for income tax purposes, and must be signed by the appraiser, whose tax identification number must be listed. Accordingly, the appraiser is a person to whom the civil tax penalty for aiding and abetting an understatement of tax liability (sec. 6701) could apply.

The donor must attach to the return on which the deduction is first claimed a summary of the written appraisal, with such information and in a form to be prescribed by the Treasury Department. The appraisal summary must be signed by the appraiser and list the appraiser's tax identification number. The donor must retain the appraisal itself.

In addition, the donor must include in the return statements of the cost basis and the acquisition date of the donated property, and any other information to the extent required by Treasury regulations. If there is reasonable cause why the donor does not have information on the cost basis or acquisition date, the donor may substitute an explanatory statement, pursuant to Treasury regulations, with the return.

If a donor fails to comply with these requirements, then the amount of deduction otherwise allowable is reduced by the greater of (1) the amount of the otherwise allowable deduction in excess of the donor's basis for the donated property, or (2) ten percent of the otherwise allowable deduction. However, the IRS, in its discretion, may waive all or part of this disallowance if the taxpayer establishes that there was reasonable cause for failure to comply with these requirements.

Information report by donee on sale

If the donee charity sells, exchanges, or otherwise transfers such donated property within two years of the date of receipt, the donee must furnish an information report to the IRS (with a copy to the donor) setting forth the donor's name and tax identification number, a desoription of the property, the date of contribution, the amount received on the disposition and the date of disposition. The bill provides certain penalties for failure to comply with these requirements.

Disallowance for certain overvaluations

The bill provides for disallowance of otherwise allowable charitable deductions under section 170 where the claimed value of property with respect to which a charitable deduction is taken exceeds the correct value (i.e., the value determined by a court or by agree-

[3] The committee expects that in certain instances an appraiser who is regularly retained by a party could be considered, pursuant to Treasury regulations, as an employee of that party for purposes of this appraisal requirement (for example, where a longstanding relationship with the appraiser would cause a reasonable person to question the independence of the appraiser).

ment between the IRS and the taxpayer) by at least 50 percent. The disallowance operates as follows:

(a) If the claimed value is at least 150 percent, but less than 175 percent, of the correct value, then the disallowance equals one-half of the amount of any otherwise allowable deduction in excess of the taxpayer's basis in the property.

(b) If the claimed value is at least 175 percent, but less than 200 percent, of the correct value, then the disallowance equals the amount of the otherwise allowable deduction in excess of basis.

(c) If the claimed value is 200 percent or more of the correct value, then the donor would not be entitled to any deduction (either basis or value) for the property.

This disallowance is not subject to any reasonable cause exception or waiver authority. The disallowance applies without regard to whether the section 6659 penalty applies to the taxpayer.

Modifications to section 6659 penalty generally

The bill amends the section 6659 penalty generally (i.e., for all incorrect valuations made subject to the penalty) by deleting the exception for property held for more than five years, and by extending the penalty to incorrect valuations for estate and gift tax purposes. In this regard, section 6659 is modified to apply in the case of valuation understatements. If the claimed value is two-thirds or less but not less than 50 percent of the correct value, an addition to tax is imposed equal to 10 percent of the understatement attributable to the undervaluation. The addition to tax increases to 20 percent if the value claimed is more than 40 percent but less than 50 percent of the correct amount, and to 30 percent if the value claimed is less than 40 percent of the correct amount. The exception in present law for an understatement of less than $1,000 and the reasonable cause waiver authority in present law will apply with respect to such incorrect valuations.

Effective Date

The appraisal requirements (including the disallowance sanction for failure to comply) and the donee information reporting requirement apply to charitable contributions made after December 31, 1984. The overvaluation disallowance rule and the section 6659 penalty changes apply to returns filed after December 31, 1984.

Revenue Effect

The amendments made by this section of the bill are estimated to increase fiscal year budget receipts by $14 miilion in 1985, $40 million in 1986, $46 million in 1987, $52 million in 1988, and $57 million in 1989.

10. Disclosure of Return Information to Local Agencies (sec. 155 of the bill and sec. 6103 of the Code)

Present Law

Section 6103 provides for the confidentiality of returns and return information of taxpayers. The conditions under which returns and return information can be disclosed are specifically enumerated in that section. Disclosure of returns and return information to local income or wage tax administrators is not permitted. Unauthorized disclosure is a felony punishable by a fine not exceeding $5,000 or imprisonment of not more than 5 years, or both, under section 7213. An action for civil damages may also be brought for unauthorized disclosure under section 7431.

Reasons for Change

The committee would like to enable large cities that impose either an income or a wage tax to receive returns and return information in the same manner, and with the same safeguards, as States are eligible to do.

Explanation of Provision

The bill provides that the Secretary may, in his sole discretion, disclose returns and return information to local tax administrators of jurisdictions with a population in excess of 2 million that impose an income or wage tax. Any disclosure would be required to be in the same manner and with the same safeguards as disclosure is made to a State. The present law requirements of maintaining a system of standardized requests for information and the reasons for the request and of maintaining strict security against release of the information are also made applicable to the local agencies. Disclosure will be permitted only for the purpose of, and only to the extent necessary in, the administration of a local jurisdiction income or wage tax. Disclosure of returns or return information to any elected official or the chief official (even if not elected) of the local jurisdiction will not be permitted. Any unauthorized disclosure of returns and return information by an employee of an agency receiving this information will subject the employee to the fine and imprisonment provided by section 7213 and to the civil action provided by section 7431.

Effective Date

This provision will be effective on the date of enactment.

11. Tax Court Small Tax Case Provision (sec. 156 of the bill and sec. 7463 of the Code)

Present Law

Under present law, taxpayers using the "small tax case" procedure many appear pro se or be represented by any person admitted to practice before the Tax Court. In general, small tax cases are cases involving $5,000 or less for any one taxable year or period. Such proceedings are generally conducted in a more informal atmosphere, and the Court's opinion is final and may not be appealed.

Reasons for Change

The committee believes that Tax Court cases could be handled more expeditiously if the dollar limit on the cases in which the taxpayer may elect the small tax case procedures were raised.

Explanation of Provision

The bill raises the dollar limit in small tax cases to $10,000.

Effective Date

The provision will be effective on the day after enactment of the bill.

12. Changes in Accounting Method (sec. 157 of the bill and sec. 446 of the Code)

Present Law

Under present law, a taxpayer is not permitted to change its method of accounting without the consent of the Secretary. Some taxpayers who are using improper methods of accounting have argued that there is no requirement that they request permission to change from the improper to a proper method of accounting. Thus, they assert the failure of the Secretary to consent to a change in method as a defense to, for example, the negligence penalty.

Reasons for Change

The committeee believes that the interpretation placed on present law by taxpayers with improper methods of accounting may create an unintended protection against penalties for taxpayers.

Explanation of Provision

The bill provides that a failure to file a request of the Secretary to change a method of accounting will bar the taxpayer from asserting as a defense to any penalty under the Code the fact that a change from the method of accounting was not permitted because the Secretary has not given his consent. Thus, a taxpayer using an improper method of accounting cannot assert that such conduct was not negligent because permission has not been granted to change to a permissible method.

Effective Date

The amendments relating to changes in accounting method will apply in taxable years beginning after the date of enactment. The committee does not intend that any inference be drawn with respect to the validity of the defense asserted by some taxpayers under present law.

13. Interest on Failure to File, Valuation Overstatement, and Substantial Understatement Penalties (sec. 158 of the bill and secs. 6651, 6659, and 6661 of the Code)

Present Law

A taxpayer who fails to file a tax return by the date required (unless the failure is due to reasonable cause and not to willful neglect) is subject to an addition to tax of 5 percent of the amount of tax due for the first month of the failure to file, and 5 additional percent for each additional month, up to a maximum of 25 percent (sec. 6651). A taxpayer who files a tax return on which there is a valuation overstatement is subject to an addition to tax of from 10 to 30 percent (depending on the amount of overstatement) of the understatement of tax attributable to the valuation overstatement (sec. 6659). A taxpayer who files a tax return on which there is a substantial understatement of tax is subject to an addition to tax of 10 percent of the amount of the underpayment attributable to the understatement (sec. 6661). Interest on penalties and additions to tax is generally imposed only for the period from the date of notice and demand to the date of payment (sec. 6601(e)). A time sensitive, interest-like element is added to the negligence and fraud penalties for the period from the last day (without extensions) prescribed by law for payment of the tax to the date of the assessment of the tax (or, if earlier, the date of payment of the tax) (sec. 6653).

Reasons for Change

The committee believes that the strength of the failure to file, valuation overstatement, and substantial understatement penalties should not be diluted by delays, which may be substantial when a taxpayer purposefully resorts to every available administrative and judicial process to avoid resolution of a case. An interest element running from the due date of the return should be added to these penalties to increase their efficacy. Specifically, the committee does not believe that a taxpayer who delays resolution of his case should be subject to a lighter penalty (by reason of the time value of money) than a taxpayer who settles his case promptly.

Explanation of Provisions

The bill provides that interest at the rate prescribed in section 6621 shall be imposed on the addition to tax prescribed for the failure to file a tax return under sec. 6651(a)(1) as if the entire amount of addition to tax that is due were required to be paid on the due date of the return (with extensions). The bill also provides that interest shall be imposed on the addition to tax prescribed for a gross valuation overstatement under sec. 6659 and for a substantial understatement of liability under sec. 6661 from the due date of the return (with extensions) with respect to which the valuation overstatement or the substantial understatement was made to the date of payment.

Effective Date

These provisions are effective for interest accruing on or after the date of enactment with respect to additions to tax for which notice and demand is made after the date of enactment.

14. Penalty for Fraudulent Withholding Information (sec. 159 of the bill and sec. 7205 of the Code)

Present Law

Section 7205 provides that an individual required to supply information under section 3402 who willfully supplies false or fraudulent information or willfully fails to supply information (such as, for example, on a Form W-4) is subject to a criminal penalty or a fine not to exceed $1,000 or imprisonment of not more than one year, or both. The penalty also applies to certain false certifications made in connection with backup withholding under either section 3406 or 6676. The penalty is in lieu of any other penalty provided by law, except the penalty provided by section 6682.

Reasons for Change

The committee is concerned that the language providing that this penalty is in lieu of any other penalty might be read to provide that an individual who willfully attempts to evade tax and who also files a false Form W-4 would only be subject to a criminal penalty for filing a false Form W-4 and not to the willful attempt to evade tax penalty under section 7201. The committee believes that the criminal penalty under section 7205 should not be exclusive. This result is in accordance with *United States* v. *Grumka* (6th Cir., No. 83-1550, March 5, 1984).

Explanation of Provision

The bill provides that the penalty is in addition to any other penalty provided by law.

Effective Date

This provision will take effect for actions or failures to act occurring after the date of enactment.

15. Federal Tax Deposits (sec. 160 of the bill and sec. 7502 of the Code)

Present Law

Employers are required to deposit employment taxes (such as income tax withheld from employees and FICA taxes) in designated accounts in banks or other financial institutions. Deposits must be made as frequently as 8 times per month, depending on the amount required to be deposited. Interest and penalties may be imposed if a deposit is not made by the date due. Employers may treat a deposit as timely made if it is mailed as required two days prior to the due date of the deposit.

Reasons for Change

Some corporations are abusing the timely mailing rule by using certified or registered mail to deposit taxes with distant financial institutions, thereby retaining the use of the funds until after the due date. Consequently, the funds are not deposited by the appropriate date and the funds are unavailable to the Treasury. The depositor retains use of the funds until the deposit is delivered. The committee understands that in some instances delays in deposit (and the resulting use of funds) of up to 2 weeks may be achieved.

Explanation of Provision

The bill amends section 7502 to provide that a deposit in excess of $20,000 from a large depositor that is required to be made on a prescribed date must be made by that date, regardless of the method of delivery. A large depositor is a depositor required to make deposits more than once a month under the regulations prescribed under section 6302. It is immaterial whether the depositor in fact makes deposits more than once a month or not. The committee believes that the $20,000 threshold distinguishes appropriately between large and small depositors.

Effective Date

This provision will be effective for deposits required to be made after June 30, 1984.

16. Damages for Instituting or Maintaining Proceedings Before the Tax Court Primarily for Delay (sec. 161 of the bill and sec. 6673 of the Code)

Present Law

Section 6673 gives the Tax Court discretionary authority to award damages of up to $5,000 against taxpayers who institute or maintain proceedings primarily for delay or upon frivolous grounds. TEFRA increased the maximum amount of the damages from $500 to $5,000, and provided that the penalty could be asserted when proceedings were "maintained" in addition to "instituted," effective for any action or proceeding in the Tax Court commenced after December 31, 1982.

Reasons for Change

The committee believes that the Tax Court should have discretionary authority to award the increased amount of damages in any currently docketed case, not only actions and proceedings commenced after December 31, 1982. This is consistent with the TEFRA amendment in that damages can be awarded not only where actions are "instituted," but also where they are "maintained" for delay.

Explanation of Provision

The bill provides that, in addition to its current application, section 6673 can be applied to any proceeding before the Tax Court as of 120 days after the date of enactment. This 120-day period provides taxpayers who maintain proceedings before the Tax Court potentially subject to damages under section 6673 because of this amendment to withdraw or settle those proceedings before the awarding of the increased maximum amount of damages can occur.

Effective Date

The provision becomes effective 120 days after enactment.

17. Backup Withholding on Independent Contractors (sec. 162 of the bill and sec. 3406 of the Code)

Present Law

Section 3406(e) provides that if a payee of any reportable payment does not furnish his taxpayer identification number (TIN) to a payor in the manner required, backup withholding will apply to any reportable payment made by the payor to the payee. A reportable payment is a payment required to be shown on returns under sections 6041 (relating to information at source), 6041A(a) (relating to remuneration for services), 6042(a) (relating to dividends), 6044 (relating to patronage dividends), 6045 (relating to returns of brokers), 6049(a) (relating to interest), and 6050A (relating to certain fishing boat operators). The Treasury Department has issued temporary regulations that require that the payee certify that his TIN is correct under penalties of perjury for payments of interest, dividends, patronage dividends, and amounts subject to broker reporting. The payee may provide his taxpayer identification number in any manner for other types of reportable payments under the temporary regulations.

Reasons for Change

The committee believes that in general the Secretary's authority to require that the payee certify that his TIN is correct under penalties of perjury should be limited to payments of interest, dividends, patronage dividends, and amounts subject to broker reporting.

Explanation of Provision

The bill amends section 3406 to provide that the Secretary's authority to require that the payee certify under penalties of perjury that his TIN is correct, is limited to interest, dividends, patronage dividends, and amounts subject to broker reporting. With respect to other reportable payments, the Secretary may provide that the TIN may be furnished in any manner, except that certification under penalties of perjury may not be required. The Secretary may require, however, that any TIN be certified without regard to this restriction after the Secretary notifies the payor that the TIN furnished by the payee is incorrect.

Effective Date

The provision will be effective for any TIN required to be furnished after the date of enactment.

18. Reporting of State Tax Refunds (sec. 163 of the bill and sec. 6050E of the Code)

Present Law

An information return must be filed with the Secretary with respect to any State or local government income tax refund, credit, or offset aggregating $10 or more during the calendar year which is paid or credited to an individual. A statement showing the aggregate amount of the refunds must be furnished to the individual during January of the calendar year following the calendar year in which the amount is paid or credited to the individual. There is no specific enumerated penalty on the State or local government officer having control of the refunds for failure to file the statement required by section 6050E.

Reasons for Change

The committee believes that the burden on the State or local government of mailing separate statements to individuals in January should be reduced. The committee also believes that these information returns are significant compliance tools; consequently, State and local government officials who do not comply with the revised requirements should be penalized.

Explanation of Provision

The bill provides an exception to the general rule that the copy of the statement must be supplied to the individual during January of the year following the year in which a refund, credit, or offset of State or local income taxes is made. The exception is that a State or local government that makes a payment of refunds to an individual may supply the statement to the individual with the payment. The bill also provides that failures to file the statement required (unless the failure is due to reasonable cause and not willful neglect) will be subject to the section 6652(a) penalty of $50 for each failure, not to exceed $50,000 in any calendar year.

Effective Date

These provisions apply to any payment of refunds, credits, and offsets made after the date of enactment. The requirement contained in subsection (b) of section 6050E that statements be furnished to individuals is made effective for refunds, credits, or offsets occurring after the date of enactment. The committee intends that no punitive action be taken against any State or local government or any officer or employee of a State or local government who fails to provide a statement to taxpayers regarding refunds, credits, or offsets occurring on or before the date of enactment.

19. Clarification of Change of Venue for Certain Tax Offenses (sec. 165 of the bill and 18 U.S.C. 3257(b))

Present Law

The general venue provision for the prosecution of Federal offenses committed in more than one district is 18 U.S.C. 3237(a). Except as otherwise provided by law, a Federal offense may be prosecuted in any judicial district where the offense was begun, continued, or completed. An offense involving use of the mails, or transportation in interstate or foreign commerce, is a continuing offense which may be prosecuted in any judicial district from, through, or into which the mail or commerce moves.

Section 3237(b) modifies the general venue provisions of section 3237(a) in cases where a prosecution is instituted for violation of certain specific tax statutes (26 U.S.C. 7201 and 7206(1), (2), or (5)), the offense involves use of the mails, and the prosecution is commenced in a district other than the district in which defendant resides. Modification of the general venue provision is also provided for prosecutions under 26 U.S.C. 7203. In such cases, the defendent may file a motion within 20 days after arraignment electing to be tried in the district in which he was residing at the time the alleged offense was committed. The Courts of Appeal for the Second Circuit (*in re United States (Clemente),* 608 F.2d 76 (2d Cir. 1979), cert. denied, 446 U.S. 908 (1980)) and the Fourth Circuit (*in re Petition of the United States (Nardone),* 706 F.2d 494 (4th Cir. 1983)) have held that the transfer of venue election is available only when venue in the district of prosecution is dependent on the use of the mails. The Court of Appeals for the Ninth Circuit (*United States* v. *United States District Court (Solomon),* 693 F.2d 68 (9th Cir. 1982)) and several district courts have held, on the other hand, that when the mails are used as part of the offense, the election to transfer the prosecution is available even though venue is not based on the mailing.

Reasons for Change

The Committee agrees with the Committee on the Judiciary that the transfer of venue option was enacted to provide a defendant with a shield against having to defend a tax prosecution far from his residence where the place of prosecution is based solely on a mailing to a distant office of the Internal Revenue Service. It was not intended to be a sword permitting transfer on the election of the defendant in cases where the prosecutor seeks to establish venue wholly apart from the receipt by the Internal Revenue Service of materials transmitted by mail.

In Senate Report No. 98-225, the Committee on the Judiciary endorsed the view of the Second Circuit and the Fourth Circuit that section 3237(b) has no application in situations where venue is predicated on facts independent of any mailing. S. 1762, as reported, was passed by the Senate on February 2, 1984.

Explanation of Provision

The bill clarifies section 3237(b) by providing expressly that a transfer of venue is required only when the sole basis for venue in a particular district is the receipt by the Internal Revenue Service of mailed materials. This provision is identical to section 1208 of S. 1762, as passed by the Senate on February 2, 1984.

Effective Date

The provision will be effective on the date of enactment.

20. Tax Shelter Study (sec. 164 of the bill)

The bill provides that the Secretary of the Treasury shall submit to the Congress, by December 1, 1984, a report on a study of tax shelters. The study should specifically report on possible extensions or expansions of the minimum tax requirements, extension or revision of "at-risk" and "recapture" rules, the impact of changing depreciation methods to more closely reflect economic depreciation and of providing a full basis adjustment for the business tax credits, and proposals to limit the deductibility of artificial accounting losses.

21. Revenue Effects of Compliance Provisions

The compliance provisions of the bill are estimated to decrease fiscal year budget receipts by $2 million in 1984, and increase fiscal year budget receipts by $19 million in 1985, $100 million in 1986, $177 million in 1987, $232 million in 1988, and $251 million in 1989.

L. Depreciation Provisions

1. Twenty-year Accelerated Cost Recovery for Real Property (sec. 171 of the bill and sec. 168 of the Code)

Present Law

Under the accelerated cost recovery system (ACRS), most domestic real property qualifying as recovery property may be depreciated, under tables prescribed by the Treasury, over 15 years. The 175-percent (200-percent in the case of low-income housing) declining balance method, switching to the straight-line method, may be used. For this purpose, real property includes elevators and escalators. Depreciation is allowed based on the number of months during a taxable year the property is in service. Elections are provided to use the straight-line method over 15, 35, or 45 years.

Recovery property is generally property placed in service by the taxpayer after December 31, 1980. However, certain property placed in service by the taxpayer after December 31, 1980, will not qualify as recovery property. For example, if, after December 31, 1980, a taxpayer buys property from a person who owned it at any time in 1980, and leases it back to such person, the property will not qualify as recovery property. Furthermore, under section 168(f)(10)(B)(i), the transferee of property in certain carryover basis transactions is required to be treated as the transferor for purposes of determining depreciation deductions to the extent of the carryover basis.

In general, each component of a building is to be depreciated in the same manner as the building itself. However, the first component placed in service by a taxpayer after December 31, 1980, with respect to a building placed in service by the taxpayer before January 1, 1981, may be depreciated as recovery property under ACRS even though the building cannot. Subsequent components are to be depreciated in the same manner as such first component.

Under section 57(a)(12)(B), accelerated cost recovery deductions with respect to 15-year real property constitute an item of tax preference for purposes of the corporate minimum tax. The item of tax preference is the excess of the deduction allowed over the deduction which would have been allowed had the property been depreciated on a straight-line basis over 15 years.

Reasons for Change

Prior to the Economic Recovery Tax Act (ERTA) of 1981, real property could be depreciated on a component-by-component basis over a depreciation period based on the estimated economic life of each component. The average depreciation period for real property was over 30 years. ERTA reduced the minimum depreciation period for most real property, and components, to 15 years—less than one-half the estimated economic life of real property under prior law.

This overly generous depreciation for real property has contributed to the rapid growth of tax-oriented real estate partnerships. The most recent Statistics of Income data show that one-third of all partnerships filing returns in 1981 were primarily engaged in real estate transactions. Of these 522,000 real estate partnerships, 59 percent reported no taxable income; instead they claimed tax losses of $17.8 billion.

The 50-percent reduction in the depreciation period for real property has also resulted in a growing number of sale-leaseback transactions involving corporate headquarters, hotels, retail stores, and other types of real property. In these transactions, corporations with taxable income insufficient to utilize accelerated depreciation deductions on new construction have sold buildings to tax-shelter partnerships and leased them back. Such transactions are known as "depreciation strips" since the corporation guarantees to lease the property and pay all operating costs on a long term basis; in effect, this leaves the purchaser with the right to depreciate the property. The liberalization of the depreciation rules in 1981 has also encouraged pre-1981 investors, who rely on the old depreciation rules, to "churn" their property, i.e., to sell to new investors who can utilize ACRS deductions. These "depreciation strips" and related churning transactions have a large tax revenue cost, and do not increase capital formation or economic growth.

In addition to the liberal depreciation rules, real property benefits from other special provisions of the tax code. Real property is exempted from the "at-risk" rules, which permit deduction of interest payments and depreciation only to the extent that the investor is at-risk. This exemption is especially valuable in real estate investments, which are often heavily financed with non-recourse debt. Real property also benefits from special recapture rules. If the straight-line method of depreciation is used, none of the gain on resale is recaptured (i.e., subject to tax as ordinary income). For residential property, more favorable rules require only partial recapture for property depreciated under an accelerated method. Finally, a number of taxpayers defer recognition of gain by using the installment sale rules. Under the installment method, the buyer gives the seller a note for the property which is paid in subsequent years. The buyer immediately obtains depreciation deductions on the property, but the seller only recognizes gain as installments are received. This mismatch of income and deductions, as a result of the deferral of gain, can result in a substantial tax reduction.

Rapid depreciation, high interest deductions, favorable recapture rules, and the installment sale method are combined in tax-oriented real estate shelters to achieve low or even negative effective tax rates. A negative tax rate results when tax deductions are larger than the property's gross income, in present value terms. In this situation, the government, in effect, provides a cash subsidy for investment. Thus, the tax system may encourage investment in certain real property projects which have a fairly low pre-tax rate of return, because of the off-setting tax subsidies. For example, despite the glut of rental housing in certain Sun Belt regions, syndicated tax shelters have continued to overbuild. Investors can more readily afford to finance construction in markets with high vacancy rates because of the generous depreciation deductions and other tax benefits associated with residential property. The nation's economic growth is reduced to the extent that investment is diverted from more productive investments, with a higher pre-tax rate of return. To maximize economic growth, it is necessary to ensure that the tax system does not distort the flow of capital to the most productive investment projects.

To some extent, this overly generous depreciation has encouraged businesses and individuals to rent property from tax shelters rather than to own the buildings and other property they use. It also may have the unintended effect of encouraging the growth of sale lease-backs, churning, and other tax-motivated transactions which contribute nothing to net capital formation and economic growth. The committee believes that increasing the depreciation life of real property in the 15-year recovery class by 5 years will reduce the tax revenue cost associated with tax-motivated real estate shelters, "depreciation-strips," and churning transactions without harming incentives for capital formation in the most productive real property investments. Even at 20 years, the depreciation period for real property is at least one-third less than the average life of real property under pre-1981 law. The 5-year stretchout of the recovery period for real property will reduce the economic inefficiency and tax revenue cost associated with purely tax-motivated transactions. This provision will also reduce overbuilding and improve the allocation of capital. Finally, increasing the recovery period to 20 years will make it less likely that investors will be able to combine tax benefits to achieve negative effective tax rates (i.e., subsidies) on debt-financed property.

Explanation of Provisions

Under the bill, real property which under present law would be eligible to be written off over 15 years is to be written off over not less than 20 years. This is 20-year real property. However, as under present law, the 175-percent declining balance method, switching to the straight-line method, may be used under tables to be prescribed by the Secretary. Under the bill, taxpayers may elect to depreciate 20-year real property on a straight-line basis over 20, 35, or 45 years, but not 15 years.

No building components covered by the bill are to be written off more rapidly than is discussed above, regardless of how the building is being depreciated. All building components covered by the bill are to be written off in the same manner. For example, assume that a taxpayer placed a building in service on December 31, 1983, and added the first component to it on December 31, 1984. The bill applies to the component even though the building is being depreciated under ACRS over 15 years.

The bill makes numerous conforming changes. For example, accelerated cost recovery deductions with respect to 20-year real property are tax preference items for purposes of the corporate minimum tax. The tax preference amount is the excess of the deduction allowed over what would have been allowed had the property been depreciated on the straight-line method over 20 years.

The bill also clarifies that the rehabilitation tax credit is allowable only with respect to 15-year or 20-year real property.

The provision is not applicable to low-income housing (or components thereto). For this purpose, low-income housing means property described in clause (i), (ii), (iii), or (iv) of section 1250(a)(1)(B).

Effective Date

The provision is generally effective for property placed in service by the taxpayer after March 15, 1984. The committee anticipates that, under regulations, rules similar in concept to those of section 168(f)(10)(B)(i) will apply in determining allowable depreciation deductions.

Under transitional rules, the provision does not apply, except as noted below, to property the construction of which was commenced by or for the taxpayer on or before March 15, 1984. Nor does it apply, except as noted below, to property that the taxpayer was under a binding contract to construct or acquire on March 15, 1984. Neither transitional rule is applicable to property placed in service by the taxpayer after December 31, 1986.

The committee understands that taxpayers often (i) sign binding contracts to purchase or construct property, or (ii) commence, or have commenced for them, construction of property and then transfer their rights in the contract or the property before placing the property in service. The provision does not apply to property placed in service before January 1, 1987, by a transferee of a transferor-taxpayer's rights in such a contract or such property, but only if: (1) the bill would not have applied if the transferor-taxpayer had placed the property in service; and (2) the transfer occurs before the property is placed in service by the transferor-taxpayer.

The committee intends that construction is not to be considered to have commerced solely because drilling is performed to determine soil conditions, architect's sketches or plans are prepared, or a building permit is obtained. Generally, construction will be considered to have commenced when land preparations and improvements, such as clearing, grading, excavation (including any significant required archaeological excavation), or filling, are undertaken. However, construction will not be considered to have commenced solely because clearing or grading work is undertaken, or drainage ditches are dug, if such work is undertaken primarily for the maintenance or preservation of raw land and existing structures and is not an integral part of plan for construction. In the case of the demolition of existing structures where construction has not otherwise commenced, construction is considered to commence when demolition begins if the demolition is undertaken to prepare the site for specific construction. Construction will not be considered to have commenced solely because of the demolition of existing structures if demolition is not undertaken as part of a plan for the construction of specific buildings or improvements.

The committee also intends that construction of property is considered to have begun on or before March 15, 1984, if the property is an integral part of an integrated facility and construction of part of that facility began on or before March 15, 1984. An integrated facility is a multi-property facility constructed as a single project on a single site and to be operated as a single, unitary facility as described in a written plan (evidenced by internal documents of the taxpayer, such as purchasing and financing documents) existing on March 15, 1984. Property is an integral part of an integrated facility if:

(1) the property is described as part of the same project in written plans of the taxpayer in existence on March 15, 1984;

(2) the property is an integral part of the planned operation of the project when a significant part of the project will first be placed in service; and

(3) the property will be constructed during the same time as the rest of the project.

Thus, for example, three separate apartment builaıngs are not part of one integrated facility if it is planned that only one building will be placed in service initially. On the other hand, if a taxpayer plans to construct lodging and convention facilities and to operate them as a unit, then both a hotel and a separate convention center to be constructed during the same time on a single site are part of the same integrated facility because both properties are necessary for the consummation of the taxpayer's plan. However, if the hotel is planned to be ready to be placed in service in 1985, and construction of the convention center is not planned to begin until 1986, then those properties are not part of an integrated facility.

Although improvements such as parking lots, access roads, and utility hook-ups may be part of an integrated facility, the start of construction of such property (which can be used in connection with any type of facility) is not to be considered the start of construction of other property in the facility.

Revenue Effect

These provisions will increase fiscal year budget receipts by $95 million in 1984, $496 million in 1985, and $1,295 million in 1986, $2,341 million in 1987, $3,464 million in 1988, and $4,639 million in 1989.

2. Recapture and Installment Sales (sec. 172 of the bill and sec. 453 of the Code)

Present Law

When a taxpayer sells depreciable real property at a gain, some of the gain may be treated as ordinary income under the recapture rules of section 1245 or section 1250.

When a taxpayer sells property at a gain in a qualifying installment sale, generally no gain is recognized to the taxpayer until the taxpayer receives principal payments under the installment sale transaction. In general, an installment sale includes a sale of property where at least one payment is to be received after the close of the taxable year during which the sale occurs. In other words, if on January 1 a taxpayer sells an item of real property with a $20 basis for a $100 note payable more than one year thereafter, the taxpayer would recognize none of the gain in the year of the sale. This would generally be true even though all of the gain, when recognized, will be ordinary income under one of the recapture rules. Gain is recognized when principal payments are received. In general, the amount of gain to be recognized in any one year is that proportion of the payments received in that year which the gross profit realized or to be realized bears to the total contract price. Thus, if the taxpayer in the above example received a $20 principal payment in the year after the sale, $16 of it would be includible in income ($20 x $80/100). Under Treas. reg. sec. 1.1245-6(d)(1) and Treas. reg. sec. 1.1250-1(c)(6), all gain recognized under the installment sale is first treated as ordinary income up to the amount of recapture income realized by the taxpayer in the transaction.

Reasons for Change

In an installment sale, the buyer gives the seller a purchase note which is paid in subsequent years. Under current law, the buyer immediately obtains depreciation deductions on the property, but the seller only recognizes gain as installments are received. The mismatch of income and deductions, as a result of the essentially unrestricted deferral of tax on gain, lowers the overall effective rate of tax.

The current-law recapture rules for real property act to curb the incentive to "churn" property, i.e., to replace property as soon as depreciation and other deductions are exhausted. However, the installment sale rules permit the deferral of recapture and capital gains tax, and thus circumvent the disincentive for churning. Taxpayers using the installment method may be able to multiply the tax benefits of accelerated depreciation and investment credits by replacing property after the associated tax benefits are exhausted, which often occurs well before the expiration of the property's useful life.

Some have argued that gain on property, whether from appreciation in value or prior depreciation deductions, should be deferred until the installment payments are made, i.e., when the the seller has the cash to pay the tax. However, with respect to real property recapture income, the seller has already obtained the benefits of depreciation deductions claimed on the property prior to the sale. Thus the committee believes that deferral of gain, arising from prior real property depreciation deductions, cannot be justified on the grounds that the seller lacks the means to pay the tax.

The committee believes that tightening the current-law installment sale rules will reduce the tax revenue cost associated with certain churning, sale lease-back, and other tax shelter transactions, without harming incentives for more productive types of investment. In addition, limiting the deferral of gain available in installment sales will reduce the tax advantage of investors who churn property compared to those investors who hold property for substantially all of its economic life. Finally, this provision will make it more difficult for investors to multiply the tax benefits of the ACRS system, and to achieve negative effective tax rates (i.e., subsidies) by engaging in churning transactions.

Explanation or Provisions

Under the bill, the recapture rules of sections 1245 (insofar as it relates to real property) and 1250 override the installment sale rules. In other words, depreciation recapture income with respect to any real property will be recognized in full in the year of an installment sale of such property, even if no principal payments are received in that year. The committee intends that, for purposes of this rule, real property has the same meaning it does in section 189 of present law, determined without regard to subsection (d) thereof.

Under the provision, for purposes of applying the installment sale rules, the adjusted basis of the real property being sold is to be increased by the amount of recapture income includible in gross income in the year of the sale. Thus, assume in the example above that $10 of the $80 gain is real property recapture income. That $10 is includible in the year of the sale and is added to the $20 basis for purposes of applying section 453(c). Gross profit is therefore $70 ($100 less $30). Of the $20 payment received in the next year (and each year thereafter), $14 is includible in income ($20 x $70/$100).

Effective Date

The provisions are effective with respect to installment sales after March 15, 1984. However, the provisions are not applicable with respect to installment sales occurring after March 15, 1984, pursuant to a contract binding the taxpayer on March 15, 1984.

Revenue Effect

The provisions will increase fiscal year budget receipts by $39 million in 1984, $91 million in 1985, $177 million in 1986, $192 million in 1987, $209 million in 1988, and $226 million in 1989.

3. Non-accelerated Cost Recovery for Movies (sec. 173 of the bill and secs. 48 and 168 of the Code)

Present Law

Under the Economic Recovery Tax Act of 1981, most tangible personal property of a character subject to the allowance for depreciation which is placed in service after December 31, 1980, can qualify as recovery property, eligible for depreciation under the accelerated cost recovery system (ACRS). Most tangible personal property qualifying as recovery property can be depreciated, on an accelerated basis, over 3 or 5 years. Under section 168(e)(2), for depreciation purposes, recoverv property does not include depreciable personal property which the taxpayer elects to depreciate under the unit-of-production method, the income forecast method, or certain other methods of depreciation not expressed in a term of years. Under the income forecast method, a taxpayer can deduct in any taxable year that portion of its basis in property computed by multiplying that basis by a fraction the numerator of which is the income derived from the property in that year and the denominator of which is all the income which the taxpayer reasonably expects to derive from the property.

Present law also provides general investment credits for certain tangible personal property. In the case of eligible property which is not recovery property, the amount of the credit allowed depends on the useful life of the property. In general, if the useful life is 3 years or more but less than 5 years, a credit of 3⅓ percent is allowed. If the useful life is 5 years or more but less than 7 years, a credit of 6⅔ percent is allowed. In the case of property with a useful life of 7 years or more, a 10-percent credit is allowed. In the case of recovery property, a 6-percent credit is allowed for 3-year property, and a 10-percent credit is allowed for 5-year property. In the case of certain movies and video tapes, generally section 48(k) provides a special 6⅔-percent credit with respect to specified costs. Those costs may include certain contingent amounts which are deductible when paid or incurred under the principles of *Associated Patentees* v. *Commissioner,* 4 T.C. 979 (1945), acq., 1959-2 C.B. 3.

Reasons for Change

Present law is unclear as to whether movies or video tapes are eligible for ACRS or the general investment credit. For example, both, in the case of personal property, generally only apply to tangible personal property. While it has been held that negatives of feature films qualify as tangible personal property (*see,* e.g., *Walt Disney Productions* v. *United States,* 480 F.2d 66 (9th Cir. 1973), cert. denied, 415 U.S. 934 (1974)), Treas. reg. section 1.48-1(f) is to the contrary. Furthermore, despite the special credit rules of section 48(k), the committee understands that some taxpayers have taken the position that although movies and video tapes depreciated over the income forecast method or unit-of-production method are not recovery property for depreciation purposes, they nevertheless are eligible for the general investment credit and are not subject to section 48(k).

The committee desires to clarify the rules.

Explanation of Provisions

Under the bill, movies and video tapes cannot qualify as recovery property for either depreciation or investment credit purposes. Furthermore, only section 48(k) may be applicable to allow a credit.

The bill also clarifies that the general basis adjustment rules of section 48(q) are applicable to movies and video tapes. When a tax credit is allowable with respect to deductible contingent amounts, the amount deducted is to be reduced by the amount of what would otherwise have been the basis reduction.

Finally, the bill clarifies that the general investment credit at-risk rules of section 46(c) (8) and (9) are not to apply to qualified films and video tapes as defined in section 48(k).

Effective Dates

The provision to the effect that movies and video tapes cannot qualify as recovery property is effective as of the effective date of section 168. However, that provision is not applicable to qualified films and video tapes as defined in section 48(k) which the taxpayer, on a return filed before March 16, 1984, depreciated under ACRS. The provisions relating to the section 48(q) basis adjustment and the general investment credit at-risk rules of sections 46(c) (8) and (9) have the same effective dates as section 48(q) and sections 46(c) (8) and (9), respectively.

Revenue Effect

The provision will increase budget receipts by less than $10 million annually.

4. Election for Sound Recordings (sec. 173 of the bill and secs. 48 and 168 of the Code)

Present Law

Under the Economic Recovery Tax Act of 1981 (ERTA), most tangible personal property of a character subject to the allowance for depreciation which is placed in service after December 31, 1980, can qualify as recovery property, eligible for depreciation under the accelerated cost recovery system (ACRS). Most tangible personal property qualifying as recovery property can be depreciated, on an accelerated basis, over 3 or 5 years. Under section 168(e)(2), for depreciation purposes, recovery property does not include depreciable personal property which the taxpayer elects to depreciate under the unit-of-production method, the income forecast method, or certain other methods of depreciation not expressed in a term of years. Under the income forecast method, a taxpayer can deduct in any taxable year that portion of its basis in property computed by multiplying that basis by a fraction the numerator of which is the income derived from the property in that year and the denominator of which is all the income which the taxpayer reasonably expects to derive from the property. Contingent amounts (e.g., royalties, residuals, and participations) are frequently paid with respect to sound recordings to songwriters, publishers, unions, artists, and others. In many instances, such amounts (not including advance royalties) are deductible when paid or incurred under the principles of *Associated Patentees* v. *Commissioner,* 4 T.C. 979 (1945), acq., 1959-2 C.B. 3.

Present law also provides investment credits for certain tangible personal property. In the case of eligible property which is not recovery property, the amount of the credit allowed depends on the useful life of the property. In general, if the useful life is 3 years or more but less than 5 years, a credit of 3⅓ percent is allowed. If the useful life is 5 years or more but less than 7 years, a credit of 6⅔ percent is allowed. In the case of property with a useful life of 7 years or more, a 10-percent credit is allowed. In the case of recovery property, a 6-percent credit is allowed for 3-year property, and a 10-percent credit is allowed for 5-year property.

With certain exceptions, property which is used predominantly outside the United States does not qualify for the investment credit. Nor, in most cases, does property used by a tax-exempt organizaton or a governmental unit. Under the tax-exempt entity leasing portion of the bill, property used by certain foreign persons does not qualify for the credit either.

Reasons for Change

Sound recordings are frequently depreciated under the income forecast method or other methods of depreciation not expressed in a term of years. The committee understands that such methods of depreciation are often substantially more generous than ACRS would be.

Present law is unclear as to whether sound recordings and similar property are eligible for ACRS or the investment credit. For example, both generally apply only to tangible property. It is the position of the Treasury Department that sound recordings are not tangible property (Treas. reg. sec. 1.48-1(f)). But some courts have held to the contrary (*see* e.g., *EMI North America, Inc.* v. *United States,* 675 F. 2d 1068 (9th Cir. 1982). The committee wishes to clarify the status of sound recordings.

For depreciable personal property, ACRS and the investment credit rules were designed to provide tax benefits to a taxpayer worth, on a present-value basis, no more than what the value of the tax benefits would have been had the property been expensed in the taxable year it is placed in service. The use of a method of depreciation more generous than ACRS, combined with the claiming of an investment credit, provides tax benefits that are greater than current expensing. The committee believes such benefits are excessive.

Finally, the committee also understands that it is unclear under present law whether the distribution of the original or of copies of master sound recordings outside the United States causes the property to be treated as used predominantly outside the United States. The committee bill provides clarification on this issue.

Explanation of Provision

Under the bill, two options are provided with respect to each sound recording. First, a taxpayer can elect to depreciate a sound recording as if it were 3-year property and take a 6-percent investment credit (if otherwise eligible for the credit). This election will not be given effect unless all taxpayers with an ownership interest in the sound recording also so elect. Alternatively, the taxpayer, in the absence of such an election, can depreciate it under the income forecast method, deducting any contingent amounts to the extent permitted by present law, and take no investment credit.

If the taxpayer elects the first option, all capital costs, including all non-United States production costs but not including contingent amounts, are to be recovered under the rules applicable to 3-year property. Contingent amounts may continue to be deducted when paid or accrued to the extent they are deductible when paid or incurred under present law.

For purposes of determining any investment credit, basis or cost would include only qualified United States production costs. For this purpose, qualified United States production costs consist of production costs allocable to the United States (including possessions of the United States). Furthermore, no contingent amounts are to be treated as part of basis or cost for investment credit proposes.

The basis adjustment rules of section 48(q) are to apply, but the general investment credit at-risk rules (secs. 46(c) (8) and (9)) are not to apply.

No inference is intended as to whether sound recordings qualify as tangible personal property, including whether they otherwise qualify for the investment credit, under present law.

The bill also provides that the foreign use rules of section 48(a)(2) (relating to the investment credit) and section 168(f)(2) (relating to depreciation) are not applicable with respect to distributions of sound recordings outside the United States. Again, no inference is intended as to present law.

Finally, the bill provides that sound recordings used by foreign persons are not to be treated as used by tax-exempt entities.

A sound recording is defined as a work resulting from the fixation of a series of musical, spoken, or other sounds, regardless of the nature of the material objects in which such sounds are embodied.

Effective Dates

The provisions are generally effective for sound recordings placed in service after March 15, 1984. The provision to the effect that sound recordings used by foreign persons are not to be treated as used by tax-exempt entities has the same effective date as the tax-exempt entity leasing provisions of the bill.

Revenue Effect

The provisions will increase fiscal year budget receipts by $5 million in 1984, $10 million in 1985, $10 million in 1986, $10 million in 1987, $10 million in 1988, and $10 million in 1989.

M. Miscellaneous Reform Provisions

1. Inclusion of Tax Benefit Items in Income (sec. 175 of the bill and sec. 111 of the Code)

Present Law

Under present law, a taxpayer who recovers an item for which a deduction was claimed in a prior tax year must generally recognize income if the deduction resulted in reduction in taxes in the earlier year. Under the judicially created tax benefit rule, the taxpayer takes into income in the year of recovery an amount equal to the portion of the deduction that produced a tax benefit. Correspondingly, the taxpayer excludes from income an amount equal to the portion that did not produce a tax benefit. The rationale of the tax benefit rule is that the taxpayer should be put in more or less the same after-tax position as if only the proper amount had been deducted.

The tax benefit rule has been codified in section 111 as to recoveries of bad debts, taxes, and delinquency amounts previously deducted. If a previously-deducted amount is recovered, section 111 permits a "recovery exclusion" from gross income for an amount equal to the portion of the deduction in the prior year that did not reduce taxes.

Section 111, as amplified by regulations, has the effect of allowing an individual taxpayer to recover on a tax-free basis State taxes and other items deducted as itemized deductions in a prior year up to the amount by which the zero bracket amount exceeds the taxpayer's other itemized deductions for that year.[1] For example, assume that for 1983 a married couple filing a joint return had $3,700 in itemized deductions, of which $500 related to State income taxes paid in 1983. In 1984, they receive a tax refund from the State in the amount of $200. Under present law, the entire $200 would be regarded as a recovery exclusion and would be excluded from gross income.[2]

Reasons for Change

The treatment accorded under section 111 to State income tax refunds and other itemized deductions subject to the zero bracket amount or similar statutory floor fails to reflect economic reality in certain cases. The statute assumes that a taxpayer first recovers the portion (if any) of the amount deducted in the prior year that did not reduce taxable income.[3] The assumption that the first dol-

[1] The legislative history of the predecessor of section 111 supports this interpretation. See H.R. Rep. No. 2333, 77th Cong., 2d Sess. 70 (1942); S. Rep. No 1631, 77th Cong. 2d Sess. 80 (1942).

[2] See Rev. Rul. 79-15, 1979-1 C.B. 80, for examples of the application of section 111 to State tax refunds.

[3] The portion that did not reduce taxable income will be the difference between the taxpayer's other itemized deductions and the zero bracket amount.

lars recovered are not those which produced a tax benefit may, in certain cases, be erroneous and produce a windfall to the taxpayer.

Thus, in the above example, the couple claimed excess itemized deductions of $300 in 1983 and reduced their total taxable income by that amount. If they had deducted only those taxes which they actually owed to the State, they would have claimed only $100 in excess itemized deductions ($3,200 other itemized deductions, plus $300 State taxes, less the $3,400 zero bracket amount). By allowing them to recover $200 without tax consequences, the regulations fail to achieve the tax benefit rule's objective of putting taxpayers in roughly the same position as if the "erroneous" deduction had never been taken.

The committee has concluded that the law should be amended to more accurately reflect the tax benefit concept.

Explanation of Provision

The bill amends section 111 to provide that when an amount attributable to a prior year's deduction is recovered, such amount may be excluded from gross income only to the extent it did not reduce income subject to tax. Thus, in the example described above, the $200 recovered in 1984 would be included in gross income in that year.

As under present law, an increase in a carryover which has not expired will be treated as reducing income subject to tax.

Effective Date

The provision will apply to amounts recovered after December 31, 1983, in taxable years ending after that date.

Revenue Effect

It is estimated that the provision will increase fiscal year budget receipts by $229 million in 1985, $253 million in 1986, $274 million in 1987, $300 million in 1988, and $330 million in 1989.

2. Below-Market and Interest-Free Loans (sec. 176 of the bill and sec. 7872 of the Code)

Present Law

Transfers of income other than by interest-free or below-market interest rate loans

Direct assignments of income

Investment income is generally taxed to the owner of the income producing property, even if the owner of the property makes a gift of the right to receive the income prior to its receipt. The rationale for this rule is that the owner of the property realizes the income upon the exercise of control over its disposition. *Helvering* v. *Horst,* 311 U.S. 112 (1940). Further, an assignment of the right to receive income is a taxable gift by the assignor to the assignee which occurs at the time of the assignment. In such case, the amount of the gift is the value of the right received by the donee.

For example, if a cash method taxpayer detaches coupons from a bond and gives them to his or her son, without receiving fair value in exchange, and the son receives the interest represented by the coupons, the interest income would be included in income by the parent donor under the principles of *Horst.* In addition, the donor would be treated for gift tax purposes as having made a gift to the son in an amount equal to the value of the interest income to be received by the son.

Transfers of income-producing property to trusts

In general, the income of a trust is taxed to the trust to the extent that it is retained by the trust or is taxed to the trust's beneficiaries to the extent that the trust's income is distributed to its beneficiaries. However, under Code sections 671-679, a transferor of property to a trust (a "grantor") is treated as the owner of the transferred property for Federal income tax purposes if he retains certain powers over, or interests in, the trust. In such event, income, deductions and credits of the trust are attributed directly to the grantor.

Under section 676, a grantor is treated as the owner of a revocable trust. In addition, under section 673(a) a grantor is treated as the owner of all or a portion of a trust in which he has a reversionary interest in either corpus or income if, as of the inception of that portion of the trust, the grantor's interest will, or may reasonably be expected, to take effect in possession or enjoyment within 10 years commencing with the date of the transfer of that portion of the trust. For example, if a grantor were to transfer $50,000 to a trust, and the trust agreement were to provide that (1) the income would be distributed annually to the grantor's son, (2) the trust would terminate after eight years, and (3) at termination, the trust corpus would be returned to the grantor, the grantor would be treated as the owner of the trust and the income generated by it would be taxed to the grantor.

For gift tax purposes, a transfer of property to a trust is a taxable gift from the grantor of the trust to the trust's beneficiaries in the amount of the value of the beneficiaries' interests in the trust. A transfer to a trust results in a taxable gift to the extent of the value of the beneficiaries' interest in the trust regardless of whether the grantor is treated as the owner of the trust under the grantor trust rules. In the example set forth above, the grantor would be treated as having made a taxable gift to his or her son in an amount equal to the value, determined at the time of the transfer to the trust, of the right to the use of $50,000 for a period of eight years.

Demand or term loans to family members

Under present law, an interest-free or below-market interest rate loan without consideration results in a gift from the lender to the borrower for Federal tax purposes. *Dickman* v. *Commissioner,* 465 U.S. — (1984), 52 U.S.L.W. 4222 (U.S. Feb. 22, 1984). In the case of a demand loan, the Internal Revenue Service takes the position that the amount of the gift is the value of the right to the use of the money for "such portion of the year as the [lender] in fact allows the [borrower] the use of the money." Rev. Rul. 73-61, 1973-2 C.B. 408. Under this approach, the amount of the gift is calculable as of the last day of each calendar year during which the loan is outstanding.[4]

In the case of a term loan, the amount of the gift is the excess, at the time the money and note are exchanged, of the amount of money borrowed over the present value of the principal and interest payments required to be made under the terms of the loan. See Rev. Rul. 73-61, supra; Rev. Rul. 81-286, 81-2 C.B. 176; *Blackburn* v. *Commissioner,* 20 T.C. 204 (1953); *Mason* v. *United States,* 365 F. Supp. 670, aff'd 513 F.2d 25 (1975); and *Dickman* v. *United States,* supra.

It is unclear whether, under present law, interest-free or below-market interest rate loans without consideration have any Federal income tax consequences. To date, courts have addressed only the gift tax consequences of such transactions.

Loans to employees or shareholders

Demand loans

The Internal Revenue Service has taken the position that, in the case of an interest-free or below-market interest rate loan to an employee or shareholder,[5] the borrower derives an enonomic benefit that should be included in income for Federal income tax purposes. Under the Service's position, the amount of the income

[4] In *Dickman,* the Supreme Court did not reach the question of the valuation of the gift. In dicta, however, the Court stated that "to support a gift tax. . . . the Commissioner need not establish that the funds lent did in fact produce a particular amount of revenue; it is sufficient for the Commissioner to establish that a certain yield could readily be secured and that the reasonable value of the use of the funds can be reliably ascertained."

[5] Other than a loan to which section 482 (relating to commonly controlled corporations) applies.

would be the excess of the interest that would have been charged by an independent lender over the interest, if any, that is actually paid under the terms of the loan.

Notwithstanding the Internal Revenue Service's position, the Tax Court has consistently held that these non-family interest-free or below-market interest rate demand loans do not result in taxable income. In *J. Simpson Dean* v. *Commissioner,* 35 T.C. 1083 (1961), for example, the controlling shareholders of Nemours Corporation borrowed substantial sums of money from the corporation on a non-interest bearing basis. The Internal Revenue Service sought to impute interest income to the borrowers. The Tax Court, however, held that the transactions did not result in income to the borrowers on the grounds that had they "borrowed the funds in question on interest bearing notes, their payment of interest would have been fully deductible by them under section 163." [6] See also, *Beaton* v. *Commissioner,* 664 F.2d 315 (1st Cir. 1981); *Martin* v. *Commissioner,* 649 F.2d 1133 (5th Cir. 1981); *Suttle* v. *Commissioner,* 625 F.2d 1127 (4th Cir. 1980); *Baker* v. *Commissioner,* 75 T.C. 166, aff'd 677 F.2d 11 (2nd Cir. 1982); *Creel* v. *Commissioner,* 72 T.C. 1173 (1979); *Zager* v. *Commissioner,* 72 T.C. 1009 (1979); *Hardee* v. *United States,* 708 F.2d 661 (Fed. Cir. 1983).

Term loans

The Federal tax treatment under present law of non-family interest-free or below-market interest rate term loans is unclear. In one case, the Tax Court held that shareholders of a corporation, who obtained an interest-free loan from the corporation in order to purchase the corporation's assets, received a distribution of earnings taxable to them as a dividend. Further, the Court held that the amount of the dividend was the excess of the fair market value of the property received over the present value of the taxpayer's note. *Boyd* v. *Commissioner,* 5 TCM (CCH) 791 (1946). But see *Greenspun* v. *Commissioner,* 72 T.C. 931, aff'd 670 F.2d 123 (9th Cir.1982).

Loans between commonly controlled corporations

Section 482 provides that, in the case of two or more orgainzations, trades, or businesses (whether or not incorporated, organized in the United States, or affiliated) owned or controlled directly or indirectly by the same interests, the Secretary may distribute, apportion or allocate gross income, deductions, credits or allowances between or among such organizations, trades, or businesses, if he determines that such distribution, apportionment, or allocation is necessary in order to prevent evasion of taxes or clearly to reflect the income of any such organizations, trades, or business. Treasury regulations under that section provide that where one member of a group of controlled entities makes a loan or advance directly or indirectly to, or otherwise becomes a creditor of, another member of such group, and charges no interest, or charges interest at a rate

[6] The Tax Court distinguished this case from the cases involving rent-free use of corporate property by shareholders or officers (C.f., *Alex Silverman* v. *Commissioner,* 28 T.C. 1061, aff'd. 253 F.2d 849 (8th Cir. 1958)) on the grounds that rental payments would not have been deductible in those cases.

which is not equal to an arm's-length rate, appropriate allocations may be made to reflect an arm's-length interest rate for the use of the money. The term "arm's-length interest rate" is defined as the rate which was charged, or would have been charged at the time the indebtedness arose, in independent transactions, with or between unrelated parties under similar circumstances. A safe-haven is provided for qualifying loans by a creditor not regularly engaged in the business of making loans or advances of the same type to unrelated parties. Treas. Reg. sec. 1.482-2.

Loans in connection with sale or exchange of property

Under section 483, if a contract for the sale or exchange of property provides for deferred payments of part or all of the purchase price, and the deferred payments include unstated interest, a portion of each deferred payment will be treated as interest. Deferred payments include unstated interest if the total of the deferred payments exceed the sum of the present values of such payments plus the present values of any stated interest due under the terms of the contract. Generally, section 483 applies to payments made under a contract for the sale or exchange of property that are made more than six months after the date of the sale or exchange, if at least one payment is due more than one year after the date of the sale or exchange. Section 483 does not apply to contracts with a sales price that $3,000 or less, certain sales or exchanges of patents, and sales or exchanges that result only in ordinary income to the seller.[7]

Reasons for Change

An interest-free or below-market interest rate loan is the economic equivalent of a loan bearing a market rate of interest, and a payment by the lender to the borrower to fund the payment of interest by the borrower. In many instances, the failure of the tax laws to treat these transactions in accordance with their economic substance provides taxpayers with opportunities to circumvent well-established tax rules.

Loans between family members (and other similar loans) are being used to avoid the assignment of income rules and the grantor trust rules. An interest-free or below-market interest rate family loan involves a gratuitous transfer of the right to use the proceeds of the borrowing until repayment is demanded (in the case of a demand loan) or until the end of the term of the loan (in the case of a term loan). If the lender had assigned the income from the proceeds to the borrower, the assignment of income doctrine would tax the lender (and not the borrower) on the income. If the lender had transferred the principal amount to a trust established for the benefit of the borrower that was revocable at will (similar to a demand loan), or that would terminate at the end of a period of not more than 10 years (similar to a term loan), the income earned on trust assets would be taxed to the lender under the grantor trust provisions set forth in Code secs. 671-679.

[7] See the provision of the bill which repeals this "ordinary income" exception.

Loans from corporations to shareholders are being used to avoid rules requiring the taxation of corporate income at the corporate level. An interest-free or below-market interest rate loan from a corporation to a shareholder is the economic equivalent of a loan by the corporation to the shareholder requiring the payment of interest at a market rate, and a distribution by the corporation to the shareholder with respect to its stock equal to the amount of interest required to be paid under the terms of the loan. If a transaction were structured as a distribution and a loan, the borrower would have dividend income and an offsetting interest deduction. The lender would have interest income. By structuring the transaction as an interest-free loan, the lender avoids including in income the interest that would be paid by the borrower. As a result, the lender is in the same economic position as it would be if it were able to deduct amounts distributed as dividends to shareholders.

Loans to persons providing services are being used to avoid rules requiring the payment of employment taxes and rules restricting the deductibility of interest in certain situations by the person providing the services. An interest-free or below-market interest rate loan to a person providing services is the economic equivalent of a loan requiring the payment of interest at a market rate, and a payment in the nature of compensation equal to the amount of interest required to be paid under the terms of the loan. In many instances, a transaction structured in this manner would not result in any tax consequences for either the lender or the borrower because each would have offsetting income and deductions. However, there are a number of situations in which the payment of compensation and a loan requiring the payment of interest at a market rate will not offset.[8]

The committee bill recharacterizes certain interest-free and below-market interest rate loans as arms-length transactions involving (1) a gift, a dividend, or a payment in the nature of compensation, or some other payment in accordance with the substance of the transaction, to fund the payment of interest on the loan at a statutory rate; and (2) the payment of interest by the borrower at a statutory rate resulting in income to the lender and a deduction to the borrower. In the case of a demand loan, the gift, dividend, compensation, or other payment, is deemed to occur annually. In the case of a term loan other than a loan in which the deemed payment by the lender to the borrower is gratuitous in nature, the gift, dividend, compensation, or other payment, is deemed to occur at the time that the loan is made.[9] However, in the case of a loan in which the deemed payment by the lender is gratuitous in nature, there is little difference between a term loan

[8] For example, if a taxpayer uses the proceeds of an arms-length loan to invest in tax-exempt obligations, the deduction for interest paid on the loan would be disallowed under section 265. Similarly, in the case of a term loan that extends beyond the taxable year in which it is made, income and deductions will not offset because the compensation income is includible in the year the loan is made.

[9] This treatment is consistent with the treatment of deferred compensation under section 83 which taxes transfers of property in connection with the performance of services when there is no substantial risk of forfeiture. No avoidance of the rules of section 83 are possible in the case of demand loans since, in such cases, the borrower's right to the use of the funds is subject to a substantial risk of forfeiture.

and a demand loan. Accordingly, the committee bill treats these term loans the same as demand loans for income tax purposes.

The committee bill provides several exceptions and limitations so that the new rules do not apply to non-abusive transactions. The committee recognizes that it is very common for loans to be made from time to time on an interest-free basis without any tax avoidance purpose. Generally, the principal amount of these loans is relatively insignificant and they are repaid within a short period. In addition, the committee believes that interest-free loans to finance the purchase of consumption items, such as higher education, personal residences, etc., do not result in the shifting of income from one person to another. In these situations, the committee believes that there generally may be no significant distortions of the income taxation of the parties to the loan. Accordingly, the bill contains a number of exceptions and limitations to the general rules applicable to interest free or below market interest rate loans, where tax avoidance is not a principal purpose of the loan, and where the loans are not used to purchase or carry property producing net investment income.

The committee recognizes that it also is common for businesses to make advances to employees for expenses that may reasonably be expected to be incurred by the employees in connection with their employment. Generally, these advances are repaid on a regular basis, and do not result in any significant distortion of the taxation of the parties to the loan. Accordingly, the committee bill contains an exception for small below-market interest rate loans between an employer and an employee, or an independent contractor and a person for whom such contractor provides services.

Explanation of Provision

Overview

Under the bill, interest-free or below-market interest rate loans are recharacterized in cases where the transactions create serious potential for tax avoidance. The committee believes that most non-abusive transactions are not affected by the bill. For example, loans to family members of less than $100,000 are generally unaffected for income tax purposes except to the extent that the borrower earns interest or other investment income. In such a case, the effect of the bill is to treat a portion of such interest or other investment income as if it had been earned by the lender and not by the borrower.

Under the bill, an interest-free or below-market interest rate loan is recharacterized as an arms-length transaction in which the lender made a loan to the borrower in exchange for a note requiring the payment of interest at a statutory rate (referred to as the "designated market interest rate"). This rule results in the parties being treated as if:

1. The borrower paid interest to the lender that may be deductible to the borrower and is included in income by the lender; and
2. The lender (A) made a gift subject to the gift tax (in the case of a gratuitous transaction), or (B) paid a dividend includible in income (in the case of a loan by a corporation to a shareholder) or

(C) paid compensation [10] (in the case of a loan to a person providing services or (D) made some other payment in accordance with the substance of the transaction.

The provisions are generally applicable to gift and nongift term and demand loans. A gift loan is any interest-free or below-market loan with respect to which the deemed payment by the lender to the borrower is gratuitous in nature. A nongift loan is any loan other than a gift loan. A loan by a parent to a corporation controlled by his or her son or daughter is to be treated, in general, as a gift loan if the failure to charge interest at a market rate is gratuitous in nature.

Under the bill, demand loans and term gift loans are subject to these provisions if no interest is payable on the loan, or interest is payable at a rate less than the designated market interest rate. A term nongift loan is subject to these provisions if the amount of the loan exceeds the present value of all payments due under the loan. A demand loan is any loan which is payable in full at any time upon the demand of the lender. A term loan is any loan which is not a demand loan.

The committee intends that absent application of a specific exception, the provisions are to be applicable to any transaction specified in the statute or regulations that involves, in substance, an interest-free or below-market interest rate loan.

Timing and amount of transfers

The bill provides different rules for the timing and amount of the transfers described above depending upon whether the loan is a gift loan or a nongift loan, and whether the loan is a term loan or a demand loan.

Gift loans

For income tax purposes the borrower of a gift loan is treated as having transferred to the lender (and the lender is treated as having received from the borrower) imputed interest on such loan for each day during which the loan is outstanding. Thus, an amount of interest equal to the imputed interest is included in income by the lender. Such amount would be deductible by the borrower to the same extent as interest actually paid by the borrower.[11] Under this rule, term and demand gift loans are treated in a similar manner for income tax purposes.

For gift tax purposes, an amount is treated as transferred from the lender to the borrower as a gift. In the case of a demand loan, the amount treated as transferred as a gift is identical to the amount of the imputed interest for income tax purposes. In the

[10] For example, if a university makes a demand loan to a professor to help the professor defray relocation expenses and induce the professor to accept an offer of employment from the university, the borrower is treated as having received compensation on the last day of each calendar year during which the loan is outstanding in an amount equal to the foregone interest for such year. Further, the borrower is treated as having paid interest to the lender on such day in an amount equal to the foregone interest for the calendar year. The compensation is included in income by the borrower for the taxable year in which it is treated as received. The payment of interest by the borrower would be deductible under principles generally applicable to the payment of interest.

[11] No deduction would be allowable for such interest in cases where the borrower did not itemize his deductions for the relevant year or his deductions would be disallowed under other provisions of the Code (e.g., secs. 163(d) or 265).

case of a term loan, the amount treated as transferred as a gift is the excess of the amount of the loan over the present value of all principal and interest payments due under the loan.

Under the bill, imputed interest is, with respect to any day within the taxable year of the borrower during which a loan is outstanding, the excess of (1) the amount of interest which would have accrued on the loan if interest accrued at the designated market interest rate, over (2) any interest actually payable on the loan properly allocable to such day. Interest properly allocable to a day includes both stated and unstated interest (such as loan discount).

Amounts of imputed interest attributable to any day during any taxable year of the borrower are generally treated as transferred on the last day of such year. In the case of a demand loan, the transfer by the lender to the borrower (i.e., the imputed gift) is generally treated as occurring on the last day of the borrower's taxable year. In the case of a term loan, such transfer is generally treated as occurring on the day the loan is made. Regulations may provide different rules where appropriate (e.g., where borrowers or lenders are on a fiscal year for Federal income tax purposes).

Under the bill, the present value of any principal and interest payment is to be determined under regulations using a discount rate equal to the designated market rate compounded semiannually.

Nongift loans

In the case of a nongift loan that is a term loan, the lender is treated as transferring to the borrower, and the borrower is treated as receiving from the lender, an amount as a wage, dividend, or other payment, depending on the substance of the transaction, equal in amount to the excess of the amount of the loan over the present value of all principal and interest payments due under the loan. This transfer is treated as occurring on the date the loan is made.

Also, in the case of a nongift loan that is a term loan, the excess of the amount of the loan (i.e., the amount received by the borrower) over the present value of the payments due under the loan is treated as original issue discount for purposes of section 1272. As a result, the lender is treated as receiving interest income in a pattern producing a constant yield to maturity over the life of the loan. Similarly, the borrower is treated as paying the same amount of interest. The interest which the borrower is treated as paying would be deductible to the same extent as interest actually paid by the borrower.

In the case of a nongift loan that is a demand loan, the borrower is treated as having paid to the lender and the lender is treated as having received from the borrower imputed interest for any day during which such loan is outstanding. In addition, the lender is treated as having transferred an identical amount to the borrower as a wage, dividend, or other payment, depending on the substance of the transaction, for each day during which the loan is outstanding. Except as otherwise provided by regulations, these transfers are treated as occurring on the last day of the borrower's taxable year.

The imputed interest on a nongift loan is calculated in the same manner as in the case of a gift loan. Further, the present value of principal and interest payments due under a nongift loan that is a term loan is calculated in the same manner as it is for a gift loan that is a term loan.

Nongift loans to which the provision applies (referred to as "applicable loans") are (1) loans between corporations and shareholders of such corporations, (2) loans by employers to employees, (3) loans made to independent contractors by persons for whom such contractors perform services, and (4) any other loan described under regulations prescribed by the Secretary. It is anticipated that these regulations will describe loans which have as a principal purpose the avoidance of income tax by either the lender or the borrower. The committee intends that such regulations will not apply to below-market loans represented by interest bearing or other accounts in financial institutions, loans of the cash value of an insurance policy, or to most government-subsidized loans such as government insured or guaranteed student loans or residential mortgages. Any loan that is treated as a gift loan is not an applicable loan.

Employment taxes and information reporting requirements apply to the extent they would apply if the deemed payments under this provision were actual payments. However, no withholding is required.

Designated market interest rate

Under the bill, the designated market interest rate is a rate determined by reference to the term of the loan, as set forth below.

Term	Designated market rate
Less than 3 years	The Federal short-term rate
Over 3 years but not over 9 years.	The Federal mid-term rate
Over 9 years	The Federal long-term rate

The Federal rates are determined by the Secretary within 15 days after the close of 6-month periods ending on September 30 and March 31, respectively, and are to reflect the average market yield during such 6-month periods on outstanding marketable obligations of the United States with comparable maturities. The applicable Federal rate is compounded semiannually.

The rate determined to reflect the average yield for a 6-month period ending on September 30 is applicable during the 6-month period beginning on January 1 of the succeeding calendar year. The rate determined to reflect the average yield for the period ending on March 31 is applicable during the 6-month period beginning on the following July 1.

Under the bill, in the case of a term loan, the applicable Federal rate that is used to compute amounts of interest is the rate for the day on which the loan is made. In the case of a demand loan, imputed interest is computed on a daily basis. Further, in the case of a demand loan, the applicable Federal rate is always the Federal short-term rate for each day the loan remains outstanding.

Exceptions and limitations

Special exceptions and limitations for gift loans

A number of limitations exceptions and are provided for certain gift loans made directly between natural persons.[12] For purposes of these exceptions and limitations, a husband and a wife are treated as one person.

Minimum outstanding balance.—As a general rule, there is no imputed interest income or expense for income tax purposes, or imputed gift for gift tax purposes, with respect to a demand loan, and no imputed interest income or expense with respect to a term loan, for any day during which the aggregate amount owed by the borrower to the lender does not exceed $10,000. Further, a term loan generally will not result in an imputed gift for gift tax purposes if the aggregate amount owed by the borrower to the lender on the date the loan is made does not exceed $10,000. For this purpose, the aggregate amount owed by the borrower to the lender includes all loans regardless of the rate of interest on the loan.

Net investment income limitations.—As a general rule, no interest income or expense is imputed with respect to a demand loan or a term loan for any day if (1) the borrower's net investment income for the year in which the day falls does not exceed $1,000, and (2) the aggregate outstanding balance on all loans from the lender to the borrower does not exceed $100,000 on such day (taking into account all loans regardless of the rate of interest on the loans).

In addition, if the borrower has net investment income for the year in excess of $1,000, the maximum amount of interest income and expense that can be imputed for all days during a year in which the aggregate of all amounts owed by the borrower to the lender does not exceed $100,000 is limited to the borrower's net investment income for the year. Except as otherwise provided in regulations, determinations made under these provisions are to be made on the basis of the borrower's taxable year.

Net investment income is the excess of investment income over investment expenses. The term investment income is defined, in general, by reference to section 163(d). Thus, investment income is the sum of: (1) gross income from interest, dividends, rents and royalties; (2) net short-term capital gain attributable to the disposition of property held for investment; (3) amounts treated under section 1245 (relating to dispositions of certain depreciable property), 1250 (relating to dispositions of certain depreciable realty) and 1254 (relating to dispositions of interests in oil, gas and geothermal property) as ordinary income; and (4) any other amount under regulations prescribed by the Secretary. In addition, net investment income includes any amount included in income under the original issue discount provisions of the Code, and any amount that would be included if such provisions were applicable to all deferred payment obligations. The term "deferred payment obligations" is defined to include bonds with market discount, short-term government obligations, annuities and any similar obligations producing a determinable investment return which economically acrues currently but

[12] The committee intends that loans to persons in the capacity as custodian or guardian of another person generally be treated as loans to natural persons.

is not recognized until a subsequent year. Any income, gain or other amount derived from the active conduct of a trade or business, however, is not treated as investment income.

Generally, investment expenses include amounts allowable as deductions under sections 162 (relating to trade or business expenses), 164(a)(1) or (2) (relating to bad debts), 167 (relating to depreciation), 171 (relating to amortizable bond premium), 212 (relating to expenses incurred in connection with the production of income), and 611 (relating to cost depletion).

Tax avoidance transactions.—In general, the minimum balance exception and the net investment income limitations do not apply in three cases. First, the exception and limitations do not apply if a principal purpose of the loan is the avoidance of Federal taxes. For example, the exception and limitations do not apply to a transaction if one of the principal purposes of the transaction is to shift income to a person in a lower tax bracket. Second, the exception and limitations do not apply to the extent that the proceeds of a loan are used to purchase or carry marketable securities other than bonds or other evidences of indebtedness. A security is treated as a marketable security if, on the date of its acquisition by the borrower, there was a market for such security on an established securities market or otherwise. Third, the minimum balance exception and the $1,000 investment income limitation do not apply to the extent that the proceeds of a loan are used to purchase or carry passive income-producing assets, unless the Secretary determines that there is no tax avoidance purpose to the loan.

Also, the bill provides that the Secretary will prescribe regulations to prevent abuse of the net investment income limitation through the deferral or other distortion of a borrower's net investment income. These regulations are to apply to situations in which a party can control the timing of the receipt of investment income (e.g. where the borrower can control dividends paid by a closely held corporation) or has engaged in any activities a principal purpose of which is to defer receipt of net investment income.

Special exception for employment-related loans

Generally, there is no compensation, and no interest income and expense, with respect to any term loan to a person providing services (including independent contractors) if the aggregate amount of loans outstanding between the borrower and the lender on the date on which the loan is made is $10,000 or less. Further, there is generally no compensation, and no interest income and expense, with respect to a demand loan for any day on which the aggregate amount of loans outstanding between the borrower and the lender is $10,000 or less. For this purpose, the aggregate amount of loans outstanding includes all loans regardless of the rate of interest on the loan.

Other exceptions

The bill provides that these rules do not apply to any loan to which sections 483 or 1274 apply.[13]

[13] Below-market loans that are made in connection with transactions to which sections 483 or 1274 apply are to be governed by those sections.

Regulations

Under the bill, the Treasury is directed to prescribe such regulations as may be necessary or appropriate to carry out the purposes of this section, including (but not limited to) regulations providing that where, by reason of varying rates of interest, conditional interest payments, waivers of interest, or other circumstances, the provisions of this section do not carry out its purposes, adjustments to the provisions will be made to the extent necessary to carry out the purposes of this section. For example, the committee anticipates that regulations may provide that if a loan is made requiring the payment of interest and the interest is cancelled or reduced, the lender will have income if the cancellation or reduction is in the nature of a gift.

Further, the Secretary may prescribe regulations under the Federal estate tax requiring that a below-market gift loan be valued in the estate of the lender in a manner consistent with the gift tax treatment of such loan. For example, the regulations could provide that the value of the loan is the present value of the interest and principal payments due under the loan using a discount rate equal to the designated market rate.

Effective Dates

In general, the provisions of this section apply to term loans made after February 1, 1984, and to amounts outstanding on demand loans after the date of enactment. Any renegotiation, extension, revision or modification of any of the provisions of a term loan after February 1, 1984, is treated under the bill as the issuance of a new loan. In adopting these provisions, the committee does not intend any inference regarding the income or gift tax treatment of interest-free or below-market interest rate loans under present law.

Revenue Effect

The provisions of this section are estimated to increase fiscal year budget receipts by $108 million in 1984, $126 million in 1985, $143 million in 1986, $150 million in 1987, $158 million in 1988, and $166 million in 1989.

3. LIFO Conformity (sec. 177 of the bill and sec. 472 of the Code)

Present Law

Generally, a taxpayer may use the method of accounting for computing taxable income on the basis of which he regularly computes his income in keeping his books provided that such method clearly reflects income. However, if the production, purchase, or sale of merchandise is an income-producing factor, the taxpayer generally must take into account inventories at the beginning and end of each taxable year. Acceptable methods of accounting for inventories include specific identification, first-in first-out ("FIFO"), and last-in first-out ("LIFO"). However, under the so-called "LIFO conformity" rule, the LIFO method of inventory accounting may not be used for tax purposes unless it is also used in reporting to shareholders, partners, other proprietors, beneficiaries, or for credit purposes.

The Internal Revenue Service has issued several rulings which provide limited exceptions to the LIFO conformity rule in a variety of factual situations. For example, some foreign parent companies with U.S. subsidiaries operate in countries which do not recognize the LIFO method as a proper method of accounting for financial reporting purposes. In Rev. Rul. 78-246, 78-1 C.B. 146, the Service ruled that foreign parent corporations are permitted to convert the operating results of their subsidiaries using the LIFO method to a nonLIFO basis in consolidated financial statements under certain conditions.

In *Insilco Corp* v. *Commissioner,* 73 T.C. 589 (1980), *aff'd. in an unreported decision* (2nd Cir. 1980), the Tax Court held that the LIFO conformity rules were met by a subsidiary using the LIFO method for Federal income tax purposes where the subsidiary used the LIFO method to compute its income in its financial reports issued to its parent company, even though the parent company converted the subsidiary's earnings to a nonLIFO basis in the parent's consolidated financial statements.

Reasons for Change

The LIFO conformity rule is intended to ensure that taxpayers only use the LIFO method for tax purposes when it conforms as nearly as possible to the best accounting practice in the taxpayer's trade or business. The committee is concerned that taxpayers can avoid the effect of LIFO conformity rule under the *Insilco* decision through the creation of holding companies or subsidiaries. In addition, the committee is concerned that if a significant number of taxpayers take advantage of the *Insilco* decision, the revenue effect would be substantial. Accordingly, the committee believes that the LIFO conformity rule should be applied to all financial reports of all corporations in which the taxpayer's inventory is included. However, the committee believes that limited exceptions to the conformity requirement provided under present law (or the similar limited exceptions provided by the Treasury, if appropriate, in the future) should be allowed.

Explanation of Provision

The bill treats all members of the same group of financially related corporations as a single taxpayer for purposes of the LIFO conformity requirement. The term "group of financially related corporations" means (1) any affiliated group as defined in section 1504 (without regard to the exceptions in sec. 1504(b)) by substituting a 50 percent stock ownership test for an 80 percent stock ownership test and (2) any other group of corporations which issue consolidated or combined financial statements or reports generally to shareholders and others. Thus, the conformity requirement generally applies to a parent corporation (1) which issues financial statements to its shareholders on a consolidated basis with a subsidiary, or on a combined basis with an affiliated company, that uses the LIFO method of accounting for tax purposes or (2) which includes the results of operations under the equity method of financial accounting of a financially related corporation which uses the LIFO method of accounting for tax purposes.

Under the bill, taxpayers who had relied on *Insilco* will be required either to conform their financial statements to use LIFO for inventories of the affiliated corporation, or to change the inventories of the affiliated corporation to a non-LIFO method of accounting for tax purposes.[14] The bill will not affect the the exceptions already provided under current law or the authority under present law of Treasury to provide limited exceptions to the conformity rules in specific circumstances in the future.

Effective Date

The provisions of the bill will apply to taxable years beginning after the date of enactment.

Revenue Effect

This provision will increase fiscal year budget receipts by $105 million in 1985, $185 million in 1986, $200 million in 1987, 1988 and 1989.

[14] Where a taxpayer had adopted the LIFO method in reliance upon the *Insilco* decision, the committee expects that some taxpayers may wish to adopt a nonLIFO method as a result of the committee's bill. In such a case, the committee intends that such a change would be treated in the same manner as any taxpayer requesting a change from the LIFO method of accounting under present law (i.e., prior permission from the Internal Revenue Service must be obtained before there can be a change in accounting method and any adjustments required by the change in method of accounting would be treated generally as under present law). The committee expects that the IRS will allow adjustments to be spread over a period not to exceed 4 years, but only if the taxpayer changes his or her method of accounting in accordance with proper procedures. (As under present law, if the taxpayer is found to have improperly used the LIFO method, no spread period will be allowed). The committee contemplates that the Treasury could provide rules allowing an automatic permission to change to a nonLIFO method for an appropriate transition period.

4. Modification of Income Averaging (sec. 178 of the bill and secs. 1301 and 1302 of the Code)[15]

Present Law

Under present law, if an eligible individual has at least $3,000 of averageable income, defined as the excess of current year taxable income over 120 percent of average taxable income in the previous four years, then he may be eligible for income averaging. This procedure serves to determine tax liability attributable to averageable income with reference only to the marginal rates applicable to the first 20 percent of this amount, rather than the higher marginal rates which would apply if 100 percent of averageable income were taxed using the regular rate schedule. In other words, income averaging widens the tax brackets by a factor of five with respect to averageable income.

Under income averaging, the individual first calculates what tax liability would be on 120 percent of average taxable income in the previous four years ("average base period income"). Then the individual computes the increase in tax liability which would result if 20 percent of averageable income were added to 120 percent of average base period income. This increase is then multiplied by five and added to the tax liability calculated on 120 percent of base period income in order to determine the individual's tax liability for the year. (These tax liability computations are performed using the current year's rate schedules.)

Reasons for Change

Although income averaging was originally intended to benefit taxpayers with either widely fluctuating income or a sharp jump in real income, many taxpayers whose income has increased merely at the rate of inflation have been eligible for income averaging in recent years.

As a result, the percentage of taxpayers using income averaging has increased substantially. In 1970, only 1.35 percent of tax returns used income averaging. By 1981, this percentage had increased to 6.87 percent. This problem is magnified by indexing because indexing by itself will keep marginal tax rates constant for an individual whose increases in income are entirely attributable to inflation. Thus taxpayers may receive a double benefit from indexing and income averaging. The committee believes that such a double benefit is inappropriate. Furthermore, the 23-percent across-the-board reduction in marginal tax rates enacted in 1981, including a top rate of 50 percent on ordinary income and 20 percent on

[15] Part of this provision was contained in S. 2062 reported by the Senate Committee on the Budget on November 4, 1983.

long-term capital gains, greatly reduces the need for an income averaging provision as generous as that provided by present law.

Explanation of Provision

The bill provides that averageable income is defined as the amount by which the taxable income for the current year exceeds 140 percent, instead of 120 percent as under present law, of the average base period income. In addition, the base period is shortened to be the three prior years. Finally, the income averaging formula is modified so that it widens the tax brackets by a factor of four with respect to averageable income.[16] As a result of these changes, only those taxpayers with an unusual increase in income will receive a benefit from using income averaging, rather than taxpayers with more normal increases in income who benefit under present law.

Effective Date

This provision will apply to taxable years beginning after December 31, 1983.

Revenue Effect

This provision will increase fiscal year budget receipts by $133 million in 1984, $1,994 million in 1985, $1,886 million in 1986, $2,053 million in 1987, $2,226 million in 1988, and $2,404 million in 1989.

[16] The provisions described in the second and third sentences of this paragraph were not contained in S. 2062 as reported by the Committee on the Budget.

5. Treatment of Personal Property Used for Both Business and Personal Purposes (sec. 179 of the bill and sec. 274 of the Code)

Present Law

Under present law, the expenses of operating an automobile solely in connection with a trade or business are deductible in computing taxable income (sec. 162). In addition, because automobiles are 3-year property under the Accelerated Cost Recovery System (ACRS), a taxpayer who acquires an automobile for use in a trade or business and uses it for business purposes may be entitled to a 6-percent investment tax credit and cost recovery deductions equal to 25 percent of the basis (adjusted for one-half the investment credit claimed) of the property in the first year, 38 percent in the second year and 37 percent in the third year. The taxpayer may elect under section 179 to treat a portion of the cost of the automobile as an expense rather than a capital expenditure, thereby deducting this amount for the first year the automobile is put into service. No investment credit is allowed with respect to that portion of the cost which is deducted under section 179. The excess of the basis of the automobile over the expensing deduction is eligible for ACRS.

Specific substantiation requirements apply to business deductions claimed for expenses of travelling or of any item related to entertainment, amusement, or recreation activities or facilities (sec. 274(d)). As an alternative to ACRS deductions (or the expensing deduction) and exact computation of operating deductions, a taxpayer may account for operating expenses and depreciation through the use of standard mileage allowances prescribed by the Secretary. Currently, a taxpayer is entitled to a deduction of 20.5 cents per mile of business use. This 20.5 cent allowance is subject to a limitation of 15,000 miles per year for 4 years. The deduction for mileage in excess of the limitation is at a rate of 11 cents a mile. In addition, all taxpayers may take itemized deductions for interest expenses, casualty losses, taxes, and other deductions allowed to the taxpayer without regard to their trade or business connection, which are associated with use of the automobile.

If a taxpayer uses an automobile partly for business and partly for personal purposes, deductions for operating expenses are available only with respect to the business use of the automobile (sec. 262). In the case of the investment tax credit and depreciation, the taxpayer may take into account only that portion of the cost of the automobile which bears the same ratio to total cost as his business use bears to his total use of the automobile. Investment credit may be recaptured if the proportion of business use in years after the automobile is placed in service falls below the proportion of business use in that initial year. Certain recapture rules apply to expensing deductions in certain circumstances, but no such rules apply to ACRS deductions.

In the case of tangible property other than automobiles, similar rules apply with respect to expenses, depreciation, and the investment tax credit, except that no standard mileage rate or similar rules apply. Further, present law prohibits the deduction of any expenses with respect to a facility used in connection with entertainment, amusement, or recreation (sec. 274(a)).

Reasons for Change

The committee believes that the investment incentives afforded by the investment credit and the accelerated cost recovery system should be directed to capital formation rather than to subsidize the personal use of business assets by taxpayers. In particular, the committee is concerned that many taxpayers may be abusing the investment tax credit, the allowance for depreciation, and the deductibility of business expenses by recharacterizing personal use of assets as business use. This practice tends to undermine public confidence in the fairness of the tax laws and in the ability of the Internal Revenue Service to adequately enforce those laws.

Explanation of Provisions

The bill provides new rules that limit the tax deductions for business use of personal property that is used more than an insignificant amount for personal purposes. In addition, the bill provides for explicit rules to be used in calculating deductions for operating expenses and depreciation in the case of automobiles that are used more than an insignificant amount for personal purposes.

Rules with respect to automobiles

Under the bill, if the business use of an automobile in any year is not at least 90 percent on a mileage basis, the taxpayer will be required to use IRS prescribed mileage allowances to account for that portion of the operating expenses, license and registration expenses, depreciation (including expensing) and insurance allocable to the business use of the automobile. For purposes of this rule, unless he is an outside salesman, the taxpayer will be deemed to have used the automobile less than 90 percent in business if it is taken home at night and the taxpayer's principal place of his principal business is not at that home. For this purpose, business use will include any use for which the owner receives a fair market value compensation or with respect to which a fair market value is included in the user's income and, if the user is an employee of the taxpayer, in wages for income tax withholding purposes. The fact that an automobile is used to display material that advertises the owner's or user's trade or business does not convert an otherwise personal use into a business use. These rules will not affect the deductions for interest, casualty losses, or State or local taxes or other deductions which are available without regard to whether the automobile is used in a trade or business.

The standard mileage allowances that a taxpayer will be required to use when business use falls below 90 percent will be prescribed by the IRS. The committee anticipates that these mileage allowances will be similar to those that are now provided under the substantiation regulations; however, since a greater number of cars employed in a wider variety of uses will come under these mileage allowances, the IRS may conclude that mileage allowance at the higher rate for a larger number of miles than is provided under current practice is appropriate. The committee further anticipates that the Treasury may conclude that a separate component of the mileage allowance for depreciation is appropriate; as under present law, an appropriate adjustment to the basis of automobiles will be required.

With respect to the investment tax credit and depreciation, the bill requires that an automobile satisfy the 90-percent rule for both the first and second year of its use in order to qualify for the investment tax credit, ACRS, and deduction of actual operating expenses, rather than recovery of costs through the standard mileage allowances. To allow taxpayers to file their income tax returns in a timely manner, the bill permits taxpayers to claim the investment tax credit and depreciation during the first year subject to a full recapture in the event the 90-percent test is not satisfied in the second year. If an automobile fails to satisfy the 90-percent requirement in the third or in a subsequent year, the investment tax credit will be recaptured as if the property had been disposed of at the beginning of the year for which business use fell below 90 percent. In addition, the deductions for accelerated cost recovery (or expensing) will be recaptured so as to include in income the excess of depreciation claimed in prior years over the amount that would have been allowed if the taxpayer had depreciated the automobile to its fair market value as of the beginning of the taxable year the failure occurs. The bill also provides that if a car fails to meet the 90-percent requirement in any year it will be treated as failing to meet that requirement in all subsequent years.

Treatment of leased automobiles

Under the bill, a lessor will be treated as having used any automobile which he leases for business purposes with respect to any use for which a fair market value lease payment is received. The lessee will be required to satisfy the 90-percent requirement in order to claim business deductions with respect to his lease payments. If a lessee fails to satisfy the 90-percent requirement, deductions with respect to business use of the car will have to be computed using the standard mileage allowances prescribed by the IRS. If the failure occurs in either of the first two years, no deductions other than those permitted using the mileage allowance will be allowed. If the failure occurs in the third or any subsequent year, the lessee will be required to use the standard allowance for the year of failure and all subsequent years. In either case, the lessee will have to recapture a percentage (computed as prescribed in Treasury regulations) of the lease payments deducted in prior years which equals the value of the portion of lease payments treated as representing the lessor's recapture liabilities (as if the lessor had disposed of the automobile) with respect to that automobile.

Treatment of tangible property other than automobiles

The bill provides that if certain types of personal property other than autcmobiles are not used at least 90 percent for business purposes, the taxpayer will not be able to claim an investment tax credit with respect to that asset and will be required to compute depreciation with respect to the business portion of the property by using a straight-line method over a 12-year life (using a half-year convention and without regard to salvage value). Assets that are subject to this rule include transportation assets (airplanes, trucks, boats, etc.), personal computers, items used for entertainment purposes (i.e. items of a type subject to the rules of sec. 274(a)), and any other items after they are specified in regulations prescribed by the Secretary. A taxpayer whose business use falls below 90 percent will be required to recompute his deductions and credits for prior years under recapture rules that are the same as those provided in the case of automobiles except that a 12-year rather than a five-year depreciation life is provided. A similar rule will apply to leased property.

Recordkeeping requirements

The bill eliminates the ability that taxpayers have under present law to substantiate their business use deductions other than by means of a contemporaneous record reflecting their use of property with respect to which deductions or credits are claimed. Under the bill, taxpayers must keep adequate contemporaneous records reflecting their business and personal use of tangible property subject to the 90-percent business requirements. Income tax return preparers will be required to verify that adequate contemporaneous records supporting deductions have been kept before signing any return which they prepare claiming deductions or credits that are subject to the substantiation requirements of these new rules or of present law.

Effective Date

The provisions apply with respect to equipment placed in service by the taxpayer and leases entered into after March 15, 1984.

Revenue Effect

It is estimated that these provisions will increase fiscal year receipts by $61 million in 1984, $514 million in 1985, $611 million in 1986, $582 million in 1987, $482 million in 1988, and $500 million in 1989.

6. Treatment of Certain Related Party Transactions (sec. 180 of the bill and sec. 267 of the Code)

Present Law

Under present law, an accrual-basis taxpayer is denied a deduction for certain accrued expenses or interest owed to related persons who use the cash method of accounting (sec. 267(a)(2)). The disallowed interest and business expenses are those which are not paid to the related person within the taxable year in which the expenses accrue or within 2½ months thereafter. This provision prevents an accrual-basis taxpayer from claiming a deduction for an accrued expense which the related cash-basis payee is not required to take into income until some subsequent time, if at all.

Because an accrued expense is deductible by a taxpayer under the accrual method of accounting only in the taxable year in which it accrues, a deduction disallowed under section 267(a) is permanently lost. It cannot be deducted at some subsequent time when payment is made.

Present law places a subchapter S corporation on the cash method of accounting for purposes of deducting business expenses and interest owed to a related cash-basis taxpayer, including a shareholder who owns at least two percent of the stock in the corporation. Thus, the corporation's deductions (which in the case of subchapter S corporation are taken into account on the shareholders' returns) are allowed at the same time the income is recognized by the shareholder. Furthermore, no deductions are lost if payment is made after the 2½-month period expires. Present law does not provide a similar rule for payments between an accrual basis partnership and a cash basis partner, although present law requires that guaranteed payments made to a partner be includible in the partner's taxable year corresponding to the year the partnership deducted the payment (secs. 706(a) and 707(c)(an accrual rule).

Finally, present law provides that no deduction is allowed for losses from sales or exchanges of property between related parties, including controlled partnerships (secs. 267(a)(1) and 707(b)(1)). Any gain recognized on a subsequent disposition of the property by the related party is reduced by the disallowed loss.

Reasons for Change

The committee believes that persons who are related should be required to use the same accounting method with respect to transactions between themselves in order to prevent the allowance of a deduction without the corresponding inclusion in income. The failure to use the same accounting method with respect to one transaction involves unwarranted tax benefits, especially where payments are delayed for a long period of time, and in fact may never be paid.

The committee also believes that the present rules may lead to an unduly harsh result in certain circumstances where payment is delayed more than 2½ months while allowing too much of a tax advantage for payments made within 2½ months after the close of a taxable year. Finally, certain related parties, such as a partnership and its partners, should be made subject to the related party rules in order to prevent tax avoidance by the use of different accounting methods.

Further, the committee is concerned that certain troubled low-income housing projects will be adversely impacted by this provision. The committee bill therefore limits the application of this provision with respect to certain resyndications of low-income housing by continuing to allow deductions for certain accrued, but unpaid, expenses.

Explanation of Provision

Under the bill, an accrual-basis taxpayer will be placed on the cash method of accounting with respect to deductions of business expenses and interest owed to a related cash-basis taxpayer. Thus, the accrual-basis taxpayer will be allowed to deduct business expenses or interest owed to a related cash-basis taxpayer when payment is made (whether or not paid within 2½ months after the close of the taxable year); in other words, the deduction by the payor will be allowed no earlier than when the corresponding income is recognized by the payee. This provision will apply to all deductible expenses (whether or not deductible under section 162, 163 or 212) the timing of which depends upon the taxpayer's method of accounting or upon the making of an election to expense an item. It will not apply, for example, to expenses such as the deductions for cost recovery or depreciation of an asset (other than an asset which is related to the performance (or nonperformance) of services by the payee).

The present-law rules relating to accruals by subchapter S corporations will be extended to accruals by partnerships to partners, as well as to accruals by partners to partnerships and shareholders to subchapter S corporations. Also, the 2-percent *de minimis* exception for shareholders of subchapter S corporations is eliminated. Thus, for example, a partnership will not be allowed to deduct accrued business expenses or interest owed to a cash-basis partner until the amounts are paid and are includible in the income of that partner. This cash basis rule will apply to any payment made to a partner holding (actually or constructively) any capital interest or profits interest in the partnership or to any person related to a partner (within the meaning of secs. 267(b) or 707(b)(1)). This rule would not apply, however, to guaranteed payments (within the meaning of sec. 707(c)) made to a partner because the present law accrual rule is continued. Also, this rule will apply to amounts accrued by an "upper tier" partnership (or a partner in the "upper-tier" partnership) which is a partner in a "lower-tier" partnership or to persons related to these partners. Finally, it will apply to amounts accrued by partners (to other partners) on behalf of a partnership, such as those amounts which the payor partner is obligated to make under the terms of the partnership agreement. The rules under section 267(e) will not apply to transactions unrelated to the the partnership or S corporation.

To illustrate the foregoing, assume that a corporation owns a one percent profits interest in partnership X and a 51-percent capital and profits interest in partnership Y. Partnership X uses the accrual method of accounting and partnership Y uses the cash method. Under the bill, unpaid interest owed by X to Y cannot be deducted by X until paid to Y because Y is related to a partner of X by reason of section 707(b)(1)(A). If, however, the corporation has only a 40-percent interest in Y and, therefore, is not related to Y under section 707(b)(1), then the new rule would not apply.[17]

The bill extends the loss disallowance and accrual provisions of section 267 (as well as other provisions of the Code applicable to related parties defined under section 267) to transactions between certain controlled corporations. For purposes of these loss disallowance and accrual provisions, corporations will be treated as related persons under the controlled corporation rules of section 1563(a),[18] except that a 50-percent control test will be substituted for the 80-percent test. These rules are not intended to overrule the consolidated return regulation rules where the controlled corporations file a consolidated return. In the case of controlled corporations, losses will be deferred until the property is disposed of (or collection of a receivable is made) by the affiliate to an unrelated third party in a transaction which results in a recognition of gain or loss to the transferee, or the parties are no longer related. In a transaction where no gain or loss is recognized by the transferee, the loss is deferred until the substitute basis property is disposed of.

The section 267 rules also are extended to transactions between a partnership or subchapter S corporation and a regular corporation which are commonly controlled. Related parties under the provisions of section 707(b) are treated as related for all purposes of the Code referring to section 267.

Certain resyndications of low-income housing (within the meaning of sec. 189(e)(5)) are excepted from the new section 267 rules (concerning transactions between partners and partnerships) with respect to certain interest on indebtedness incurred for the purpose of acquiring the low-income housing or an interest in a partnership owning that housing and certain other related business expenses.

Effective Date

The provision relating to timing of accruals will apply to taxable years beginning after December 31, 1983. However, the provision will not apply to (1) interest on indebtedness incurred on or before September 29, 1983 or incurred pursuant to a contract binding on that date and all times thereafter and (2) other expenses made pur-

[17] See Treas. Reg. sec. 1.267(b)-(1) for present law application of section 267 to partnerships. It is expected that the Treasury Regulations under this provision will provide a rule for cases not specifically covered by the new rules where the same persons are partners in both the payor partnership and payee partnership which will defer deduction accruals (until paid) to the extent of such partners' aggregate interests in the payor partnership.

[18] The component member rules of section 1563(b) have no application.

suant to a contract which was binding on September 29, 1983, and at all times thereafter.

The provisions expanding the coverage of the related party rules will apply with respect to transactions after September 29, 1983 (other than with respect to amounts paid or incurred pursuant to a contract

Revenue Effect

It is estimated that this provision will increase revenue by $46 million in fiscal year 1984, $109 million in fiscal year 1985, $176 million in fiscal year 1986, $253 million in fiscal year 1987, by $346 million in fiscal year 1988 and by $416 million in fiscal year 1989.

7. Loss Treatment for Sales of Trade or Business Property (sec. 181 of the bill and sec. 1231 of the Code)

Present Law

Under present law, gains and losses on the sale, exchange, or involuntary conversion of property used in a trade or business are generally treated as long-term capital gains and losses if the total gains from all such transactions during the year exceed the total losses from such transactions during the year. If the losses for the year exceed the gains, the gains and losses are treated as ordinary gains and losses. Any gain subject to recapture under the Code (*e.g.*, gain attributable to depreciation on section 1245 (personal) property and excess depreciation on section 1250 (real) property) is, however, treated as ordinary income notwithstanding this rule.

Thus, if a taxpayer has a net gain from the specified types of transactions during a taxable year, the taxpayer may treat the gain as capital gain, paying tax at a lower tax rate, but if the taxpayer has a net loss, the full net loss will be allowed as a deduction from ordinary income.

Reasons for Change

The current rules relating to the treatment of gains and losses from sales and exchanges of trade or business property create distortions in taxable income in certain situations because they ignore transactions in prior and subsequent taxable years. The rules are subject to manipulation by taxpayers, who may bunch sales of appreciated trade or business assets in one year and sales of depreciated property in a different year to maximize the tax benefit of the losses.

Explanation of Provision

The bill provides that net losses from sales or exchanges (but not involuntary conversions) of trade or business assets during a taxable year will be treated as capital losses to the extent of net gains on such transactions for the three preceding taxable years, and these capital losses may be carried back to those prior three years. Furthermore, if losses realized on the sale or exchange of business assets for a taxable year are treated as ordinary, any net gains realized on such transactions in the three years immediately succeeding that year will be treated as ordinary income to the extent of those losses.

Effective Date

The provision is effective for taxable years beginning after December 31, 1984.

Revenue Effect

The provision will increase fiscal year budget receipts by $27 million in 1985, $76 million in 1986, $109 million in 1987, $168 million in 1988, and $230 million in 1989.

8. Disallowance of Certain Expenses Where Taxpayer Uses Property Similar to Property Owned by Taxpayer (sec. 182 of the bill and sec. 262 of the Code)

Present Law

Deductions for personal, living, or family expenses are disallowed under section 262 of the Internal Revenue Code. Deductions are allowed for expenses incurred in a trade or business or in connection with the production of income (secs. 161 and 212 of the Code). In addition, an investment tax credit is allowed for depreciable property used in a trade or business or for the production of income.

Reasons for Change

It has come to the committee's attention that taxpayers have attempted to circumvent the prohibition on deducting personal expenses by engaging in tax swaps with other taxpayers through the mechanism of a lease or other vehicle. For example, individual A and individual B could agree that each will purchase a yacht (both yachts being comparable), and then A will lease his yacht to B and vice versa. In this case, A and B could claim entitlement to depreciation deductions and investment tax credits in amounts sufficient to offset unrelated ordinary income (such as salaries) as well as the rental income under the leases. This device could also take the form of a partnership or other pooling arrangement. The committee intends no inference as to the proper result under present law of transactions of the type described above. However, the committee believes it is important to clarify that taxpayers cannot claim depreciation deductions and investment tax credits by virtue of tax-motivated transactions designed to enable the taxpayer to obtain the personal use of similar property.

Explanation of Provision

The provisions of the bill apply where (1) a taxpayer uses property owned by another person for personal purposes and such other person (or a third person) uses similar property owned by the taxpayer for personal purposes, or (2) under regulations prescribed by the Secretary, the taxpayer has an interest in a partnership or other entity, the principal purpose of which is to permit its owners to obtain personal use of property while claiming tax benefits with respect to similar property. If the bill applies, the taxpayer is treated as using the property with respect to which tax benefits are claimed for personal purposes, to the extent of the expenses attributable to the similar property that is actually used by the taxpayer for personal purposes.

Effective Date

The provision applies to agreements entered into for the use of property after February 22, 1984.

Revenue Effect

This provision will have a negligible effect on fiscal year budget receipts.

9. Individual Alternative Minimum Tax and the Foreign Earned Income Exclusion (sec. 183 of the bill and sec. 57 of the Code)

Present Law

Under present law, individuals are subject to an alternative minimum tax which is payable to the extent it exceeds the individual's regular tax. Generally, the tax base for the alternative minimum tax is an individual's adjusted gross income (without regard to the net operating loss deduction, but using a negative amount where the taxpayer's other "above-the-line" deductions exceed gross income) plus the taxpayer's tax preferences for the year, reduced by certain itemized deductions and a minimum tax net operating loss deduction. The resulting amount, called alternative minimum taxable income, then is reduced by a $30,000 exemption ($40,000 in the case of married taxpayers filing a joint return or a surviving spouse; $20,000 in the case of a married individual filing a separate return or a trust or estate) and is subject to tax at a 20-percent rate.

If the alternative minimum tax applies, the taxpayer may reduce his tax by the refundable credits and by the foreign tax credit. For these purposes, the regular foreign tax credit rules generally apply. However, the foreign tax credit limitation is computed under a special rule. The amount of foreign tax that can be credited against the alternative tax is limited to the same proportion of the gross alternative tax as the taxpayer's alternative minimum taxable income from sources without the United States bears to his entire alternative minimum taxable income. A special rule is also provided for computing the amount of unused foreign taxes that can be carried back or carried forward.

Under section 911, certain taxpayers may exclude from income, foreign earned income up to a maximum amount. (Under another provision of this bill, that amount will be $80,000 in 1984).

Reasons for Change

The committee believes that U.S. citizens and residents should not be allowed to use the foreign earned income exclusion to reduce their total income tax liability (U.S. and foreign) to less than the amount required by alternative minimum tax.

Explanation of Provision

The provision adds the foreign earned income exclusion under section 911 for citizens and residents living abroad as an item of tax preference for purposes of computing the alternative minimum tax. The foreign tax credit will continue to be allowable against the alternative minimum tax, notwithstanding the fact that foreign taxes paid on income a taxpayer elects to exclude under the foreign income exclusion otherwise may not be credited or deducted. The foreign tax credit limitation for alternative minimum tax purposes will be computed under the present law special rule.

Effective Date

The provision applies to taxable years beginning after December 31, 1984.

Revenue Effect

The provision will increase fiscal year budget receipts by $5 million in 1985, $28 million in 1986, $35 million in 1987, $38 million in 1988, and $46 million in 1989.

10. Use of Multicompany Structure to Reduce Tax on Coal Operations (sec. 184 of the bill and sec. 631(c) of the Code)

Present Law and Background

Present law (sec. 631(c)) provides that, subject to certain special computations, royalties received on the disposition of coal or iron ore qualify for capital gain treatment. For capital gain treatment to apply, the coal or iron ore must have been held for more than one year before mining. Capital gain treatment does not apply to income realized by an owner as a co-adventurer, partner, or principal in the mining of the coal or iron ore. In the case of iron ore (but not coal), capital gain treatment is also not applicable to a disposal to a related person or to a person owned or controlled directly or indirectly by the same interests which own or control the person disposing of the ore.

If capital gain treatment is allowed for coal or iron ore royalties, the royalty owner is not entitled to percentage depletion with respect to the coal or iron ore disposed of (sec. 631(c)).

Under present law, it is possible to reduce the overall tax on coal mining operations by having a separate land-holding company acquire coal reserves and lease thbm for a retained arm's-length royalty to the company which actually conducts mining operations. Under such an arrangement, the royalties are deductible by the operating company, and the amount of the royalties received by the land company (after subtracting cost depletion and certain expenses) qualify for capital gain treatment. If the benefits of capital gain treatment exceed the loss from foregoing percentage depletion on the coal in question, the overall tax on the operation will be reduced. The Code specifically prohibits this result in the case of iron ore by denying capital gains treatment for dispositions to related persons.

Reasons for Change

The committee believes that the income tax of coal producers should be the same whether they operate through a single entity or a combination of related parties.

Explanation of Provision

Code section 631(c) is amended to specify that capital gain treatment does not apply to any disposal of coal to a related person or to a person owned or controlled directly or indirectly by the same interests which own or control the person disposing of the coal.

Effective Date

The provision is effective on the date of enactment.

Revenue Effect

This provision will increase fiscal year budget receipts by $32 million in 1985, $32 million in 1986, $36 million in 1987, $40 million in 1988, and $44 million in 1989.

11. Public Utility Dividend Reinvestment Plans (sec. 185 of the bill and sec. 305 of the Code)

Present Law

Public utility corporations may set up dividend reinvestment plans under which shareholders electing to receive dividends in the form of common stock, rather than money or other property, may exclude up to $750 per year ($1,500 in the case of a joint return) of the stock distribution from income. These amounts generally are taxed as capital gains when the stock is sold, if the stock has been held for at least 12 months.

The provision applies to distributions made before 1986.

Reasons for Change

The committee decided that an appropriate way to raise revenues would be to reassess tax incentive provisions that are too narrowly focused. The general objective of the reexamination was to retain the business tax incentives with the broadest, most neutral, stimulation to investment.

Tax-favored public utility dividend reinvestment diverts capital away from other industries which would make more productive investments if they had an even opportunity to raise funds in capital markets. Many firms, other than public utilities, have dividend reinvestment programs for shareholders, that do not rely upon special tax benefits. The committee believes that it is preferable to direct business in need of capital to the capital markets, where there is a more neutral assessment of probable profits. Moreover, recent reductions in construction budgets by many utilities have reduced their need for capital.

In addition to the foregoing general reasons to repeal the provisions, the committee took note of inequitable effects among individual taxpayers. The tax benefit provides for lower tax liability to an individual whose portfolio contains stocks with qualified public utility dividend reinvestment plans than to another individual with the same pretax income who holds different types of stocks.

Explanation of Provision

The dividend reinvestment provision is repealed for distributions made after December 31, 1984. Stock distributed before 1985 will be unaffected.

Effective Date

The provision is effective for distributions made after December 31, 1984.

Revenue Effect

The provision will increase revenues by $167 million in fiscal year 1985 and by $278 million in fiscal year 1986.

12. Estimated Income Tax Payments by Individuals (sec. 186 of the bill and sec. 6654 of the Code)

Present Law

Under present law, an individual who fails to pay an installment of estimated income tax on or before the due date generally is subject to a penalty at the rate established for interest (under sec. 6621). The penalty may not be waived. The penalty is computed by applying the interest rate to the amount of the underpayment of the installment for the period of the underpayment. The amount of the underpayment is the difference between the payments (including withholding) made on or before the due date of each installment and 80 percent of the total tax shown on the return for the year, divided by the number of installments that should have been made. Estimated tax payments of the alternative minimum tax are not required.

Reasons for Change

The committee is concerned that the Commissioner of Internal Revenue cannot waive the penalty for failure to make estimated tax payment even where the failure is due to extreme hardship. While the committee recognizes that the system cannot be administered if waivers are readily available, the Commissioner should have the authority to grant a waiver in limited extreme hardship cases. Therefore, the bill authorizes the Internal Revenue Service to waive the penalty in certain limited circumstances.

In addition, the committee believes that persons subject to the alternative minimum tax, as restructured under TEFRA, should be required to make current estimated payments just as individuals subject to other income taxes are required to do.

Explanation of Provisions

a. Alternative minimum tax

Estimated tax payments of the alternative minimum tax will be required.[19]

b. Waiver of penalty in certain circumstances

The bill also allows the Internal Revenue Service to waive the estimated tax penalty if the failure to make a payment was due to casualty, disaster, or other unusual circumstances where it would be inequitable to impose the penalty. Thus, for example, this waiver could be granted where the taxpayer's books and records were destroyed by fire or other casualty, or where payment was not

[19] This provision was contained in S. 2062, reported by the Senate Committee on the Budget on November 4, 1983.

made because of the death or serious illness of the taxpayer. Also, the penalty can be waived where it would be inequitable to impose a penalty, for example, because the taxpayer substantially overstated his or her tax liability shown on the return.

In addition, the Internal Revenue Service can waive the penalty under certain circumstances if the failure to make a payment was due to reasonable cause. The reasonable cause waiver will be available only if the taxpayer retired (after attaining age 62), or became disabled, during the taxable year for which the installment was to be made or the preceding taxable year. In the case of a joint return of husband and wife, the waiver will be available if either taxpayer satisfies this test.

Effective Date

The provisions will be effective for taxable years beginning after December 31, 1984.

Revenue Effect

The provision allowing a waiver of the penalty will not affect revenues in fiscal year 1985, will decrease revenues by $8 million in fiscal year 1986, $9 million in fiscal year 1987, $10 million in fiscal year 1988, and $11 million in fiscal year 1989.

The provision relating to the alternative minimum tax will increase revenue by $611 million in fiscal year 1985, $45 million in fiscal year 1986, $49 million in fiscal year 1987, $52 million in fiscal year 1988 and by $56 million in fiscal year 1989.

13. Taxation of the Federal Home Loan Mortgage Corporation (sec. 187 of the bill and secs. 172 and 246 of the Code)

Present Law

Tax exemption of the Federal Home Loan Mortgage Corporation ("Freddie Mac")

The Federal Home Loan Mortgage Corporation ("Freddie Mac")[20] is exempt from all Federal, State, and local taxation (12 U.S.C. sec. 1452(d)). Real property held by Freddie Mac remains subject to State and local tax.

The twelve regional Federal Home Loan Banks, which control the stock of Freddie Mac, are themselves exempt from tax. However, the member savings institutions of the Home Loan Banks are subject to tax.

Net operating loss carrybacks

Corporations are generally allowed a carryback of net operating losses to each of the 3 taxable years preceding the taxable year of the loss. In addition, for losses in taxable years beginning in 1976 or later, corporations are generally allowed a carryover of net operating losses to each of the 15 taxable years following the taxable year of the loss.

Present law provides a special rule for net operating loss carrybacks and carryovers of the Federal National Mortgage Association ("Fannie Mae"). Under this rule, for losses (other than losses from mortgage dispositions) in any taxable year beginning after December 31, 1981, Fannie Mae is allowed a carryback to each of the 10 taxable years preceding the taxable year of the loss and a carryover to each of the 5 succeeding taxable years. In the case of losses from mortgage dispositions, the normal 3-year carryback and 15-year carryover rules apply.

Dividends received deduction

Under present law (sec. 243), a corporation is generally entitled to a deduction for 85 percent of the amount of dividends received from other domestic corporations. The deduction does not apply where the corporation paying the dividend is itself exempt from tax (sec. 246).

[20] Freddie Mac was chartered by Congress in 1970 as a wholly-owned subsidiary of the Federal Home Loan Bank system. The corporation provides a secondary market for residential mortgages held by savings institutions and other lenders. In a typical arrangement, Freddie Mac packages mortgages into pools and sells securities backed by a pool of mortgages (e.g., "participation certificates") to investors. In addition, Freddie Mac is authorized to offer a "swap" program under which lenders may exchange below-rate mortgages for mortgage-backed securities.

Income from discharge of indebtedness

Present law (sec. 61(a)(12)) provides that a discharge of indebtedness for less than its principal amount generally results in income to the party discharging of the indebtedness. For example, if a taxpayer is liable on an obligation having a principal amount of $100,000, and discharges the obligation for a payment of $80,000, the taxpayer recognizes $20,000 of income.

Reasons for Change

The tax exemption for Freddie Mac was originally intended to allow the corporation to accumulate adequate capital so that it could compete against other entities in the secondary mortgage market, including Fannie Mae, a taxable entity. The purpose of this tax exemption was not to provide it with a competitive advantage.[21] In the past 13 years, Freddie Mac has become highly profitable and has accumulated sufficient capital to compete in the secondary mortgage market. As a result, the committee believes that the exemption from tax has fulfilled its function and has begun to provide Freddie Mac with a competitive advantage. Accordingly, the committee believes it appropriate to repeal the tax exemption for Freddie Mac.

While the committee believes that is appropriate to remove the tax exemption for Freddie Mac, the committee is aware that various differences exist between the corporate structure of Freddie Mac and Fannie Mae, its chief competitor, which may affect the ability of Freddie Mac to compete successfully in the secondary mortgage market once tax is imposed. Specifically, Freddie Mac has in the past sought legislation allowing it to issue common stock (as Fannie Mae now does) representing a direct private investment in the corporation. The committee views these efforts with sympathy and, in principle, supports the concept of equality between Freddie Mac and Fannie Mae in corporate as well as tax matters.

The committee bill imposes tax on Freddie Mac, effective January 1, 1985. To ensure taxation on a prospective basis only, the bill provides various rules regarding the tax treatment of assets held by Freddie Mac on the date the exemption is repealed. The bill also provides a special rule for net operating loss carrybacks and carryovers of Freddie Mac which is equivalent to that provided under present law for Fannie Mae. Finally, the bill allows savings institutions a deduction for dividends received from the Federal Home Loan Banks where the dividends are allocable to Freddie Mac income which has already been subject to tax. This provision is designed to prevent imposition of a double corporate level tax on the income of Freddie Mac.

[21] *Cong. Rec.*, April 16, 1970, pp. 12232-12233 (statement of Sen. Sparkman). The tax exemption for Freddie Mac was added by amendment on the Senate floor.

Explanation of Provision

Repeal of Freddie Mac tax exemption

General rule

The bill repeals the Federal tax exemption for Freddie Mac effective January 1, 1985. The bill does not affect the exemption of Freddie Mac from State and local taxes or taxes imposed by U.S. possessions. Real property held by Freddie Mac will remain subject to State and local taxes.

The bill provides that, for any purpose under the Code, Freddie Mac shall be treated as having no accumulated earnings and profits as of January 1, 1985. Thus, distributions paid out of retained earnings accumulated before January 1, 1985, will not be treated as dividends (under sec. 316) and the tax treatment of such distributions is not affected by the bill.

Basis for determining gain or loss on disposition of assets

Under the bill, the basis of assets held by Freddie Mac on January 1, 1985, will be determined under a different method depending upon whether the basis is being taken into account for purposes of determining gain or loss on disposition of the asset. For purposes of determining gain, the basis of any asset held on January 1, 1985, is to be the higher of (1) the regular adjusted basis of the asset in the hands of Freddie Mac or (2) the fair market value of the asset on January 1, 1985. For purposes of determining loss, the basis of any asset held on January 1, 1985, is to be the lower of these two figures. Where the amount realized on the disposition of an asset is greater than the lower of these figures, but less than the higher figure, no gain or loss is to be recognized by Freddie Mac on the disposition.

For example, if a mortgage held by Freddie Mac on January 1, 1985, has an adjusted basis to the corporation, as of December 31, 1984, of $100,000, but (because of rising interest rates) has a fair market value of $80,000 on January 1, 1985, and if Freddie Mac later disposes of the mortgage for $70,000, Freddie Mac would recognize $10,000 of loss on the transaction ($70,000 minus $80,000). If, instead, the mortgage were disposed of (following a decline in interest rates) for $110,000, Freddie Mac would recognize $10,000 of gain ($110,000 minus $100,000). A disposition for a price between $80,000 and $100,000 would result in no taxable gain or loss by Freddie Mac.

Under the same principles, if Freddie Mac owns an asset on January 1, 1985 with an adjusted basis, as of December 31, 1984, of $100,000 and a fair market value of $150,000 on January 1, 1985, a subsequent disposition of the asset for $160,000 would result in $10,000 of taxable gain, while a disposition for $90,000 would result in a $10,000 loss. If the asset were disposed of for a price between $100,000 and $150,000, neither gain nor loss would be recognized.

Treatment of participation certificates (PCs)

The bill provides specifically that rights to income retained by Freddie Mac under participation certificates (PCs) and similar interests in mortgages (including guaranteed mortgage certificates and collateralized mortgage obligations) which Freddie Mac sold prior to January 1, 1985, are not to be considered to have a built-in income component on January 1, 1985, which could be treated as an asset held by Freddie Mac as of the date of taxability. Thus, income received by Freddie Mac attributable to participation certificates held on January 1, 1985, will be taxable in the year received, regardless of whether such income is attributable to services performed by Freddie Mac prior to January 1, 1985, or to a built-in profit component as of January 1, 1985. Additionally, Freddie Mac will not be entitled to a deduction for depreciation or amortization with respect to interests in these securities. Finally, Freddie Mac will have no basis in these interests for purposes of determining gain or loss on the sale or disposition of these interests.

The committee understands that Freddie Mac previously has not sold any of its interests in participation certificates and similar properties in the ordinary course of business, and intends to continue to hold such interests in the ordinary course of its business. Accordingly, a sale of such interests during 1984 would be for the purpose of avoiding the effective date of taxation. The bill therefore provides a special rule for the treatment of any sales of interests in participation certificates or similar interests before the January 1, 1985, effective date.

Under this special rule, income and gain realized by Freddie Mac on the sale of its interest in participation certificates or similar interests in mortgages after March 15, 1984, and before January 1, 1985, is recognized on January 1, 1985.

Carryback of net operating losses

For losses arising on or after January 1, 1985 (other than losses from mortgage dispositions), the bill allows Freddie Mac a net operating loss carryback to each of the 10 taxable years preceding the taxable year of the loss, and a carryover to each of the 5 taxable years following the taxable year of the loss. For losses from mortgage dispositions, the normal 3-year carryback and 15-year carryover rules apply. These rules are equivalent to the present law rules regarding net operating losses of Fannie Mae. The committee intends that the definition of a mortgage disposition loss shall be the same as that applied under present law in the case of Fannie Mae.

Dividends received deduction

The bill allows shareholders of the Federal Home Loan Banks a dividends received deduction (under sec. 243) for dividends received from a Home Loan Bank which are allocable to dividends paid by Freddie Mac out of current earnings or profits or earnings and profits accumulated after December 31, 1984. The amount of any dividend which is allocable to Freddie Mac income is to be that amount which bears the same ratio to the total dividend as the ratio of dividends paid by Freddie Mac to the Home Loan Bank during the bank's current taxable year bears to the earnings and profits of the Home Loan Bank for that year. For example, if a Home Loan Bank has $100 million of earnings and profits and has received $25 million of dividends from Freddie Mac, and the Home Loan Bank pays a dividend of $10 million, the bank's shareholders will be allowed a deduction with respect to $2.5 million of such dividends.

If the amount of the dividends paid by a Home Loan Bank exceeds the bank's earnings and profits for the current taxable year, an allocation equivalent to that described above is to be made for accumulated earnings and profits. However, a deduction will in no case be allowed for dividends paid by Home Loan Banks allocable to dividends paid by Freddie Mac out of earnings and profits which it accumulated before January 1, 1985 (i.e., prior to the date of taxability).

The committee intends that, for purposes of making the allocations above, the Home Loan Banks may treat retained earnings for financial accounting purposes as of January 1, 1985, as accumulated earnings and profits for years before 1985.

Reserves for bad debts

The committee intends that Freddie Mac's deductions for additions to a reserve for bad debts will be determined in a manner comparable to Fannie Mae.

Effective Date

This provision is effective on January 1, 1985.

Revenue Effect

This provision will increase fiscal year budget receipts by $67 million in 1985, $109 million in 1986, $142 million in 1987, $185 million in 1988, and $240 million in 1989.

14. Interest on Debt Used to Purchase or Carry Tax-exempt Obligations (sec. 188 of the bill and sec. 265 of the Code)

Present Law

Present law (Code sec. 265(2)) disallows the deduction of interest incurred or continued to purchase or carry tax-exempt obligations. This rule applies both to individual and corporate taxpayers. The courts and the Internal Revenue Service have interpreted present law to disallow an interest deduction only where a taxpayer incurred or continued indebtedness for the purpose of acquiring or holding tax-exempt obligations.

Present law is unclear as to how the disallowance rule applies when the taxpayer incurs debt and a related party acquires or holds tax-exempt obligations.

Reasons for Change

The committee believes that taxpayers should not be able to avoid this disallowance rule by incurring debt to finance the purchase of tax-exempt obligations by their spouses or, in the case of corporations, by an affiliated corporation (whether or not such corporations file a consolidated return).

Explanation of Provision

The bill provides that interest on indebtedness of the taxpayer or a related person which is incurred or continued to purchase or carry tax-exempt obligations of the taxpayer or a related person is not deductible. For this purpose, a related person means a related person within the meaning of section 1239.

The committee bill would not alter the requirement of present law that the purpose of borrowing must be to purchase or carry tax-exempt obligations in order for an interest paid deduction to be disallowed.[1] However, if the requisite purpose could be established if the borrowing and the holding of tax-exempt obligations had been accomplished by one taxpayer, the disallowance could not be avoided merely by having one taxpayer borrow funds and another related taxpayer purchase or carry tax-exempt obligations.

For example, the committee bill would disallow interest on borrowings of a parent corporation which transfers the proceeds from the borrowings to a subsidiary as a capital contribution which subsidiary uses the capital contribution to purchase tax-exempt obligations.

However, the committee bill would not disallow interest on borrowings in the ordinary course of the trade or business of a subsidi-

[1] See e.g., *Leslie* v. *Commissioner*, 413 F.2d 636 (2d Cir. 1969); *Wisconsin Cheeseman, Inc.* v. *United States*, 388 F.2d 420 (7th Cir. 1968); Rev. Proc. 72-18, 72-1 C.B. 740.

ary of a bank merely because the bank acquired tax-exempt obligations from deposits it receives in the ordinary course of its banking business.

Effective Date

This provision is effective with respect to interest paid or incurred on term obligations incurred after the date of enactment of the bill, and on demand obligations outstanding after 60 days after the date of enactment of the bill.

Revenue Effect

This provision will increase fiscal year budget receipts by less than $5 million annually.

TITLE II—LIFE INSURANCE TAX PROVISIONS

A. Present Law

1. Pre-1959 Taxation of Life Insurance Companies

Before 1921, insurance companies were taxed in substantially the same manner as other corporate entities. Under the Revenue Act of 1921 and subsequent legislation, however, life insurance companies were accorded special tax treatment.

From 1921 through 1957, a life insurance company was only taxed on investment income. Premiums were excluded from the income computation, as were losses and expenses incurred in underwriting operations, and gains and losses from the sale of investment assets. In addition, various formulas were established to exclude from taxation the portion of investment income necessary to satisfy the company's obligations to policyholders under its insurance contracts. Although the formulas varied from time to time, their purpose was always to compute that portion of investment income allocable to policyholders. This approach of taxing income only to the extent not needed to fund current and projected liabilities to policyholders as determined under State law has been referred to as taxing a company on its free investment income.

2. The 1959 Act

In general

The general framework under which life insurance companies are taxed under present law was adopted in the Life Insurance Company Income Tax Act of 1959 (secs. 801-820 of the Code).[1] The 1959 Act significantly changed prior law by attempting to measure the total income of a life insurance company rather than just its free investment income. Nonetheless, as described below, under the 1959 Act various deductions and "special rules" resulted in an income tax base which fell short of total income.

Computing taxable income

Under the 1959 Act, a life insurance company is taxed on the lesser of its taxable investment income or its gain from operations. If a company's gain from operations exceeds its taxable investment income, the company is taxed on 50 percent of such excess. The tax with respect to the other half of the excess of gain from operations over taxable investment income is deferred; that half (along with amounts deducted for nonparticipating contracts, accident and health and group life insurance contracts) is added to a deferred

[1] Public Law 86-69, June 25, 1959. The Act was generally effective for taxable years beginning after December 31, 1957.

tax account (policyholders' surplus account) and, subject to certain limitations, is taxed only when distributed to shareholders of a stock company.[2] Thus, under the 1959 Act, a life insurance company must compute its gain (or loss) from operations and its taxable investment income. The computation of gain from operations begins with the company's total income, including the company's share of investment yield,[3] net capital gain, premiums and other considerations, decreases in insurance reserves, and all other amounts. From this total, a life insurance company is allowed deductions. These generally include the usual deductions available to taxpayers for business or investment expenses, an operations loss deduction, and certain deductions unique to the insurance business such as for payments of claims and death benefits, for increases in reserves (to the extent not funded out of the policyholders' share of investment income), and for certain payments under assumption reinsurance. All life insurance companies are also permitted to claim a small business deduction. Finally, there are three special deductions for policyholder dividends, nonparticipating contracts, group life insurance, and accident and health contracts, which are subject to limitations. Unlike the deduction for policyholder dividends, the other two special deductions do not reflect actual cash expenditures by the company or even the commitment of funds to a reserve required under State law.

In addition, a deduction is allowed for the company's allocable share of tax-exempt income and the amount of any dividends received by the company that are deductible under provisions generally applicable to all corporations. The initial inclusion of tax-exempt income, followed by the later deduction of the company's share, has the effect of allocating a portion of tax-exempt income to the policyholders' share which is not includible in the company's taxable income in any event. Thus, tax-exempt income is not as attractive to life insurance companies as to other taxpayers as a means of reducing their effective tax rate.

To compute taxable investment income, it is necessary to calculate investment yield. Investment yield is the excess of gross investment income over all applicable investment expenses. Then, the policyholders' share of investment yield is excluded.[4] Finally, the company may deduct from its share of investment yield its share of tax-exempt investment income and of the deduction for dividends received.

Under the 1959 Act and present law, the computation of a life insurance company's taxable investment income is important for

[2] Typically, this will be incurred only if a company is acquired and liquidated to achieve an increase in the basis of its assets.

[3] The computation actually begins with gross investment income, less investment expenses, from which the interest contractually required to be set aside for policyholders is excluded. A portion of an item required to be set aside for policyholders is referred to as the policyholders' share of such item. The excess of the amount of the item over the policyholders' share is the company's share.

[4] Under the taxable investment income computation, the policyholders' share of investment yield is determined in part by use of the "Menge formula," which arithmetically adjusts State-required life insurance reserves to allow the crediting of earnings at an adjusted rate that takes into account the actual earnings rate of the individual companies. In general, the effect of this computation is to allocate to the policyholder an amount at least equal to the reserves required under State law (unless under the permanent provisions, the current earnings of the company exceed 10 percent). The 1959 Act does not establish a Federal standard for computation of reserves or require that they be based on a company's actual experience.

two purposes. First, as discussed above, a company may be taxed on its taxable investment income. Second, for purposes of computing gain from operations, the aggregate amount allowed for the special deductions is limited by reference to the amount of the company's taxable investment income. Prior to amendment in the Tax Equity and Fiscal Responsibility Act of 1982 (P.L. 97-248) (TEFRA), the 1959 Act provided that the amount of deductions allowed for policyholder dividends, for nonparticipating contracts, and for accident and health and group life insurance contracts be limited to the amount by which gain from operations (before those deductions) exceeded taxable investment income, plus $250,000. This limitation was designed to ensure that most large companies be subject to tax at least on their free investment income (reduced by no more than $250,000). As explained below, this $250,000 statutory amount was modified in TEFRA.

Tax phases

The provisions described above for computing a life insurance company's taxable income require a comparison of the company's taxable investment income and its gain from operations. Depending on the mix of these elements, two companies with the same aggregate pre-tax income may owe different amounts of tax. The result is that most life insurance companies can be classified on the basis of the mix of investment income and underwriting gain as being in one of three tax categories.

Phase I Company

Under the 1959 Act, a Phase I company has a gain from operations that is less than its taxable investment income, and has reached the limit on the special deductions. A life insurance company that would typically be in this phase is an established mutual company, which might have substantial underwriting income before any policyholder dividend distributions. This company could use the deduction for policyholder dividends to reduce gain from operations.

Phase II (Positive) Company

A Phase II (Positive) company has a gain from operations in excess of its taxable investment income, taking into account any policyholder dividends. A typical life insurance company taxed under this phase is an established stock company that has no State law requirement to share favorable investment and underwriting experience with its policyholders through policyholder dividends. A Phase II (Positive) company's taxable income is generally the sum of its taxable investment income, and one-half of the excess of its gain from operations over taxable investment income. Because a company's gain from operations is roughly the sum of its taxable investment income and its underwriting gain, a Phase II (Positive) company is taxed currently on one-half of its underwriting gain while the other half becomes part of the policyholders' surplus account (known generally as the Phase III account).

Phase II (Negative) Company

A Phase II (Negative) company has a gain from operations that is less than its taxable investment income by more than $250,000 (under the 1959 Act) because of underwriting losses. Typically, a Phase II (Negative) company is a new or growing stock life insurance company that has underwriting losses because of high start-up costs associated with new insurance business. In such a case, taxable investment income is reduced by the expenses of operating the company because the underwriting income alone is not sufficient to cover the costs of the insurance business. A Phase II (Negative) company's taxable income is its entire gain from operations.[5]

3. TEFRA Changes

In TEFRA, Congress addressed certain tax avoidance techniques available to life insurance companies through both permanent provisions and temporary provisions (effective, generally, for 1982 and 1983). The latter allowed a more thorough Congressional review of the tax laws applicable to life insurance companies and their products.

Modco and other reinsurance

Provisions governing modified coinsurance transactions were permanently repealed. In addition, provisions were adopted to prevent abuse through dividend reimbursement agreements between insurance companies engaged in reinsurance transactions. Further, provisions were added to deny deductions for interest paid on indebtedness used in reinsurance transactions, and to grant Treasury special income allocation and recharacterization authority with respect to reinsurance transactions between related parties. TEFRA provided, in addition, that for years before 1982 (except in the case of fraud) the determination of whether a reinsurance contract satisfied the modified coinsurance requirements of then existing law would be made solely by reference to the terms of the contract.

Special deductions

TEFRA provided a temporary change in the limitation on the special deductions for policyholder dividends, nonparticipating contracts, accident and health and group life insurance contracts. This provision generally raised the $250,000 statutory dollar amount under the 1959 Act to $1 million, but targeted it to small life insurance companies.

TEFRA also provided an alternative limitation on the special deductions. Under this provision, the maximum amount that could be deducted was the sum of (1) 100 percent of policyholder dividends on pension contracts, (2) the statutory amount, and (3) 85 percent (77½ percent for mutual companies) of the tentative deduction for policyholder dividends, other than policyholder dividends on pen-

[5] In addition to the three tax categories discussed above, there is also a "Phase I Corridor" company, which is taxed on its entire gain from operations that is less than taxable investment income by an amount less than $250,000 (under the 1959 Act), and a "Phase III" company, which has taxable income that includes shareholder distributions of, or subtractions from, previously tax-deferred amounts from the policyholders' surplus account.

sion business. For most companies, this alternative was substantially more generous than the limitation provided under the 1959 Act.

Computation of reserves

TEFRA contained a number of temporary provisions relating to the computation of reserves. First, interest guaranteed in a contract in excess of the interest that would be earned at the rate assumed for purposes of computing statutory reserves could not be taken into account in computing the reserves to the extent such excess interest is guaranteed beyond the taxable year. Second, under TEFRA, the amount of investment yield that could be allocated to group pension contracts was limited to the amount actually credited to such contracts. Both of these provisions had the practical effect of reducing the exclusion for the policyholders' share of investment yield. Third, under TEFRA, the status of a life insurance company could not be changed because of its reserve treatment of group pension funds. This prevented reclassification for tax purposes of life insurance companies as casualty insurance companies—which would be adverse to certain stock companies and favorable for certain mutual companies—because they have removed life contingencies from pension contracts. Fourth, an arithmetic adjustment to reserves contained in the 1959 Act (the Menge formula) was changed to a geometric adjustment, allowing a slightly more generous policyholders' share of investment yield. In addition to these temporary changes, there was a permanent reduction in the amount allowed a life insurance company under the approximate formula for revaluing preliminary term reserves for insurance other than term life insurance. Under TEFRA, reserves are increased by $19 per $1,000 of insurance in force and reduced by 1.9 percent of the reserves (rather than by $21 per $1,000 reduced by 2.1 percent, as under prior law).

Consolidated returns

Under a temporary provision, related life insurance companies were allowed to compute their respective taxable incomes before consolidation (a bottom-line method). This method was allowed instead of requiring consolidation of income items before computing consolidated taxable income (a phase-by-phase method).

Annuities

TEFRA also contained permanent changes for the tax treatment of annuity contracts to companies and to policyholders. In general, companies are allowed the full deduction for amounts credited to annuity contracts. For a policyholder, cash distributions from an annuity contract before the annuity starting date are taxable to the policyholder to the extent there is income in the contract. Also, if a portion of such an income distribution is attributed to an investment in the contract that was made within 10 years of the distribution, there is a 5-percent penalty tax on such portion. There are, however, a number of exceptions to this rule; for example, no penalty applies to income distributions on or after the policyholder reaches age 59½.

Flexible premium life insurance

Finally, TEFRA adopted temporary guidelines with respect to flexible premium life insurance contracts (i.e., universal life and adjustable life), which must be met in order for the death proceeds from such contracts to be considered life insurance for tax purposes.

B. Reasons for Change

Overview

The changes in the tax treatment of life insurance companies, life insurance and annuity products, and policyholders in the bill are motivated primarily by two concerns. The first concern is the need to adjust the taxation of life insurance to reflect the unusually large increase in interest rates that has occurred since 1959. The second is the desirability of simplifying the Code and eliminating the extraordinarily complex three-phase tax structure of present law.

Rising interest rates have caused several changes in the tax position of the life insurance companies since the enactment of the 1959 Act. First, with investment income increasing because of rising interest rates, the tax liability of mutual (and, to a lesser extent, stock) insurance companies began to increase. Second, these companies made extensive efforts to reduce their increasing Federal income tax liability by entering into larger volumes of modified coinsurance transactions by which investment income was recharacterized as underwriting income. In 1981, one of the largest mutual companies used modified coinsurance so extensively that it reduced its tax to zero. Third, some stock companies, in order to compete with other financial intermediaries, began to offer investment-oriented products that, in effect, allowed them to distribute currently high investment yields tax-free to policyholders. Mutual companies were slower to enter this market because their ability to pay policyholder dividends already permitted them to pass through to policyholders favorable investment experience, although some of those dividends were taxed at the company level because of the limitation on the deduction for policyholder dividends.

In 1982, the Congress responded to these changes in the life insurance industry through a number of tax changes, including a permanent repeal of the provisions for the special tax treatment of modified coinsurance. At that time, it was estimated that the repeal of the special tax provisions for modified coinsurance would increase revenues by $2.3 billion in 1982 over an estimated prior law tax burden of $1.7 billion. Concern over the effect of so substantial a change in tax burdens led to enactment of a series of temporary provisions which generally had the effect of reducing the industry tax burden by an estimated $1.2 billion for 1982 and by the same amount for 1983. These provisions expired at the end of 1983.

Inadequacies of the 1959 Act

In reviewing the 1959 Act, the committee identified numerous inadequacies. First, drafted in the middle of a period of low and stable interest rates, the 1959 Act distinguishes between investment and underwriting income and taxes them differently. While interest rates remained stable, the 1959 Act functioned reasonably well, although it never taxed companies on their full economic income. With increases in interest rates and the evolution of new insurance products, however, the 1959 Act resulted in an inappropriate measure of life insurance company income. As a result, the committee concluded that a proper measure of the income of life insurance companies can be obtained only by replacing the complex, three-phase structure of present law with a simpler, single-phase tax.

A second inadequacy of the 1959 Act which the committee identified is that the Act includes a variety of deductions and deferral items that do not relate to a proper measure of a life insurance company's income and which provide extraordinary benefits for some companies and no benefits for other companies. In particular, the special deductions for accident and health insurance and for nonparticipating policies bear no relationship to actual expenditures by companies and tend to benefit mature stock companies more than other companies. Similarly, the deferral of tax on underwriting income is, in effect, beneficial only to certain stock life insurance companies. The revaluation of reserves from amounts computed under a preliminary term method to amounts computed under a net level premium method allows a deduction for amounts that are not, in fact, added to reserves and benefits expanding, newer, stock life insurance companies. Finally, the rules relating to deduction of policyholder dividends, which primarily affect mutual companies, operate to assure that companies are taxed on at least their investment income. These rules do not attempt to distinguish between amounts returned to policyholders as customers and amounts distributed to them as owners of the mutual company. As a result, a mutual company may be taxed on a base that is either greater than or less than its economic income.

A third concern with respect to the 1959 Act relates to the tax treatment of reserves maintained by life insurance companies. Under present law, a company's reserves are based on its statutory reserves, which are computed using assumptions under State law. The result is a significant overstatement of liabilities in comparison to those measured under realistic economic assumptions. The committee concluded that a more accurate measure of liabilities for tax purposes can be achieved by imposing specific rules for the computation of tax reserves that result in a reserve which approximates the least conservative (smallest) reserve that would be required under the prevailing law of the States.

A fourth concern which the committee identified is a significant shifting of tax toward the mutual company segment of the industry. As interest rates rose, investment income became an increasingly large portion of life insurance company income. Many stock companies can offset at least a portion of this income with losses generated by their underwriting activities. Mutual companies, on the other hand, generally charge higher premiums for their products and are less likely to have underwriting losses. Thus, with the permanent repeal of the provisions governing modified coinsurance transactions, there may be a significant shifting of tax under the 1959 Act toward mutual companies.

Single-phase tax

The single-phase tax contained in the bill was designed by reference to a stock life insurance company model. This choice was made because it provides a relatively simple tax structure for life insurance companies that bears a close resemblance to the general structure of corporate income taxation. Further, the choice of the stock company model reflected the view that life insurance is primarily a commercial activity, and that no company should engage in it without being subject to Federal corporate income taxes.

In redesigning the statutory scheme for taxation of life insurance companies, the committee was concerned that the new provisions not unduly prejudice companies by suddenly increasing their tax liability by substantial amounts. Although the committee was concerned that deductions which do not reflect economic expenses generally are inappropriate, it nonetheless concluded that the difficulties which might result from a sudden increase in the industry's tax burden warranted limited exceptions in this case. Thus, the committee provided special rules for smaller life insurance companies since most of these companies enjoyed substantial benefits under existing law. In addition, the committee bill provides an across-the-board rate reduction for life insurance companies which will cushion the impact of the new rules. In addition to these two generally applicable transition rules, the committee provided limited duration transition rules for companies that have high volumes of first-year premiums (typically growing stock companies) and for mutual companies with much greater than average equities. The committee believes that these companies will experience greater transitional difficulties than will the industry generally.

Life insurance products

Life insurance policyholders traditionally have benefited from a special position under the Code. Under present law, policyholders benefit principally from the tax-free accumulation of cash value under life insurance policies and the deductibility of interest payments for indebtedness. Cash values accumulate under any one of several premium payment systems for whole life insurance which result in larger premium payments in the early years of a contract than required to fund current insurance protection. The buildup occurs when a level premium payment plan applies to the policy, and the premium payments in the early policy years exceed the current cost of insurance computed using assumed mortality table and interest rates. In the later years of the contract, the annual cost of insurance is higher and for the nominal face amount of coverage may exceed the annual level premium payment. The cash value buildup in the policy, however, reduces the actual insurance risk and, therefore, the cost of insurance. Under present law, the policyholder is not taxed on increases in the cash value (for example, from investment earnings) unless the contract is surrendered prior to the death of the insured for an amount in excess of the gross premiums paid. Both cash value and reserves grow as the balances earn interest, but the accruals of interest are not included in the policyholder's gross income and therefore are not subject to taxation.

In light of the significant tax advantages associated with life insurance products, the committee undertook a review of those products and their treatment. Three areas of concern were identified as appropriate for legislation. First, in recent years, companies have begun emphasizing investment-oriented products that maximize the advantages of the deferral provided in the Code. When compared to traditional products, these products offer greater initial investments or higher investment returns, or both. In response, the committee adopted a definition of life insurance that treats as currently taxable investments those life insurance policies that provide for much larger investments or buildups of cash value than traditional products.

A second area of concern was the treatment of annuity contracts. The committee believes that the present-law treatment of annuities (deferral of tax on investment income) is justified only by the retirement savings purpose of annuities. Thus, an exception to the early withdrawal penalty for amounts earned on investments that are kept in the annuity contract for at least 10 years was viewed as inappropriate, since it permits penalty-free pre-retirement withdrawals. Similarly, the committee believes that an unlimited deferral should not be allowed when the income in an annuity contract is passed to another generation or outside the family. Thus, if the owner dies before annuitization, deferred income should be distributed over a limited period (5 years) unless the annuity passes to a spouse, a minor child, or a handicapped individual.

Finally, the committee believes that present-law limits on the amount of term life insurance coverage that can be provided to employees without inclusion of the cost of such insurance in the income of the employee should also apply to retired employees.

C. Explanation of Provisions

1. Overview of the Bill

General rules

Title II of the bill contains three subtitles. Subtitle A is the amendment that provides a complete substitute for the present-law tax treatment of a life insurance company. Part I of Subchapter L of the Internal Revenue Code, sections 801-819A, will be repealed and will be replaced by the amendments in subtitle A of title II of the bill. Subtitle B provides new rules relating to the treatment of life insurance products which are in addition to those of present law. Subtitle C provides for certain studies and reports to the tax committees relating to the tax burden on life insurance.

New Code section 801 imposes an income tax on the taxable income of a life insurance company as defined in section 816. Taxable income is defined as life insurance company gross income less life insurance company deductions. Life insurance company gross income is defined in section 803. The deductions which are allowed to be made from gross income are set forth in section 804, and described in some detail in section 805 (the general deductions) and section 806 (the special deductions). Further specification of these deductions is provided in sections 807 and 817 (rules for reserves and variable contracts), sections 808 and 809 (policyholder dividends), and section 810 (operations loss).

Accounting provisions that relate to life insurance company taxation are contained in section 811. In section 812, the company's share and policyholders' share are defined, and the proration of various types of income between the two shares also is described. Sections 813 and 814 relate to foreign life insurance companies and contiguous country branches of domestic life insurance companies.

Subtitle B of title II contains the definition of a life insurance contract (sec. 221), the treatment of annuity contracts (sec. 222), the limitation on the interest deduction in case of life insurance loans (sec. 223), and further rules relating to group-term life insurance purchased for employees (sec. 224).

Subtitle C contains requirements for studies which will report upon the various aspects of the industry (e.g., revenues, segment balance, etc.). These Treasury studies are to be completed at various dates and reported to the Committee on Ways and Means of the House of Representatives and the Committee on Finance of the Senate.

Relationship to the 1959 Act

Although the bill amends the Internal Revenue Code by repealing the life insurance company taxation provisions of the 1959 Act and replacing them with an entire new Part I of subchapter L, the committee intends that the provisions of the new Part I which are based on present law be interpreted in a manner consistent with present law. Thus, where provisions of existing law are incorporated in the bill, the committee expects that, in the absence of contrary guidance in this report, the regulations, rulings, and case law under existing law may serve as interpretative guides to the new provisions.

2. Tax Treatment of Life Insurance Companies

a. Definition of a life insurance company (new sec. 816)

Present Law

A company is taxed as a life insurance company if (1) it is an insurance company; (2) it is engaged in the business of issuing life insurance and annuity contracts (either separately or in combination with accident and health insurance), or noncancellable accident and health insurance contracts; and (3) more than 50 percent of its total reserves are life insurance reserves or unearned premiums and unpaid losses (whether or not ascertained) on noncancellable life, accident or health policies not included in life insurance reserves.

Under present law, there is no statutory definition of an insurance company. Treasury regulations, however, provide that an insurance company is a company "whose primary and predominant business activity during the taxable year is the issuing of insurance or annuity contracts or the reinsuring of risks underwritten by insurance companies." (Treas. Reg. sec. 1.801-3(a)).

Life insurance reserves are amounts which are (1) computed or estimated on the basis of recognized mortality or morbidity tables and assumed rates of interest, and (2) are set aside to mature or liquidate future unaccrued claims arising from life insurance, annuity, and noncancellable health and accident contracts involving (at the time the reserve is computed) life, health or accident contingencies. Also, life insurance reserves must be required by law. The term total reserves means (1) life insurance reserves, (2) unearned premiums, and unpaid losses (whether or not ascertained), not included in life insurance reserves, and (3) all other insurance reserves required by law. The term total reserves does not include deficiency reserves.

Explanation of Provision

The bill generally adopts the present-law test for determining whether an insurance company is a life insurance company and, for this purpose, continues to look to properly computed statutory reserves. However, for purposes of qualifying as a life insurance company, the bill adopts a statutory definition of an insurance company. Specifically, for purposes of qualifying as a life insurance company, a company must be one for which more than half of the business activity during the taxable year is the issuing of insurance or annuity contracts or the reinsuring of risk underwritten by insurance companies. By requiring more than half rather than that the "primary and predominant business activity" be insurance activity, the bill adopts a stricter and more precise standard for a company to be taxed as a life insurance company than does the general regulatory definition of an insurance company applicable for both life and nonlife insurance companies under present law. Whether more than half of the business activity is related to the issuing of insurance or annuity contracts will depend on the facts and circumstances and factors to be considered will include the relative distribution of the number of employees assigned to, the amount of space allocated to, and the net income derived from, the various business activities. It is the character of the business actually done in the taxable year which determines whether a company is taxable as an insurance company under the Code; see, e.g., *Service Life Insurance Co. v. United States*, 189 F. supp. 288, *aff'd. on other grounds*, 293 F. 2d 78 (8th Cir. 1961).

Because the definition of a life insurance company, under the bill, looks to the activities of the company for the entire taxable year, a company will be characterized for that year as a life insurance company or as a property and casualty company on the basis of its activities for the entire year. Thus, if more than half a company's business activity during the taxable year is the issuing of insurance and annuity contracts or the reinsuring of risks underwritten by insurance companies, and if more than 50 percent of its total reserves for the taxable year are life insurance reserves or unearned premiums and unpaid losses on noncancellable life, accident or health policies, then the company would be taxable as a life insurance company for such taxable year.[6] Any definitional change from present law, however, is not intended to override any authority of Treasury to issue regulations under section 1502 relating to the filing of consolidated returns.

The bill adopts the same definition of a life insurance reserve as under present law. In doing so, the special recognition afforded noncancellable accident and health insurance contracts in the 1959 Act as being comparable to life insurance contracts because of their long-term rate commitments is continued. However, under a special provision, an insurance company can make a permanent election to treat individual noncancellable (or guaranteed renewable) accident and health contracts as cancellable for purposes of determining the qualification fraction; the election will not affect the computation of the tax reserves for such contracts. Thus, a company with large amounts of individual noncancellable accident and health business, which might have large surplus requirements, could elect to be taxed as a property and casualty insurance company. As such, an electing company will forfeit the special and small life insurance company deductions. Likewise, any life insurance subsidiaries of a mutual life insurance company parent that elects this treatment will be taxed as mutual companies; and both the assets and the income of the electing parent will be taken into account in determining the amount of the small life insurance company deduction. The committee does not intend to provide a new election to these companies if there is a subsequent reform of property and casualty insurance taxation.

[6] In determining whether a company has the requisite reserve qualifications, the amount of the reserve taken into account for the year is the mean of the reserve at the beginning and the end of the year.

In general, the bill adopts the present-law definition of total reserves. However, the bill also provides that, for purposes of determining whether an insurance company is a life insurance company, amounts set aside and held at interest to satisfy obligations under contracts which do not contain permanent guarantees with respect to life, accident, or health contingencies shall not be included in life insurance reserves or in total reserves. Thus, these amounts are not included in either the numerator or the denominator of the qualification fraction when determining whether a company's life insurance reserves and unearned premiums and unpaid losses on noncancellable accident and health insurance contracts comprise more than half its total reserves.[7] This provision resolves for future years a question under present law as to how certain pension funds that do not contain permanent annuity purchase rate guarantees should be treated.[8] The Internal Revenue Service has ruled that a reserve for a benefit is not a life insurance reserve unless a life benefit is permanently guaranteed under the contract (Rev. Rul. 77-286, 1977-2 C.B. 228). The provision of the bill substantially adopts this position and extends it to total reserves also, but only for purposes of the qualification fraction. The fact that such funds are not treated as insurance reserves for purposes of the qualification fraction is not intended to have any effect on the characterization of the contracts or of the company issuing the contracts. Rather, whether a contract with less than a permanent guarantee should be considered an insurance or annuity contract would depend on the terms of the contract. That is, it will depend on whether the company has assumed a significant insurance risk or has made an annuity guarantee (for life or a fixed period). Generally, the assumption of solely an investment risk would not give rise to an insurance liability.

Because of a general change in State law, as well as new rules for computing tax reserves, the present-law provision that excludes deficiency reserves from the definition of life insurance reserves and total reserves has been eliminated. Rather, the new rules for computing tax reserves prohibit a company from taking into account any State requirements for "deficiency reserves" caused by a premium undercharge for purposes of computing the company's increase in revenue deduction.

b. Computation of life insurance company taxable income (new secs. 801, 803, 804, 805, and 806)

Present Law

A life insurance company currently is subject to a three-phase taxable income computation under Federal tax law. Under the three-phase system a company is taxed currently on the lesser of its gain from operations or its taxable investment income (Phase I)

[7] If these contracts have any insurance or annuity purchase rate guarantees (for life or a fixed term), then the premiums will be taken into income and the increase in the fund will be treated as increases in a reserve item under section 807(c)(3) or (4). If there are no guarantees whatsoever, then no income will be taken into account and no reserves will be treated as increased for purposes of the reserve deduction.

[8] The question was temporarily mooted by a TEFRA provision which prevented any company from changing its life insurance company status because of the treatment of such reserve funds.

and, if its gain from operations exceeds its taxable investment income, 50 percent of such excess (Phase II). Federal income tax on the other 50 percent of the gain from operations is accounted for as part of a policyholders' surplus account and, subject to certain limitations, is taxed only when distributed to stockholders or upon corporate dissolution (Phase III). Thus, although life insurance companies are taxed at the normal corporate rates under present law, special accounting rules are provided for computing taxable income. Consistent with the taxation of other taxpayers, net capital gain that is taxable to the company may be subject to an alternative tax.

Explanation of Provisions

Life insurance company taxable income (new sec. 801)

Under the bill, a life insurance company will be taxed at corporate rates, under a single-phase system, on its life insurance company taxable income (LICTI). LICTI is life insurance gross income reduced by life insurance deductions. As under present law, net capital gain that is taxable to the company may be subject to an alternative tax. A stock life insurance company will be taxed, at corporate rates, on any distributions from a pre-1984 policyholders' surplus account.

In general, as described below, a special life insurance company deduction and a small life insurance company deduction each result, in effect, in a lowering of the tax rates on LICTI. However, if amounts are subject to the alternative tax on capital gains, the special life insurance company and small life insurance company deductions do not reduce the amounts subject to that tax, because the bill already provides a lower than normal tax rate (new sec. 801).

Life insurance gross income (new sec. 803)

Under the bill, life insurance gross income is the sum of (1) premiums, (2) decreases in certain reserves, and (3) other amounts generally includible by a taxpayer in gross income. For these purposes, premiums consist of the gross amount of premiums and other consideration received on insurance and annuity contracts reduced by return premiums paid to policyholders, such as on the cancellation of a policy, and premiums and other consideration paid to another insurer on indemnity reinsurance (new sec. 803).

As under present law, the premiums and other consideration taken into account include advance premiums, deposits, fees, assessments, consideration in respect of assuming liabilities under contracts not issued by the taxpayer, and any policyholder dividends reimbursable by a reinsurer. Return premiums do not include amounts paid to policyholders, which are not fixed in the contract but depend on the experience of the company or the discretion of the management, except in the case of return premiums or other consideration returned to another life insurance company under an indemnity reinsurance contract. Furthermore, amounts rebated or returned due to policy cancellations or to erroneously computed premiums are to be treated as return premiums.

The use of the term "indemnity reinsurance" in the bill, instead of "reinsurance ceded" under present law, is not intended to be a substantive change from present law. Likewise, the reference to "insurance and annuity contract" rather than to "insurance and annuity contracts (including contracts supplementary thereto)" is not a substantive change from present law. A general provision, applicable to the life insurance company part of the Code only, states that any reference to insurance and annuity contracts includes any contract supplementary thereto (new sec. 818(d)).

Life insurance deductions (new sec. 804)

In general, under the bill, life insurance deductions consist of "general" life insurance deductions (new sec. 805), the "special life insurance company deduction" (new sec. 806(a)), and the "small life insurance company deduction" (new sec. 806(b)). For 1984 through 1987, there will also be an alternative life insurance company deduction that may be elected to be used in lieu of the special and small life insurance company deductions for those years (new sec. 806(c)).

The general deductions (new sec. 805)

The general deductions are generally the same as the deductions allowed under present law, except that the deductions currently available to life insurance companies for nonparticipating and group life contracts and accident and health contracts are eliminated. The general deductions, under the bill, are the deductions for (1) claims and benefits accrued, and losses incurred (whether or not ascertained) during the taxable year on insurance and annuity contracts, (2) net increases in reserves (see item d. below), (3) policyholder dividends (see item e. below), (4) a modified dividends-received deduction, (5) operations losses (see item f. below), (6) consideration paid for assumption reinsurance, and (7) policyholder dividend reimbursements paid to another insurance company under a reinsurance agreement. In addition, life insurance companies are allowed other deductions generally allowable to corporate taxpayers for purposes of computing taxable income, subject to certain modifications. These modifications are generally the same as under present law.

Intercorporate dividends.—With respect to the deduction for intercorporate dividends received by a life insurance company, in general the bill continues the present-law rule of prorating the deduction between the company and the policyholders as the items of investment income are allocated between the company and the policyholders. (See the discussion of new section 812 in item h. below.) However, "100 percent dividends" (i.e., dividends that would be allowed a 100 percent deduction under sections 243 or 244, and certain dividends received by foreign corporations that would be 100 percent dividends but for the foreign recipient) are not subject to proration except to the extent they are funded with tax-exempt interest or with dividends that would not qualify as 100 percent dividends in the hands of the taxpayer. For these purposes, a distribution would be considered to be funded ratably out of tax-exempt income, dividends that would not qualify as 100 percent dividends to the taxpayer, and all other taxable income of the distributing corporation. Also for purposes of applying the exception, multi-tiered corporate ownership arrangements cannot be used to change the character of the tax-exempt interest and dividends received in an attempt to avoid proper proration.

The rationale for this special rule is that dividends received by a life insurance company parent from a subsidiary represent the earnings of the subsidiary. To the extent they are distributions of fully taxable income, these earnings have already been taxed at the subsidiary level. Including them in gross investment income would have the implicit effect of taxing these earnings a second time through operation of the proration formula. However, to the extent these earnings are distributions of tax-exempt income, they have not been taxed and should be subject to proration. Without this rule, a parent life insurance company could avoid proration of tax-exempt interest by having a subsidiary own all of its tax-exempt obligations. The subsidiary would not be taxed on this income which it could distribute to the parent as dividends. However, the proposed rule would avoid this result by having gross investment income include dividends received from a subsidiary to the extent that such dividends are distributions of tax-exempt interest or of dividend income that would not be 100 percent deductible if received directly by the taxpayer. The bill also prevents a group from using multi-tier corporations to pass dividends comprised of tax-exempt income up to a parent life insurance company.

The committee is aware that, as under present law, the proration of tax-exempt income may also be avoided by distributing surplus in the form of dividends to a parent (nonlife insurance) company that could invest in tax-exempt income. This possibility is less troublesome than that of placing assets in a subsidiary because assets of a parent do not contribute to a company's surplus while assets of a subsidiary do. This difference effectively places a limitation on the amount of assets which a company may pay as dividends to a parent without jeopardizing its ability to do business under State law.

Reimbursable policyholder dividends.—The specific deduction for policyholder dividend reimbursements paid by a life insurance company to another insurance company under a reinsurance agreement was originally adopted under TEFRA, as was the rule that all policyholder dividends paid by an insurance company directly insuring the policyholder are to be treated as paid by that company. The bill adopts both provisions.[9] The bill clarifies, however, that these reimbursements for policyholder dividends are expenses of the reinsuring company (the reinsurer) and are not policyholder dividends as defined for tax purposes. Also, the bill specifically uses the term "reimbursable dividends" both in referring to the deduction allowed therefor, and in referring to the inclusion of such dividends in income by the direct writer of the insurance, in order to

[9] The committee also adopted an amendment to the TEFRA provisions, for taxable years 1981 and 1982 which is an exception to the reimbursable dividends rule. Reimbursable dividends paid pursuant to a reinsurance agreement entered into before June 30, 1955 by a life insurance company to reinsure their accident and health policies, pursuant to the direction of the National Association of Insurance Commissioners, will be treated as policyholder dividends of the reinsurer.

clarify that such dividends are deductible and includible in income on an accrual accounting basis.

The special life insurance company deduction (new sec. 806(a))

A life insurance company is allowed a deduction for any taxable year of 20 percent of its "tentative life insurance company taxable income" (tentative LICTI) over the amount of the company's small life insurance company deduction. The committee believes that although the bill provides for the proper reflection of the economic income of a life insurance company without this deduction, some adjustment is necessary to avoid suddenly imposing a substantially increased tax burden on life insurance companies. Under present law, a life insurance company is able to defer or avoid taxation on a substantial portion of its current income, and thus this provision ameliorates the hardship that might otherwise result from a sudden, substantial increase in a company's tax base.

As indicated above, the tax base for the special life insurance company deduction is tentative LICTI. Generally, a company's tentative LICTI is its life insurance company taxable income determined without regard to (1) the special life insurance company and small life insurance company deductions, and (2) any items (income or loss) attributable to any noninsurance business.

Under this provision, the special life insurance company deduction applies only with respect to income resulting from a company's life insurance business. Thus, gains and losses arising from a noninsurance business operated by a life insurance company will neither increase nor decrease the amount of the company's special life insurance company deduction (or small life insurance company deduction). For these purposes, noninsurance business means any activity which is not an insurance business. Generally, insurance business refers to the business activity of issuing insurance and annuity contracts and the reinsuring of risks underwritten by insurance companies, together with investment activities and administrative services that are required to support or are substantially related to the contracts issued or reinsured by the taxpayer. Thus, for example, if a life insurance company ran a manufacturing business directly (rather than owning stock in the company), any income and deduction items attributable to the manufacturing business would not be taken into account in computing tentative LICTI. Likewise, if a life insurance company acted as a broker, buying and selling securities directly for the public, such activities would be noninsurance business.

The concept of noninsurance business is further modified by a provision that any activity that is not an insurance business but is of a type traditionally carried on by life insurance companies for investment purposes is to be treated as insurance business if the activities do not constitute the active conduct of a trade or business. Real estate activities will be treated as insurance business if they are of a type traditionally carried on by life insurance companies and are carried on for investment purposes, whether or not they constitute the active conduct of a trade of business. In addition, the performance of administrative services in connection with any plans providing life insurance, pension, or accident and health benefits will be treated as insurance business. This modification recognizes that life insurance companies have traditionally engaged in certain types of income-producing activities as investments that could be viewed as noninsurance activities. In the case of real estate investment activities, the modification recognizes that life insurance companies have traditionally invested in real estate, either directly or through partnerships, in ways that may constitute an active noninsurance business. Likewise, life insurance companies have traditionally offered administrative services on certain deposit contracts or contracts without any insurance guarantees. Such noninsurance business activities will be treated as insurance business for purposes of computing tentative LICTI.

The application of this rule can be illustrated as follows. If a life insurance company (not eligible for any small life insurance company deduction) has $100X of net income from its insurance business and $10X of net income from its noninsurance business, the amount of its special life insurance company deduction is $20X (i.e., 20 percent of $100X). If, instead, the company has $100X of net income from its insurance business and a $10X loss from its noninsurance business, the company's deduction still would be $20X (i.e., 20 percent of $100X). The purpose of this provision is to limit the tax rate adjustment to life insurance income and protect noninsurance businesses from unfair competition from life insurance companies that enter into noninsurance businesses.

The bill limits the amount of the special life insurance company deduction by treating all life insurance companies that are members of the same controlled group as one company whether such companies join in the filing of a consolidated return or file separate returns. The special life insurance company deduction is then allocated proportionally among the life insurance company members of such group with a positive tentative LICTI. For these purposes, the term controlled group is defined generally by reference to section 1563. In prescribing this rule, it is recognized that the gain or loss of any life insurance company member will be reflected in the computation of the affiliated group's tentative life insurance company income, even if that particular member is not allowed to join in the consolidated return because it has not been a member of the affiliated group for the required time or is a foreign corporation. To eliminate any excessive detriment or benefit (from year to year) arising from the operation of the controlled group tentative LICTI computation the bill provides special regulatory authority for the Secretary of the Treasury to prescribe proper adjustments to be made in the application of this provision.

In lieu of this rule, the bill permits a life insurance company with a loss from operations to elect to have its loss not taken into account by other life insurance companies that are within the same controlled group as the loss company, but that do not file a consolidated return with the loss company in the year of the election. Where this election is made, a limitation is imposed on the ability to utilize losses of the electing loss company against nonlife company income. This limit is equal to 80 percent of the life company losses that, but for the election, would have reduced the controlled group's tentative income. Life company losses subject to the 80 percent limitation will be considered to be used in full when applied against nonlife company income; that is, there will be no carryover of the remaining 20 percent of life company loss. Under an ordering rule, life company losses subject to the 80 percent limitation are applied in consolidation against nonlife company income prior to life company losses not subject to the limitation. This election is not applicable with respect to the computation of the small life insurance company deduction.

Life company losses that are not applied against nonlife company income in the year of the election may be carried over. Such losses must first be applied against life company income in a carryover year and, to the extent so applied, are not subject to the 80 percent limitation. Life company losses carried over and used against nonlife company income are subject to the 80 percent limitation to the extent of other life company income of the controlled group not taken into account in computing the 80 percent limitation in that or any prior year.

For instance, suppose that foreign life company P conducts U.S. insurance operations through branch B and U.S. life subsidiary L. All of L's stock is held by P's U.S. noninsurance subsidiary N. B has income of $50, N has income of $70, and L has a loss of $100. If L makes the election described above, then B's special deduction would be .20 x $50=$10. In computing the consolidated income of the N affiliated group, $50 of L's losses—*i.e.*, L's losses to the extent of B's income—would be subject to the 80% limitation. Thus, under the ordering rule, N's income would be offset by $40 of limitation losses ($50 x .80) and $30 of nonlimitation losses. L would have a loss carryover of $20. Assume that the loss cannot be carried back to prior years. If, in the subsequent year, L and N each has income of $10 and B has income of $5, the carryforward of $20 would first be applied without limitation to the $10 of L's income. $5 of the remaining $10 carryforward would, due to B's income, be subject to the 80% limitation when offset in consolidation against N's income. The remaining $5 carryforward could be used without limitation. The affiliated group would thus have taxable income in the subsequent year of $1 ($20 −$10 −(.8)($5) −$5).

Also, a special rule applies to corporations joining in the filing of a consolidated Federal income tax return. Under this rule, no items of income or loss of nonlife members of the affiliated group joining in the return are taken into account for purposes of computing tentative LICTI.

The small life insurance company deduction (new sec. 806(b))

Under the bill, small life insurance companies are allowed an additional special deduction that is not available to other taxpayers. This deduction also is based on tentative LICTI, and applies before the special life insurance company deduction.

The amount of the deduction is 60 percent of so much of tentative LICTI for such taxable year as does not exceed $3,000,000, reduced by 15 percent of the excess of tentative LICTI over $3,000,000. For example, if a small life insurance company has tentative LICTI of, $2,900,000, its small life insurance company deduction would be $1,740,000 (i.e., 60 percent of $2,900,000). If the company's tentative LICTI is, $3,900,000, its small life insurance company deduction would be $1,665,000 (i.e., 60 percent of $3,000,000 reduced by 15 percent of the excess of $3,900,000 over $3,000,000).

Under this provision, the maximum benefit that can be enjoyed by a small company is $1.8 million, and a company with a tentative LICTI of $15 million or more would not be entitled to any small company deduction. For these purposes, the term tentative LICTI has the same meaning as it does for purposes of the special life insurance company deduction, that is, it does not include any items (income or loss) attributable to a noninsurance business.

As in the case of the special life insurance company deduction, the small life insurance company deduction is computed by treating all life insurance companies that are members of the same controlled group as one company whether those companies join in the filing of a consolidated return or file separate returns. The small life insurance company deduction is then allocated among the life insurance company members of such group in proportion to each such member's separate positive tentative LICTI.

The small life insurance company deduction is only allowable to companies with gross assets of less than $500,000,000. Except for real property and stock, which are taken into account at fair market value, the amount attributable to an asset is the adjusted Federal income tax basis of such asset for purposes of determining gain. Interests in partnerships or trusts are not treated as assets of the company. Rather, a company is treated as owning its proportionate share of the assets of any partnership or trust in which it has an interest. These rules are intended to prevent companies from holding assets in a noncorporate entity in order to qualify for the small company deduction. With some modifications, this approach for valuing assets is consistent with the valuation of assets of life insurance companies for tax purposes under present law.

The asset qualification for the small company deduction is determined on the basis of a controlled group as defined in section 1563. In general, the committee believes that this controlled group rule, which takes into account both insurance and noninsurance businesses, is appropriate because the small companies that require added special treatment are those that cannot look to a parent corporation or affiliate with substantial assets for capital during their growth period. Similarly, the restriction will prevent the small company deduction from creating an incentive for large noninsurance businesses to take over small independent insurers. However, the committee believes that a one-year transition period for purposes of applying the asset aggregation rule is appropriate for cases in which transactions between noninsurance members (that do not act in the capacity of financial intermediaries) and the insurance members of a controlled group indicate that the capital of the noninsurance members is not available to the insurance members. Thus, for 1984, the asset qualification for the small company deduction will be determined by aggregating only the assets of controlled group members that can be classified as financial intermediaries (e.g., insurance companies, banks, savings and loans, finance companies, securities brokers, and similar institutions), provided the following requirements also met: (1) a life insurance company was not added to the controlled group after September 27, 1983, (2) an election for life-nonlife consolidation is not in effect; and (3) the capital received by life company members of the controlled group from nonlife company members after January 1, 1983, does not exceed dividends paid by the life company members after such date.

As in the case of the special life insurance company deduction, the committee believes that, without this provision, the bill provides for the proper reflection of taxable income. Nonetheless, the committee recognizes that small life insurance companies have enjoyed a tax-favored status for some time, and believes that it would not be appropriate to dramatically increase their tax burden at this time.

The alternative life insurance company deduction (new sec. 806(e))

In lieu of both the special life insurance company deduction and the small life insurance company deduction, a company can elect, for 1984 through 1987, to claim the alternative life insurance company deduction. The amount of the alternative deduction for any year is determined in part as a percentage of the combined special and small life insurance company deductions and in part a percentage of the qualified first-year premium amount. The amount of the alternative deduction will converge over five years to the sole use of the special and small life insurance company deductions, being calculated as follows: 20 percent of the combined special and small company deduction, plus 80 percent of the qualified first-year premium amount, for 1984; 40 percent of the combined special and small company deduction plus 60 percent of the qualified first-year premium amount, for 1985; 60 percent of the combined special and small company deduction, plus 40 percent of the qualified first-year premium amount, for 1986; and 80 percent of the combined special and small company deduction, plus 20 percent of the qualified first-year premium amount, for 1987. After 1987, there will be no alternative deduction.

The qualified first-year premium amount means 20 percent of premiums for newly issued individual ordinary life and individual noncancellable accident and health insurance contracts and the amount of the premiums taken into account cannot exceed 200 percent of the net level premium for the benefits of such contract (computed assuming that the contract extends for and premiums are payable over the life of the insured). Premiums paid for annuity contracts, group contracts, or credit life insurance contracts will not contribute to the qualified first-year premium amount. Similarly, premiums on single-premium products, one-year term products, and renewals will not qualify. For these purposes, a policy will be considered a renewal if the individual insured had been insured previously (within the last year) under a policy issued by the same company or by a member of the same controlled group. Finally, only premiums on directly written coverage that is retained by the company will be taken into account in determining the qualified first-year premium amount. Thus, the amount of qualified premiums must be reduced by the amount of premiums for reinsurance ceded.

In addition, the following special rules apply to the election. First, the election must be made consistently by all life insurance companies within a controlled group. Second, to the extent that the alternative deduction contributes to a loss in any year, the loss can only be used to reduce life insurance income in current or future years (that is, the resulting loss cannot be used to reduce nonlife insurance company income). Third, a company (or controlled group) can revoke its election at any time in order to use the special and small company deductions; such revocation will result in forfeiture of any future use of the alternative deduction.

c. Policyholders surplus accounts (new sec. 815)

Present Law

As noted above, present law permits stock life insurance companies to defer the tax on 50 percent of their gain from operations in excess of their taxable investment income. The deferred income is added to a policyholders surplus account, along with amounts deducted for nonparticipating contracts and group life and accident and health insurance contracts. Amounts in the policyholders surplus account are taxed only when distributed by the company to its shareholders. To determine whether amounts have been distributed, a company must maintain a shareholders surplus account which generally includes the company's previously taxed income and certain nontaxable items that would be available for distribution to shareholders. Distributions to shareholders are treated as being first out of the shareholders surplus account, then out of the policyholders surplus account and finally out of other accounts.

Explanation of Provision

In general, the bill eliminates any further deferral with regard to income for 1984 and later years. Although companies will not be able to enlarge their policyholders surplus account after 1983, they will not be taxed on previously deferred amounts unless they are treated as distributed to shareholders or subtracted from the policyholders surplus account under rules comparable to those provided under the 1959 Act, but which reflect the basic changes in the tax structure under the bill.

The bill provides that any direct or indirect distribution to shareholders from an existing policyholders surplus account of a stock life insurance company will be subject to tax at the corporate rate in the taxable year of the distribution. For these purposes, the term distribution is intended to include actual and constructive distributions. See *Union Bankers Insurance Co.*, 64 T.C. 807 (1975). Although new amounts will not be added to the policyholders surplus account, a shareholders surplus account must be continued in order to maintain a record for tax purposes of previously taxed and other amounts that are eligible for distribution before a distribution is made from the policyholders surplus account. Thus, the bill provides for appropriate additions to the shareholders surplus account based on the new provisions adopted and replacing the 1959 Act.

Specifically, for each taxable year, the excess of the sum of the following amounts over the taxes paid for the year will be added to the shareholders surplus account: (1) LICTI (determined without regard to any distributions from the policyholders surplus account); (2) the special life insurance company deduction; (3) the small life insurance company deduction; (4) the deduction allowed the company for intercorporate dividends received; and (5) excluded tax-exempt interest. In developing this list of additions to the shareholders surplus account under the new provisions, additions for certain capital gains and the policyholders' share of the intercorporate dividend deduction were not included in order to prevent some of the double counting that existed under the 1959 Act. Also, the addition for the small company deduction of $25,000 under the 1959 Act was eliminated as was that deduction under the new tax structure. On the other hand, under the bill, the amount of the new special life insurance company deduction of 20 percent of tentative LICTI is added to the shareholders' surplus account, along with the new small life insurance company deduction. These new items may substantially increase annual additions to the shareholder surplus account, in comparison with present law, and thus may more than offset the modifications made to the account to eliminate double counting.

Aside from the changes indicated for maintaining the shareholders surplus account, the bill generally adopts the provisions of the 1959 Act with respect to the phase III tax. Thus, the ordering rules for distributions and subtractions, the requirement that distributions from the policyholders surplus account be "grossed up" for taxes payable thereon, and limitations on the size of the policyholders surplus account as a percentage of reserves, in general, will continue to apply. In so continuing these provisions, the committee intends that any reference to reserves be to reserves computed in a manner consistent with the provisions of the 1959 Act.

Finally, the bill provides a special provision to relieve a company from tax on·a distribution from a policyholders' surplus account due to a reduction of premium volume brought about by a reinsurance transaction ordered by the Federal Reserve Board.

d. Deductions with respect to reserves (new secs. 807 and 817)

Present Law

A life insurance company is allowed to deduct (or exclude from income) increases in its year-end reserves over those for the prior year. Under present law, there are two elements to the deduction for reserves. First, for purposes of computing its taxable investment income, a life insurance company can exclude from its investment yield (i.e., gross investment income less investment and similar expenses) the policyholders' share of that investment yield. Second, for purposes of computing gain and loss from operations, a life insurance company can deduct increases in reserves allocable to premium income (i.e., increases in reserves, adjusted to not include required interest that is credited to its reserves and excluded in the computation of taxable investment income). A life insurance company's tax reserves are based on its reserves for State regulatory purposes (i.e., statutory reserves) and, as a general rule, a company's deduction reflects an increase in its statutory reserves over its statutory reserves for the prior year.

Under present law, life insurance reserves must be (1) required under State law, (2) computed or estimated on the basis of recognized mortality or morbidity tables and an assumed rate of interest, and (3) set aside to mature or liquidate future claims under life, annuity, or noncancellable accident and health insurance contracts.

Statutory reserves are calculated under a preliminary term method or the net level premium method. Generally, under a preliminary term method, first year expenses (e.g., commissions) are funded out of the premiums for the first year, and only the excess of net premiums reduced by such expenses is available to fund reserves. Under the net level method, the first year expenses are treated as funded out of net premiums over the life of the contract. Companies using this method for State regulatory purposes have larger reserves in the early years of a contract than companies using the preliminary term method. However, because expenses not funded out of premiums must be funded out of surplus, the net level method is, for all practical purposes, not generally available to companies with limited amounts of surplus.

A life insurance company is allowed to revalue its preliminary term reserves for tax purposes to eliminate a disparity that would otherwise result in the tax treatment of life insurance companies with greater amounts of surplus and companies with smaller surplus accounts. Reserves computed for statutory purposes on a preliminary term basis may be revalued to a net level premium basis using either an exact revaluation method or an approximate revaluation. Reserves recomputed under the approximate formula (as modified by TEFRA) are revalued by increasing such reserves by (1) $19 per $1,000 of insurance in force for other than term insurance, less 1.9 percent of the reserves under such contracts, and by (2) $5 per $1,000 of term insurance in force under such contracts which at the time of issuance cover a period of more than 15 years, less 0.5 percent of the reserves under such contracts. The approximate revaluation formula may result in greater reserves than actual net level premium reserves or reserves recomputed using an exact revaluation method.

Under present law, if as of the close of any taxable year the basis for determining the amount of any increase or decrease in reserves differs from the basis for such determination as of the close of the preceeding taxable year, any resulting income or loss is taken into account ratably over a 10-year period.

In addition to the rules described above which apply to life insurance contracts, other rules provide for unearned premium and unpaid loss reserves for accident and health insurance contracts. Under these rules, unpaid losses may be estimated and reserved for on a nondiscounted basis. For purposes of determining the amount of the deduction for the addition to the unearned premium reserve, gross premiums are considered to be earned pro rata over the life of the contract.

Explanation of Provisions

In general, life insurance companies are allowed a deduction for a net increase in reserves and must take into income any net decrease in reserves. Unlike their treatment under the 1959 Act, the deduction for increases in reserves would take into account increases due to both premiums and assumed interest credited to the reserves. In general, the net increase or net decrease in reserves, is computed by comparing the closing balance for reserves to the opening balance of the reserves, where the closing balance of the reserve becomes the opening balance for the following year.

Also, in computing the net increase or net decrease in reserves, the closing balance of the reserve items is reduced by the policyholders' share of tax-exempt interest. This continues the view under present law that a life insurance company's reserve liability to its policyholders in effect entitles the policyholders to a pro rata portion of each item of investment income.

Reserves taken into account

In computing the net increase or net decrease in reserves, the bill specifies that six items, which are all reserves or in the nature of reserves, be taken into account. These are (1) life insurance reserves; (2) unearned premiums and unpaid losses included in total reserves; (3) amounts that are discounted at interest to satisfy obligations which are obligations under insurance and annuity contracts which do not involve life, accident, or health contingencies when the computation is made; (4) dividend accumulations and other amounts held at interest in connection with insurance and annuity contracts;[10] (5) premiums received in advance and liabilities for premium deposit funds; and (6) reasonable special contingency reserves under contracts of group term life insurance or group accident and health insurance which are held for retired lives, premium stabilization, or a combination of both.

The six items specified in the bill generally are the same items as under present law. However, the bill requires that the amount of the contingency reserves held for retired lives and premium stabilization be reasonable in relation to the amount of coverage provided by, and the loss experience suffered by, the company with respect to the underlying group contract. Also, the bill requires that the discount rate used by the companies for a reserve amount for an insurance and annuity obligation that does not involve life, accident, or health contingencies be the higher of the prevailing State assumed interest rate or the interest rate assumed by the company in determining the guaranteed benefits. These rates are to be determined when the obligation first ceases to involve life, accident, or health contingencies.

The statutory listing of items to be taken into account in computing the net increase or net decrease in reserves refers to life insurance reserves "as defined in section 816(a)." Section 816(a) requires a proper computation of reserves under State law for purposes of qualifying as a life insurance company. This cross reference is intended merely to identify the type of reserve for which increases and decreases should be taken into account and is not intended to superimpose the requirement of proper computation of State law reserves for purposes of allowing increases in such reserves to be recognized. Conceivably, a similar reference in present law required proper computation under State law in order for deductions to be allowed, because present law used the statutory reserves as the basis for measuring deductions and income for tax purposes.

[10] The investment portion of any life insurance contract which fails to meet the definition of a life insurance contract under section 7702 is treated as a reserve under section 807(c)(4).

The bill, however, takes a new approach by prescribing specific rules for computing life insurance reserves for tax purposes, and as a consequence, the amount of the deduction allowable or income includible in any tax year is prescribed regardless of the method employed in computing State statutory reserves.

Computation of reserves

For purposes of determining life insurance company taxable income, the bill provides that the life insurance reserves for any contract shall be the greater of the net surrender value of the contract or the reserves determined under Federally prescribed rules. In no event will the amount of the tax reserves at any time exceed the amount of the statutory reserves. The net surrender value is the cash surrender value reduced by any surrender penalty except that any market value adjustment required on surrender is not taken into account. Generally, the comparison of the net surrender value of a contract and the Federally prescribed reserves for the benefits under the contract is made on a aggregate benefit basis; however, the comparison may be made on a benefit-by-benefit basis if the benefit is a qualifying supplemental benefit or qualifying substandard risk (see discussion below on special rules). Also, the comparison of contract cash surrender values and Federally prescribed reserves can be done on a group basis (i.e., grouping contracts that are identical as to plan of insurance, year of issue, age of issue, etc.) or on an individual contract basis.

The bill requires that, in computing the Federally prescribed reserve for any type of contract, the tax reserve method applicable to that contract must be used, along with the prevailing State assumed interest rate and the prevailing commissioners' standard tables for mortality or morbidity. The prescribed rules for computing tax reserves are intended, generally, to allow companies to recognize at least the minimum reserve that most States would require them to set aside, but no more unless the net surrender value is greater. To avoid State-by-State variations, the rules prescribed in the bill are based on the general guidelines recommended by the National Association of Insurance Commissioners (NAIC) and adopted by a majority of the States.

Reserve method

With respect to the reserve method to be used, the bill prescribes specific tax reserve methods for particular types of contracts. For life insurance contracts, the prescribed method is the applicable Commissioners' Reserve Valuation Method (CRVM) in effect when the contract is issued. This is the date that appears on the policy form. For annuity contracts, the prescribed method is the applicable Commissioners' Annuities Reserve Valuation Method in effect when the contract is issued. For noncancellable accident and health insurance contracts, a 2-year full preliminary term method is required. Finally, for all other contracts, the reserve method prescribed by the NAIC or, if no method is so prescribed, a method consistent with whichever of the prescribed methods that would be most appropriate for the contract. An example of a life insurance contract not presently covered by an NAIC prescribed method is a universal life insurance contract. Until NAIC prescribes an appropriate method for universal life insurance, reserves should be computed on a method consistent with CRVM. Also, the committee understands that the NAIC has not prescribed a method for contracts issued by assessment companies in Texas (i.e., either mutual assessment companies or stipulated premium companies), because such life insurance companies generally are not found outside of Texas. Under Texas law, reserves for such policies are computed on a haif-year full preliminary term method and such method should be considered to be consistent with CRVMs prescribed by the NAIC.[11]

The new provision specifies that the reserve methods prescribed do not incorporate any provisions which increase the reserve because the net premium (computed on the basis of Federally prescribed assumptions) exceeds the actual premiums or other consideration charged for the benefit. Thus, the computation of the tax reserves will not take into account any State law requirements regarding "deficiency reserves" (whether such reserves are as defined under present law or whether the NAIC prescribed method would otherwise require a company's reserves to reflect a gross premium charge that is less than the net premium based on minimum reserve standards).

In general, the Federally prescribed reserve methods refer to those recommended by the NAIC for the particular type of contract. There is no requirement that the method also be required based on the prevailing view of the States. Thus, as a general rule, in computing any life insurance reserve, a company should take into account any factors specifically recommended by the NAIC. If specific factors are not prescribed by the NAIC recommended reserve method, the prevailing State interpretation of such method should be considered for purposes of determining what factors can be taken into account in applying the computation method for tax purposes.

Interest rates and mortality tables

With respect to the assumed interest rate and the mortality or morbidity tables to be used in computing the Federally prescribed reserve, the bill looks to the "prevailing view" of the States. A view is considered to be a prevailing view if it is recognized by at least 26 States when the contract is issued.[12] Thus, the "prevailing State assumed interest rate" means, for any contract, the highest assumed interest rate permitted to be used in computing life insurance reserves for insurance or annuity contracts of that type as of the beginning of the calendar year in which the contract is issued in at least 26 States. If the highest assumed interest rate is actually determined by the States during the year but declared effective as of the beginning of the calendar year, such rate would be consid-

[11] An exception from the general mortality and morbidity tables requirements for reserves for life insurance contracts issued by assessment companies is also provided as a nonCode amendment. These companies may use the table used for State law purposes if that mortality and morbidity table was developed by taking into account the particular experience of those companies and was in existence and in use by 1965. Further revisions of such unique tables would be allowed for tax purposes only if the table is revised in a manner consistent with the way in which the original table was developed. Finally, there is a nonCode amendment that allows mutual assessment companies in Texas to use their statutory reserves for tax purposes. (sec. 217(g) of the bill).

[12] In the case of reinsurance, the issue date that should be referred to for these purposes is that of the underlying policies and not the date of the reinsurance contract.

ered so effective for tax purposes, also. For nonannuity contracts, the issuing company may elect, on a contract by contract basis, to use the prevailing interest rate from the preceding calendar year. In determining the highest assumed rates permitted in at least 26 States, each State should be treated as permitting the use of every rate below its highest rate. Also, the highest State assumed interest rate referred to in the bill is the highest permitted to be used in computing reserves without taking into account any limitations that might be imposed by States if a different rate is assumed for computing cash surrender values under standard nonforfeiture laws.

Like the prescribed interest rate, the prevailing commissioners' standard tables for mortality or morbidity to be used for computing the Federally prescribed reserves are, with respect to any contract, the most recent tables prescribed by the NAIC and permitted to be used for that type of contract in computing reserves under the laws of at least 26 States when the contract is issued. If a table becomes a prevailing commissioners' standard table during a calendar year, the table shall be such as of the beginning of the calendar year. Generally, when mortality and morbidity tables are being updated and adopted by the States, companies will have three full years after a particular set of tables becomes the prevailing view of the States before such table becomes mandatory for computing reserves for tax purposes. For example, it is the understanding of the committee that the 1980 C.S.O. tables for life insurance contracts have now been adopted by at least 26 States. Thus, although companies will be able to use either the 1958 C.S.O. tables or the 1980 C.S.O. tables for taxable years 1984, 1985, and 1986 for computing tax reserves, the 1980 C.S.O. tables will have to be used for contracts issued after 1986. Companies may adjust the prevailing commissioners' standard tables, as appropriate, to reflect risks incurred under the contract if such risks are not otherwise taken into account. For example, a company may use an appropriate multiple of a table to reflect the substandard classification of particular insureds because of poor health. An appropriate multiple will reflect the greater mortality expected in excess of the mortality of the group implicit in the prevailing commissioners' standard table. Also, adjustment to the tables may be appropriate to reflect the risks involved in writing term insurance on individuals for whom the company requires no evidence of insurability (that is, if the company does not underwrite the risks); or because the insureds reside in a foreign country known to be experiencing civil strife.

The bill also provides special rules for existing contracts where standard tables are not available or where multiple tables (or projections) are available. Generally, if there is no prevailing commissioners' standard table applicable to a contract when it is issued, the table used for purposes of computing the Federally prescribed reserve shall be determined under Treasury regulations. However, for contracts issued before 1948 (when the use of commissioners' standard tables was first required), the mortality or morbidity tables used for State law purposes can be used in recomputing all reserves for tax purposes as of January 1, 1984, and thereafter in computing the Federally prescribed reserve. The bill also specifically provides that, if there are multiple mortality and morbidity tables (e.g., projections of the standard table) that meet the definition of the prevailing commissioners' standard table, the table that generally yields the lowest reserve must be used in computing the Federally prescribed reserve.

Change in computing reserves

The present law rule allowing income or loss resulting from a change in the method of computing reserves to be taken into account ratably over a 10-year period is retained under the bill.

Special rules

In addition to the above described rules for computing the Federally prescribed reserves, the bill provides some special rules for life insurance reserves under pension plan contracts, group contracts, certain supplementary benefit provisions, substandard risks, and contracts issued by foreign branches of domestic life insurance companies.

Pension plan and group contracts

For purposes of computing the amount of life insurance reserves for pension plan contracts, the net surrender value of a contract is deemed to be an amount equal to the balance in the policyholder's fund (determined without regard to any market value adjustment). The term "policyholder's fund" refers generally to any experience fund, experience accumulation or asset share allocable to the contract.

For purposes of computing the Federally prescribed reserve for any group contract, the date the contract is issued is generally the date as of which the master plan is issued. However, if a benefit is guaranteed to a plan participant after such date, the company must take into account the date as of which the benefit is guaranteed in computing its reserves.

Supplemental benefits

Under the bill, the amount of the life insurance reserve for certain enumerated supplemental benefits is the statutory reserve. The committee believes that, due to the *de minimis* nature of the enumerated supplemental benefit reserves, economic distortions caused by using statutory reserves would be minimal. The supplemental benefits listed are any (1) guaranteed insurability benefit,[13] (2) accidental death or disability benefit,[14] (3) convertibility benefit, (4) disability waiver benefit, or (5) any other benefit prescribed by regulations, if such benefit is supplemental to a contract for which there is a policyholder reserve item taken into account for taxable income purposes. The reserve for any other benefit provided for under the contract and not listed above, whether or not such a benefit is considered supplemental under State law, must be com-

[13] The term "guaranteed insurability benefit" is intended to include guaranteed annuability benefits.

[14] Because of the intended *de minimis* nature of the listed supplemental benefits.a disability income benefit provision (other than one that provides for income payments only to carry the premiums of the policy or some other incidental expenses of the insured) is not intended to be construed as a supplemental benefit.

puted using the Federally prescribed method (as described in section 807(d)).

If a supplemental benefit is a "qualified supplemental benefit", the life insurance reserve for such benefit shall be computed separately as though such benefit were under a separate contract. A qualified supplemental benefit is a supplemental benefit as listed in the bill, if there is a separately identified premium or charge for such benefit and any cash value (i.e., net surrender value) under the contract attributable to any other benefit is not available to fund such supplemental benefit. The use of any loan provision to pay premiums or charges due for the supplemental benefit is not intended to be construed as making any net surrender value available for the purposes of this provision.

For example, if a contract provides for a qualified supplemental benefit (e.g., accidental death or disability) and the net surrender value of the contract is $4,000 and the reserves are $3,800 for the basic death benefit and $50 for the supplemental benefit, the total reserve for tax purposes will be $4,050 if none of the net surrender value is attributable to the qualified supplemental benefit. In essence, the supplemental benefit is considered a separate contract and the reserve is computed as the greater of the net surrender value or the tax reserve. If, however, the supplemental benefit was not a qualified supplemental benefit, the total reserve for tax purposes would be $4,000 because the supplemental benefit would not be considered a separate contract and the amount of the life insurance reserve for the contract is the greater of the net surrender value (i.e., $4,000) or the Federally prescribed reserves amount (i.e., $3,800 + $50).

Substandard risks

The amount of life insurance reserve for any "qualified substandard risk" will be computed as if under a separate contract. A substandard risk is a qualified substandard risk if (1) the insurance company maintains a separate reserve for such risk, (2) there is a separately identified premium charge for such risk, (3) the amount of the net surrender value under the contract is not increased or decreased by reason of such risk, and (4) the net surrender value under the contract is not regularly used to pay premium charges for such risk. For example, the committee expects that regulations could provide that a provision for the systematic borrowing based on the net surrender value of the contract to pay both the basic premium and the substandard charge will be considered to disqualify the substandard risk in certain situations. However, loan provisions that are not actually used on a regular and automatic basis would not result in disqualification of the substandard risks.

The amount of the life insurance reserve determined for any qualified substandard risk will in no event exceed the sum of the separately identified premium charges for such risk plus interest, less mortality charges. The aggregate amount of insurance in force under contracts to which these special rules for substandard risks can apply cannot exceed 10 percent of insurance in force (other than term insurance) under life insurance contracts of the company. The substandard classification of any insurance in force in excess of 10 percent can only be taken into account through an appropriate adjustment to the prevailing commissioners' standard table in computing the Federally prescribed reserve. Also, if a company computes a separate substandard reserve under the qualified substandard risk provision, the mortality assumption for purposes of computing the reserve for the basic benefit cannot take into account any substandard risk factors.

Term life insurance and annuity benefits

The bill provides a special rule for contracts issued before January 1, 1989 under plans of insurance in existence on March 15, 1984, for purposes of computing tax reserves with respect to riders for term life insurance and annuity benefits. Term life insurance and annuity benefits included in insurance contracts will be treated as qualified supplemental benefits, for purposes of allowing the tax reserve to be computed for such benefits as though each benefit were a separate contract. However, such benefits will not be treated as qualified supplemental benefits for purposes of using the statutory reserve as the tax reserve for such benefit because riders for term life insurance and annuity benefits generally would not be of the de minimis nature shared by the specifically enumerated qualified supplemental benefits (see discussion above). Accordingly, the reserves for such benefits will be computed under the general reserve rules, as the greater of the net surrender value or the Federal tax reserve, rather than (as with other qualified supplemental benefits) the reserves used on the annual statement. Also, to be treated as a qualified supplemental benefit, the riders for the term life insurance and annuity benefits must meet all other requirements for such treatment (that is, there is a separately identified premium or charge for such benefit and any cash value under the contract attributable to any other benefit is not available to fund such benefit).

Reserves under foreign law

There is a special rule which allows domestic life insurance companies to recognize, in lieu of the Federally prescribed reserve, the minimum reserve required by the laws, regulations, or administrative guidance of the regulatory authority of a noncontiguous foreign country if (1) the reserves arise out of life, accident or health insurance contracts issued to residents of the foreign country and (2) the foreign country requires the domestic company (as of the time it began operations in the foreign country) to operate in such country through a branch. The reserve cannot exceed the net level reserve for a contract as determined using NAIC standards and the interest rates and mortality tables used in the contract.

Variable contracts (new sec. 817)

The bill continues to provide special rules for variable annuities and contracts with reserves based on segregated asset accounts, but conforms the tax treatment of such contracts to that of variable pension plan contracts and extends those rules to variable life insurance contracts. Thus, with respect to any variable contract, the reserve items taken into account at the close of the taxable year for purposes of determining net increases or net decreases must be adjusted by subtracting any amount attributable to appreciation in the value of assets or by adding any amount attributable to depreciation. Such adjustments for appreciation or depreciation are to be made whether or not the company has disposed of the assets during the taxable year.[15] The company's basis in the assets underlying all variable contracts also will be adjusted for appreciation or depreciation, to the extent the reserves are adjusted. Thus, the corporate level capital gains tax is eliminated. This basis adjustment provision generally conforms the tax treatment of all variable contracts to that of variable pension plan contracts under present law.

The bill adopts a provision that grants the Secretary of the Treasury regulatory authority to prescribe diversification standards for investments of segregated asset accounts underlying variable contracts. The diversification requirement is provided in order to discourage the use of tax-preferred variable annuities and variable life insurance primarily as investment vehicles. The committee believes that, by limiting a customer's ability to select specific investments underlying a variable contract, the bill will help ensure that a customer's primary motivation in purchasing the contract is more likely to be the traditional economic protections provided by annuities and life insurance. The committee anticipates that any regulations prescribing diversification standards changing current practice will have a prospective effective date.

If the segregated asset account does not meet the prescribed diversification standards, then a variable contract based on the account will not be treated as an annuity, endowment, or life insurance contract for purposes of subchapter L (relating to taxation of insurance companies), section 72 and section 7702(a) (relating to the definition of a life insurance contract). An exception is provided from the general investment diversifications provisions for a segregated asset account used for variable life insurance contracts if the account invests only in securities issued by the United States Treasury. Finally, the bill specifically provides that a company can use an independent investment advisor with respect to the segregated asset accounts underlying their variable contracts.

The bill also continues the separate accounting requirements under present law for various income, exclusion, deduction, asset, reserve, and other liability items properly attributable to variable contracts. For example, with respect to variable contracts, the company's share of dividends received, and the policyholders' share of tax-exempt interest (which reduces the closing balance of the reserves), will be determined with reference to the income and deduction items attributable to the underlying separate account. Likewise, the equity base of the separate account will be determined under the separate accounting requirement and aggregated with the company's average equity base for its general account business.

[15] In addition to the adjustment of reserves for variable contracts, an adjustment is provided for any appreciation or depreciation during a year affecting deductions for death claims, etc., under section 805. This adjustment will apply only to the extent of such appreciation or depreciation, and not in the greater amount that such appreciation or depreciation affects death benefits. Thus, if under a variable life insurance contract, appreciation in the value of separate account assets of $100 increased death benefits by $200, the amount of the adjustment to death benefits on account of this provision is $100.

e. Policyholder dividends (new secs. 808 and 809)

Present Law

In general, under present law, policyholder dividends are dividends and similar distributions to policyholders. Interest paid and return premiums are not policyholder dividends. This statutory language has been expanded in regulations so that the term policyholder dividends generally refers to amounts returned to policyholders that are not fixed in the contract and depend on the experience of the company or the discretion of management. However, taxpayers have taken the position that the term does not include excess interest (i.e., amounts in the nature of interest that are paid or credited to policyholders and are determined at a rate in excess of the rate used under the contract for purposes of computing the company's reserve deduction) even though such amounts are not fixed in the contract but depend upon the experience of the company or the discretion of management.

Under present law, policyholder dividends paid by mutual and stock life insurance companies are deductible at the company level. Special rules apply, however, to limit the amount of this deduction. Under the permanent provisions of the 1959 Act the deduction for policyholder dividends (and certain other special deductions) is limited to the excess of gain from operations over the taxpayer's taxable investment income plus a statutory amount of $250,000. Under temporary provisions added to the Code in TEFRA and applicable in 1982 and 1983, the deduction was limited to either (1) an amount computed under the 1959 Act rule with the $250,000 statutory amount increased to $1 million, phasing down to zero as the sum of the company's policyholder dividends and other special deductions increases from more than $4 million to $8 million, or (2) an amount equal to the statutory amount (as modified), plus 100 percent of dividends on pension business, plus 77½ percent of nonpension policyholder dividends for mutual companies (85 percent for stocks). Under present law, policyholder dividends are accounted for on a reserve basis, and a company is allowed to deduct additions to its policyholder dividend reserves for dividends that are payable during the year following the taxable year.

Explanation of Provisions

As under present law, the bill allows a deduction for dividends or similar distributions to policyholders. The bill departs from present law, however, in that the amount of the deduction for any taxable year is the amount of policyholder dividends paid or accrued during the taxable year rather than the amount of the increases in the reserves for policyholder dividends that are payable during the year following the taxable year. Under the fresh start transitional rule, this change from a reserve to an accrual method is not to be treated as a change in a method of accounting. Thus, no income or loss is to be recognized with respect to amounts in existing policyholder dividend reserves.

Policyholder dividends defined (new sec. 808)

The bill adopts a broad definition of the term policyholder dividends to include any distribution to a policyholder that is the economic equivalent of a dividend. Thus, in addition to any amount paid or credited to policyholders (including an increase in benefits) when the amount is not fixed in the contract but depends on the experience of the company or the discretion of management, the term policyholder dividends specifically includes excess interest, premium adjustments, and experience-rated refunds. Thus, the bill corrects a possible deficiency of present law which may permit companies to avoid the limitations on policyholder dividends through the use of excess interest and experience-rated refund products rather than traditional dividend paying products.

The term excess interest means any amount in the nature of interest that is paid or credited to a policyholder and determined at a rate in excess of the prevailing State assumed interest rate for the contract (i.e., the rate used under the bill for purposes of determining the amount of the company's Federally prescribed reserve under the rules contained in new section 807(d)). Amounts in the nature of interest include all amounts paid for the use of money regardless of the particular designation adopted by the payor or payee. Thus, amounts in the nature of interest include interest payments with respect to amounts left on deposit and amounts paid in lieu of interest such as in the case of origination or service fees. Similarly, amounts in the nature of interest include amounts calculated as interest such as the increase in reserves attributable to assumed or guaranteed interest rates rather than premium contributions.Thus, for example, any increase in the cash surrender value of a contract above that which would result if the prevailing State assumed interest rate were used to compute the increase is treated as excess interest. The term premium adjustment means any reduction in the premium under an insurance or annuity contract which, but for such reduction, would have been required to be paid under the contract. If no premium amount is fixed in the contract, variations in premiums paid during the course of the contract are not considered premium adjustments. Further, a change in the amount of a premium that is attributable to the insurability of the insured is not considered a premium adjustment Finally, the term experience-rated refunds means any refund or credit based on the experience of the contract or group involved. Thus, for example, if a company sells a group policy to an employer covering the lives of its employees and the premiums received exceed the sum of the claims paid and other expenses, any refund of such excess is an experience-rated refund. The bill also adopts the general rule that any policyholder dividend that increases any of the benefits payable under the contract (including the cash value), or reduces the premium otherwise required, is treated as paid to the policyholder and returned by the policyholder to the company as a premium.

Reduction of certain deductions of mutuals (new sec. 809)

Although the general rules and definitions relating to policyholder dividends apply to stock and mutual life insurance companies alike, the amount of the deduction for mutual companies is reduced by an amount referred to in the bill as the "differential earnings amount." If the differential earnings amount exceeds the allowable deduction, then such excess will reduce the closing balance of the company's reserves. This reduction reflects the committee's recognition that, to some extent, policyholder dividends paid by mutual companies are distributions of the companies' earnings to the policyholders as owners.

Because mutual companies' policyholders are also the owners of the enterprise, policyholder dividends paid to them are distributions from the company that are a combination of price rebates, policyholder benefits and returns of company profits. Although there is no precise way to segregate a policyholder dividend or other payment into these various components, the committee believes that it is valid to conclude that profit-oriented enterprises tend to distribute earnings to their owners in amounts that are proportional to the owners' equity in the business. Thus, the committee believes that the portion of a policyholder dividend that is a distribution of earnings can be measured as a percentage of the mutual company's equity (the "average equity base"). To determine the appropriate percentage of the equity base, the after dividend rates of return on equity for both stock and mutual companies were examined, and it was determined that the average pre-tax return on equity of mutual companies falls below that for a comparable group of stock companies. The committee believes that this difference is attributable to distribution by mutual companies of earnings to their owners.

Under the bill, this theoretical approach to identifying ownership distributions by a mutual company is given effect by means of a reduction in the policyholder dividends deduction by a "differential earnings amount". This amount is computed by multiplying the company's average equity base for the taxable year by the "differential earnings rate" for the taxable year. The differential earnings rate is the excess of the "imputed earnings rate" over the "average mutual earnings rate". As explained below, the "imputed earnings rate" is set in the Code (and subsequently adjusted) to provide comparable treatment for stock and mutual companies.

Imputed earnings rate

The imputed earnings rate for 1984 is 16.5 percent. For taxable years beginning after 1984, the imputed earnings rate will be an amount which bears the same ratio to 16.5 percent as the current stock earnings rate (i.e., the numerical average of the rates of return for the 50 largest stock life insurance companies for the three years preceding the taxable year) bears to the base period stock earnings rate (i.e., the numerical average of the rates of return for the 50 largest stock companies for 1981, 1982, and 1983).

The committee anticipates that this 16.5-percent rate will result for 1984 in the mutual segment of the industry bearing 55 percent of the aggregate industry tax burden. The committee believes that this is appropriate in the light of a number of factors including the historic allocation of the industry's tax burden, the relative percentages of assets held by the stock and mutual segments of the industry and the difference in treatment of mutual company policyholders and stock company shareholders.[16] Since the committee believes that the 16.5-percent rate results in an appropriate allocation of the industry's tax burden for 1984, it has decided to adjust this rate in proportion to changes in the rate of return for large stock companies and not simply to replace the imputed rate with one equal to the actual rate of return of a group of stock companies in subsequent years.

The rate of return for any stock company is to be determined by the Secretary by reference to a company's statement gain from operations as a percentage of its equity base. In calculating this rate, the Secretary is to take into account companies that may be operating at a loss and, in effect, have a negative rate of return, as well as companies that are operating on a profitable basis. Further, the authority granted the Secretary to determine the rate of return includes authority to disregard or recharacterize a transaction determined by the Secretary to have been engaged in principally to manipulate the imputed earnings rate. For example, if a noninsurance parent company with a life insurance subsidiary makes a substantial capital contribution to its life insurance subsidiary during the taxable year (but such amount is not reflected in the assets at the beginning or end of the year), the Secretary would compute the rate of return for the subsidiary without taking into account the amount contributed by the parent or the income generated by such amount if the Secretary determined that the contribution was principally intended to enable the life insurance subsidiary to manipulate its rate of return. In making this determination, the Secretary would consider such factors as the existence of any nontax business purpose for the transaction and the reasonable needs of the subsidiary for capital.

A numerical average of stock earnings rates is used in order to reduce the potential impact of any manipulation of the rate by a few large stock companies. The three-year period is used to preclude the possibility of sharp rises or declines in the rate of return for the stock segment of the industry, giving the mutual companies some ability to plan for and predict tax costs for purposes of marketing their products. The 50 largest stock companies are to be determined by the Secretary of the Treasury on the basis of gross assets. For purposes of ascertaining the top 50 companies and their earnings rates, assets of a company among the 50 largest will be aggregated with assets of any affiliated life companies (i.e., affiliated groups will be treated as one company).

Average mutual earnings rate

The average mutual earnings rate for any year would be the weighted average of the rates of return for mutual companies. The

[16] Earnings that are distributed by a stock company to its shareholders are included in income by the shareholders. In contrast, in the case of a mutual company, earnings that are distributed are not included in income by the policyholders.

use of an aggregate or weighted average approach is intended to prevent manipulation by large mutual companies through payment of overly large amounts of policyholder dividends which would substantially increase the differential earnings rate and adjustment in the following year.

Average equity base

The average equity base of a stock or mutual company is the average of (1) the equity base determined as of the close of the taxable year, and (2) the equity base determined as of the close of the preceding taxable year. For purposes of computing a company's average equity base for a taxable year beginning in 1984, the equity base for 1983 will be computed under the rules contained in the bill as if the bill were in effect for such year. The term equity base means an amount equal to the statutory surplus and capital plus any nonadmitted financial assets, the excess of statutory policy reserves over tax reserves,[17] the amount of any mandatory securities valuation reserve, the amount of any deficiency reserve or any voluntary reserve, and 50 percent of the amount of any provision for policyholder dividends (or other similar liability) payable in the following taxable year. The term nonadmitted financial asset does not include due and accrued investment income reported as a nonadmitted asset, investments in office furnishings or fixtures, or agents' balances owed to the company. Thus, for example, an amount of due and accrued interest on defaulted bonds is not a nonadmitted financial asset, even though the underlying defaulted bond may be a nonadmitted financial asset. Also, in determining the excess of statutory reserves over tax reserves, the amount of statutory reserves should not include any amount attributable to deferred and uncollected premiums that have not yet been included in life insurance gross income.

Amounts included in equity under the bill would generally refer to and be valued as amounts shown on the annual statement of the company. However, a classification or characterization of an item on a company's annual statement in an attempt to avoid the requirements of the bill is to be disregarded. Thus, for example, if a company sets up a provision on its annual statement for excess interest that it will distribute in the year following the taxable year, and this provision is separate from its provision for policyholder dividends and is not adjusted for in restating annual statement reserves to tax reserves, the provision will be treated as an "other similar liability" payable in the following taxable year, requiring that 50 percent of such amount be included in the equity base.

As stated above, a company's average equity base is the average of its equity base determined as of the close of the taxable year and its equity base determined as of the close of the preceding taxable year.

[17] The bill contains a special transition rule for determining the average equity base for a mutual life insurance company or its subsidiary issuing excess interest life insurance contracts. For purposes of determining the excess of statutory policy reserves over tax reserves, the tax reserves may be computed without regard to the accounting rule that prohibits a company from taking into account amounts in the nature of interest in excess of the prevailing State assumed interest rate, which is guaranteed beyond the end of the taxable year (see explanation of the account rule in new sec. 811). This rule will apply to reserves for life insurance contracts issued prior to January 1, 1985, under plans of life insurance in existence on July 1, 1983.

Differential earnings rate

The differential earnings rate for any taxable year is based on a comparison of the adjusted imputed earnings rate and the average mutual earnings rate for the second preceding year. This rule is necessary because, for any taxable year, the Secretary will not have the data required to determine the average mutual earnings rate prior to the date a mutual company will file its Federal income tax return. However, when actual data becomes available, any difference between the average differential earnings amount for the taxable year and the average differential earnings amount for the second preceding taxable year is to be taken into account as an addition to or deduction from income (before computation of the special life insurance deduction and the small life insurance deduction) for the taxable year during which the Secretary determines the average mutual earnings rate for the prior taxable year. Because any additions to or deduction from income will be taken into account in the first year during which the actual average differential earnings rate can be recomputed, no interest payments are required. If a company ceases to be a mutual insurance company in any year, then any adjustment will have to be taken into account for the taxable year giving rise to the adjustment.

Special rules

The bill also contains some special rules or modifications. First, the equity base of any mutual life insurance company can be reduced by that portion of the equity base attributable to the life insurance business that is properly allocable to reserves or liabilities for life insurance contracts issued on the life of residents of Western Hemisphere countries that are noncontiguous to the United States. The equity that is properly allocable to such contracts is the same proportion as the reserves for such contracts bears to the total tax reserves on life insurance contracts (if that proportion is at least 1 to 20). This special equity base modification recognizes that a company may need to maintain higher levels of surplus because of the special classification or substandard nature of certain insureds living in foreign countries undergoing civil strife.

Second, a special rule is provided for certain mutual life insurance companies that are successor companies to fraternal benefit societies. Under this provision, the mutual life insurance company can reduce its average equity base by the present value of the statutory surplus assumed from its predecessor fraternal benefit society. The application of this provision is limited, also, to mutual life insurance companies that assumed the surplus of a fraternal benefit society in 1950.

Third, the bill provides a 5-year transition rule for high surplus mutual life insurance companies for purposes of applying the ownership differential provision. A company is a high surplus company if its equity base to asset ratio for 1984 exceeds a percentage of assets that is approximately 130 percent of the arithmetic average equity base to asset ratio of the 50 largest mutual life insurance companies, (as determined by the Secretary using the most recent data available). A high surplus company need not apply the differential earnings rate to the excess portion of its equity base. The amount of any excess equity not taken into account in applying the differential earnings rate will decrease ratably each year, until 1989 when the entire equity base of a high surplus company is subject to the differential earnings rate.

Fourth, certain modifications to the equity base are required if a mutual life insurance company owns one or more subsidiary life insurance companies. Such subsidiaries are generally treated as stock life insurance companies in computing such subsidiaries' entity level income tax liability. However, for purposes of computing the differential earnings amount, a mutual parent of a subsidiary life insurance company must include the equity of such company in its own equity base (in lieu of the stock of the subsidiary). At the same time, for purposes of determining the statement gain from operations of the mutual parent, the mutual parent would ignore any dividends it received from the subsidiary. Also, for purposes of computing the average mutual earnings rate and the imputed earnings rate, life insurance subsidiaries of a mutual life insurance company would be counted as mutual companies. If a subsidiary life insurance company is owned by more than one mutual entity and is not a member of an affiliated group, the Secretary is given regulatory authority to prescribe how proper adjustments should be made in the equity bases of mutual life insurance companies owning stock therein to carry out the general rules described above. This treatment is in contrast to the treatment of nonlife insurance subsidiaries, the stock of which will be included in the parent mutual company's equity and the earnings of which will only be taken into account in computing the average mutual earnings rate when and as dividends are received by the parent mutual company.

f. Operations loss deduction (new sec. 810)

Present Law

Generally, operations losses may be carried back to each of the 3 taxable years preceding the loss year and may be carried over to each of the 15 taxable years following the loss year. For a life insurance company that qualifies as a new company in the loss year, the 3-year carryback may be added, instead, to the 15-year carryover.

Explanation of Provision

The operations loss deduction provided in the bill is substantially the same as that in section 812 in present law and new section 810 is treated as a continuation of present law section 812. Modifications are made that will conform the definition of an operations loss deduction to the new method for determining life insurance company taxable income. In both the bill and present-law section 812, the operations loss deduction is consistent with the general treatment for a net operating loss in section 172.

The operations loss deduction for any taxable year is defined as the excess of life insurance deductions (which are described in section 804, above) over life insurance gross income (which is defined in section 803, above). The loss from operations for any taxable year may be carried back 3 taxable years and carried over 15 years, just as under present law. The 18-year carryover for a new life insurance company, as well as the definition of a new life insurance company, are unchanged from present law. Other rules, relating to the amount of carrybacks and carryovers and the election for operations loss carrybacks, also remain unchanged from present law.

No change has been made in the modifications to the computation of the loss from operations, which modifications exclude the carrybacks and carryovers of the operations loss deduction from the computation of life insurance taxable income and also relate to the limitation on the aggregate amount of dividends received deduction.

The operation of new section 810 may be illustrated by the following example. Assume that company A has the following results for 1984, 1985, and 1986:

	1984	1985	1986
Tentative LICTI	100,000	200,000	200,000
Small company deduction (sec. 806(b))	(60,000)	(120,000)	(120,000)
Special life company deduction (sec. 806(a))	(8,000)	(16,000)	(16,000)
Taxable income	32,000	64,000	64,000

Assume further that for 1987 and 1988, company A had losses from operations of $150,000 and $200,000, respectively. Under new section 810, the results will be as follows:

	1984	1985	1986
Taxable income	32,000	64,000	64,000
Small company deduction	60,000	120,000	120,000
Special life company deduction	38,000	16,000	16,000
Offset amount	100,000	200,000	200,000
1987 carryback	(100,000)	(50,000)	
1988 carryback		(150,000)	(50,000)
Taxable income after carryback	0	0	150,000

Thus, in 1986, the life insurance company taxable income for purposes of the small company deduction and the special life insurance company deduction is $150,000 after carryback of the net operating loss.

g. Accounting provisions (new sec. 811)

Present Law

Generally, under present law, all computations entering into the determination of life insurance company taxable income are to be made under an accrual method of accounting or, to the extent permitted under regulations, under a combination of an accrual method with any other recognized method other than the cash receipts and disbursements method. Except as provided in the general rule, all such computations are to be made in a manner consistent with the manner required for purposes of the annual statement approved by the National Association of Insurance Commissioners. This provision has been interpreted to mean the State regulatory accounting procedures should control so long as they are not inconsistent with accrual accounting rules (*Commissioner v. Standard Life and Accident Insurance Company*, 433 U.S. 148 (1977)). Also, the accounting provisions include a general prohibition against deducting an item more than once in computing taxable income.[18]

When two or more related parties (within the meaning of sec. 1239) are parties to a reinsurance agreement, present law gives the Secretary authority to allocate or recharacterize any items necessary to reflect the proper source and character of the taxable income of each related party.

Also, there was a temporary rule (adopted under TEFRA) for computing reserves on contracts where interest is guaranteed beyond the end of the taxable year; any interest which is computed at a rate which is in excess of the lowest rate assumed in the contract and is guaranteed beyond the end of the taxable year is taken into account in computing reserves as if such interest were guaranteed only up to the end of the taxable year.

Finally, under present law there are specific rules for the amortization of premium and accrual of discount on bonds and for life insurance companies with short taxable years.

Explanation of Provision

The bill retains the general rule in present law that life insurance companies must use an accrual method, or a method permitted under the regulations that combines an accrual method with another recognized method. However, the bill makes it clear that accounting methods required for State regulatory purposes apply only to the extent that they are not inconsistent with Federal tax accounting rules. The change from present law was intended to reinforce the primacy of the Federal tax rules and not impose a new method of tax accounting on life insurance companies. Thus, for example, agents' commissions paid by direct insurers would continue to be treated as sales expenses and deductible when paid, as has been allowed historically (even though they arguably might be classified as acquisition expenses to be amortized).

Although the bill continues to provide a general prohibition against any double deduction of an item, it also adopts a new rule

[18] Actually, the prohibition is against deducting an item more than once in computing each subpart of taxable income—taxable investment income and gain or loss from operations.

that disallows a reserve for any item unless the gross amount of premiums and other consideration attributable to such item are required to be included in gross income. Thus, because deferred and uncollected premiums for a contract do not accrue until paid, the contractual liability related to those premiums may not be recognized until the premiums are taken into income. This provision of the bill, in effect, reverses the holding of the Supreme Court in *Commissioner v. Standard Life and Accident Insurance Co.*, 433 U.S. 148 (1977), by statutorily requiring a matching of the reserve deduction with the related income item.

In the case of reinsurance agreements, the bill expands the reallocation authority granted Treasury. As under present law, in the case of a reinsurance agreement between two or more related persons, the Treasury can allocate among the parties and recharacterize income, deductions, assets, reserves, credits, and any other items related to the reinsurance agreement in order to reflect the proper source and character of the items for each party. Under the bill, however, related parties are defined as they are in section 482. Thus, two or more parties are related if they are organizations or entities, whether or not incorporated or affiliated, owned or controlled directly or indirectly by the same interests. Also, Treasury can use its recharacterization authority for a reinsurance agreement between unrelated parties where one of the parties to the agreement (with respect to any contract covered by the agreement), in effect, is an agent of another party to such agreement or is a conduit between related persons. Thus, although one party may not have de facto control over the business of the other party (as required by sec. 482), it may have unilateral control over the profit levels for both parties with respect to specific lines of business covered by a reinsurance agreement, which can be used to distort the income of the parties. The bill also makes it clear that the reallocation and recharacterization authority can be used when one party to the reinsurance transaction acts as a conduit between related parties. The committee believes that whether a party is an agent of, or conduit between, other parties must be determined in light of all the facts and circumstances. An example of a fact that would tend to establish that an agency relationship existed is control on the part of the reinsurer over the amount of policyholder dividends that are paid by the reinsured. Treasury's new reallocation authority will apply to any risk reinsured after September 27, 1983, whether or not the reinsurance agreement was entered into before such date.

Finally, the bill includes, as a permanent provision, the accounting rule adopted as a temporary provision in TEFRA for computing reserves for contracts that guarantee excess interest beyond the end of the taxable year. Under the bill, the provision is modified to reflect the new Federally prescribed reserve rules. Thus, any amount in the nature of interest that is credited under any contract for any period at a rate in excess of the prevailing State assumed interest rate for the contract for such period and is guaranteed beyond the end of the taxable year can only be taken into account in computing reserves as if it were guaranteed to the end of the taxable year. Under this rule, "amounts in the nature of interest" include both implicit and explicit guarantees for determining contractual benefits. Thus, "amounts in the nature of interest" refers to amounts credited to policyholder reserves as assumed interest or as interest paid on such items.

With respect to the special rules for amortization of premium and accrual of discount on bonds, and short taxable years for life insurance companies, the bill makes no change from present law.

h. Definition of company's share and policyholders' share (new sec. 812)

Present Law

Under present law, all items of investment yield (i.e., gross investment income, including tax-exempt interest and dividends received, less certain investment expenses) are allocated between the policyholders and the company. Amounts allocated to policyholders are not included in taxable investment income or gain from operations. Generally, this allocation is accomplished by means of a proration formula which, in general, compares amounts credited to policyholders to investment yield. The practical effect of the proration formula is to treat additions to reserves as funded in part out of tax-exempt income thus limiting the tax benefit a company can enjoy by the receipt of tax-exempt income.[19]

The proration formula is different depending upon whether taxable investment income or gain from operations is being computed. For purposes of computing taxable investment income, each item of investment yield is allocated between the policyholders and the company in the same proportion that the sum of the company's policy and other contract liabilities bears to its total investment yield. These policy and contract liabilities are (1) the adjusted life insurance reserves, multiplied by the adjusted reserves rate (Menge formula), (2) the mean of the pension plan reserves at the beginning and end of the taxable year, multiplied by the current earning's rate, and (3) interest paid, including interest paid on indebtedness to persons other than customers.

For purposes of computing gain from operations, each item of investment yield is allocated between the policyholders and the company in the same proportion as the required interest bears to the investment yield. Required interest is the amount of interest guaranteed to the policyholders using the interest rate assumed by the company for purposes of calculating the adjustments to its section 810(c) reserves, as well as excess interest on annuity contracts.

Explanation of Provision

The distinction between taxable investment income and gain from operations has been eliminated. However, the general concept that items of investment yield should be allocated between policyholders and the company has been retained. Under the bill, the formula used for purposes of determining the policyholders' share is based generally on the proration formula used under present law in computing gain oı loss from operations. Thus, amounts credited

[19] "Tax-exempt income" refers generally to tax-exempt interest and deductible intercorporate dividends.

to policyholders will no longer include interest paid on indebtedness if the interest is paid to a person who is not a customer. For example, interest paid on a loan that is incurred to purchase a subsidiary company or other asset will not be included in determining the policyholders' share of investment yield items. On the other hand, the bill expands the items to be taken into account for the policyholders' share by including all amounts that may be paid or credited to policyholders as customers, including policyholder dividends.

Specifically, under the bill the policyholders' share of any item is 100 percent of the item reduced by the company's share of the item. The company's share is defined as the percentage obtained by dividing the company's share of net investment income by total net investment income. Net investment income is defined as 90 percent of gross investment income. Gross investment income is generally the same as under present law, and includes tax-exempt interest. However, gross investment income does not include dividends received from a subsidiary which are eligible for the 100 percent dividends received deduction (or which would have been eligible for the 100 percent dividends received deduction if the recipient were not a foreign corporation) except to the extent such dividends are paid, directly or indirectly, out of tax-exempt income. The net investment income definition as 90 percent of gross investment income generally reflects the historical level of industry investment expenses. With the adoption of this provision, the proration computation required under present law will be simplified because of the elimination of the necessity to identify and to allocate expenses to investment rather than underwriting activities, along with the accompanying audit problems.

The company's share of net investment income is the excess of net investment income over the sum of: (1) required interest for reserves; (2) the deductible portion of any excess interest; (3) the deductible portion of any amount in the nature of interest (whether or not a policyholder dividend) credited to a policyholder or customer fund under a pension plan contract [20] for employees not yet retired or to a deferred annuity contract before the annuity starting date; and (4) a fraction of the deductible portion of policyholder dividends (not including the deductible portion of any amounts previously included under (1), (2) or (3), or of any premium or mortality charge adjustments associated with a contract for which excess interest was credited during the taxable year). The amount of the required interest for reserves is determined at the prevailing State assumed interest rate. Whether or not a payment constitutes excess interest will be determined by the contract terms. The deductible portion of any policyholder dividend is that portion remaining after a pro rata reduction of all policyholder dividends by the differential earnings amount under section 809 (if applicable). Finally, the fraction of the deductible portion of policyholder dividends to be included will be determined by applying a mini-fraction. The numerator of the mini-fraction is gross investment

[20] The definition of pension plan contracts is the same under the bill as under present law except that the phrase "purchased under contracts" is eliminated since it was considered unnecessary (new sec. 818(a)).

income (including tax-exempt income), less required interest, excess interest and the amounts credited to pension plan contracts and deferred annuities (items (1), (2) and (3) described above). The denominator of the mini-fraction is gross income (including tax-exempt income), less net increases in reserve items. The application of this mini-fraction to the deductible portion of policyholder dividends recognizes that some portion of traditional policyholder dividends consist of redundant premiums (i.e., rebates of mortality and expense charges). In so recognizing this, the assumption is made that, except for those items specifically allocated to be paid out of investment income (i.e., amounts generally in the nature of interest), all other sources of income are available to pay all other expenses ratably. Thus, the company's share is the amount of net investment income that remains after paying or crediting amounts to policyholders.

Because reserve increases might be viewed as being funded proportionately out of taxable and tax-exempt income, the net increase and net decrease in reserves are computed by reducing the ending balance of the reserve items by the policyholders' share of tax-exempt interest. Similarly, a life insurance company is allowed a dividends-received deduction for intercorporate dividends from nonaffiliates only in proportion to the company's share of such dividends. 100 percent deductible dividends from affiliates are excluded from application of the proration formula, if such dividends are not themselves distributions from tax-exempt interest or from dividend income that would not be 100 percent deductible if received directly by the taxpayer.

i. Foreign tax credit (new sec. 818(f))

Present Law

Life insurance companies are generally subject to the same rules governing foreign income as other U.S. corporations. The United States taxes U.S. citizens and residents and U.S. corporations on their worldwide income. The United States allows U.S. taxpayers to offset the U.S. tax on their foreign income by the income taxes paid or açcrued to a foreign country ("foreign tax credit").

A credit is available only for foreign taxes that are income taxes under U.S. concepts and certain taxes paid to a foreign government in lieu of an income tax otherwise imposed by that foreign government. Certain taxes on gross premiums of U.S. taxpayers engaged in the life insurance business in a foreign country have been held to be creditable "in lieu of" taxes (Rev. Rul. 74-311, 1974-2 C.B. 211; Rev. Rul. 72-84, 1972-1 C.B. 216). Income taxes paid by foreign subsidiaries of U.S. corporations are creditable when the U.S. corporation receives a dividend or a deemed dividend from the foreign subsidiary.

The foreign tax credit limitation

A fundamental premise of the foreign tax credit is that it should not offset U.S. tax on U.S. source income. Accordingly, the Code contains a limitation to ensure that the credit offsets the U.S. tax on only the taxpayer's foreign income. Under this limitation, the total pre-credit U.S. tax is multiplied by the ratio of foreign source taxable income to total worldwide taxable income to establish the amount of U.S. taxes that would be paid on the foreign income in the absence of a foreign tax credit. This amount is the upper limit on the foreign tax credit.

To calculate U.S. taxable income and foreign taxable income, which is necessary to compute the limitation, all deductions must be allocated against gross income, and apportioned against gross U.S. income or gross foreign income. Expenses that are properly allocated or apportioned to a class of U.S. (or foreign) source income reduce gross income in that category (sec. 861(b), 862(b), and 863; Reg. sec. 1.861-8). Expenses that cannot definitely be allocated to a class of gross income are generally deducted ratably from all classes of gross income.

The Internal Revenue Service has taken the position in a private letter ruling (applicable under pre-1982 law) that the numerator of the foreign tax credit limitation fraction (foreign source taxable income) is computed on a phase-by-phase basis. Thus, a company taxable on only its investment income (i.e., a phase-one company) would receive no foreign tax credit for premium taxes if all of its investment income were U.S. source income, even if the investment income arose from reserves held with respect to foreign business. Some taxpayers have taken the position that application of a phase-by-phase foreign tax credit limitation is improper under pre-1982 law.

Explanation of Provision

Elimination of the present law three-phase system presupposes that gross premium income and gross investment income contribute in similar ways to total income. The committee believes that certain deductions generally bear the same relationship to gross premium income that they bear to gross investment income. Similarly, these deductions generally bear the same relationship to gross U.S. source income that they bear to gross foreign source income. These deductions should, therefore, generally reduce U.S. source gross income and foreign source gross income ratably in calculating the foreign tax credit limitation. Similarly, reserve decreases should generally produce U.S. source gross income and foreign source gross income ratably.

Under its general rule, the bill provides that in calculating U.S. source income and foreign source income, three items will be treated under regulations as items which cannot definitely be allocated to an item or class of gross income. Thus, these items will be allocated ratably among all classes of gross income. These items are policyholder dividends (determined under new section 808(c)), reserve adjustments (under subsections (a) and (b) of new section 807), and death benefits and other amounts described in new section 805(a)(1).

The following example illustrates the application of the bill's general rule to a life insurance company that has $2,100 of gross income from all sources (including $100 of income from a net reserve decrease) and $1,800 of expenses (consisting of a death benefits deduction of $1,200 and a policyholder dividends deduction of $600):

Gross income	U.S.	Foreign source	Worldwide
Investment	$700	$300	$1,000
Premiums	600	400	1,000
Total	$1,300	$700	$2,000
	(65%)	(35%)	
Items subject to ratable allocation:			
Income from net reserve decrease	65	35	$100
Death benefits deduction	(780)	(420)	$(1,200)
Policyholder dividends deduction	(390)	(210)	(600)
Worldwide net income	195	105	300

Under the bill's general rule, these items will be allocated in this way regardless of the current residence of the decedents whose deaths caused the death benefit payments, the source of the premiums those decedents had paid the company in any year, the residence of the policyholders receiving or crediting dividends, or any other factor.

In some cases, the bill's general rule could be inequitable in its application to companies that can easily identify gross income to which these expenses relate. Therefore, taxpayers will be able to elect to treat the expenses that are the subject of the general rule of the bill as properly apportioned or allocated among items of gross income in the manner and to the extent prescribed in regulations. The election will apply for all taxable years of the taxpayer to which the bill applies. It must be made on or before September 15, 1984. Once made, it will be irrevocable, except with the consent of the Commissioner.

For example, a foreign country may require life insurance companies that sell policies there to maintain reserves there. In such a case, a taxpayer could show that some deductions for reserve increases, policyholder dividends, and claims should be treated as properly apportioned or allocated among items of gross income. In addition, a taxpayer could show that some such deductions should be treated as properly apportioned or allocated to some portion of the company's investment income attributable to the company's worldwide surplus. However, a taxpayer who makes such showings will not be able to show that those deductions are properly apportioned or allocated solely to an undue amount of foreign source investment income. For example, a company whose worldwide surplus is 15 percent of reserves and that makes the election will not be able to show that any of these deductions are properly apportioned or allocated solely to foreign source investment income (from any foreign country) attributable to surplus above 15 percent above reserves that the company must maintain in a foreign country.

The election will not apply to the special life insurance company and small life insurance company deductions. All companies will treat these deductions as items which cannot definitely be allocated to an item or class of gross income.

j. Foreign life insurance companies' minimum surplus (new sec. 813)

Present Law

Foreign corporations in general

Foreign corporations generally are subject to U.S. tax only on certain U.S. source income and on income that is effectively connected with a trade or business conducted in the United States. The United States generally imposes a flat 30-percent tax on the gross amount of U.S. source investment income (and certain other U.S. source income) paid to foreign persons when that income is not effectively connected with a U.S. trade or business. The tax on gross amounts of interest, dividends, and royalties may be reduced or eliminated under bilateral income tax treaties.

Taxation of foreign life insurance companies in general

A foreign corporation carrying on an insurance business within the United States, that would qualify as a life insurance company if it were a U.S. corporation, is taxable like a U.S. life insurance company on its income effectively connected with its conduct of any U.S. trade or business. The determination of whether a foreign corporation would qualify as a life insurance company considers only the income of the corporation that is effectively connected with the conduct of its business carried on in the United States.

Effectively connected income of a foreign corporation carrying on an insurance business within the United States includes all income (such as investment income attributable to required reserves) from foreign sources that is attributable to the U.S. business.[21] Such a foreign corporation is taxable at the 30 percent or lower treaty rate on its U.S. source investment income that is not effectively connected with a U.S. trade or business.

A foreign life insurance company that is engaged in a U.S. trade or business is taxable on U.S. source underwriting income but not on foreign source underwriting income (unless that foreign source underwriting income is effectively connected with a U.S. trade or business).

Minimum surplus requirement

A special rule may alter the U.S. tax on foreign life insurance companies doing business in the United States when they hold a relatively small surplus attributable to the U.S. business in the United States. This rule applies when the surplus of a foreign life insurance company held in the United States is less than a speci-

[21] Some Canadian insurance companies contended that the U.S.-Canada income tax treaty exempts from U.S. tax passive income they receive from Canadian sources, even when that passive income is effectively connected with and attributable to a U.S. business. The Court of Claims has rejected that contention (Great-West Life Assurance Co. v. United States, 82-1 USTC para. 9374 (1982)).

fied minimum. That minimum amount is the foreign company's total insurance liabilities on U.S. business multiplied by the ratio of the average surplus of domestic corporations to their total liabilities. The Secretary of the Treasury determines this ratio each year.

If the foreign insurance company's surplus held in the United States is less than this minimum amount, then certain deductions of the company decrease. The policy and other contract liability requirements, and the required interest for computing gain from operations, are reduced by the deficiency multiplied by the current earnings rate. An increase in tax caused by this adjustment of surplus may be offset by a reduction in the flat-rate tax on investment income not effectively connected with the U.S. business. The reason for reduction in the flat-rate tax is that part of that investment income, in effect, may be income subject to tax under the minimum surplus adjustment.

For the purpose of this minimum surplus requirement, Regulations provide for a separate computation of surplus with respect to segregated asset accounts of foreign life insurance companies. For such accounts, in general, the required surplus is 1 percent of liabilities (Treas. reg. sec. 1.819-2(b)(4)).

Explanation of Provision

The bill generally retains the Secretary's ratio adjustment, with modifications. A foreign company taxable as a life insurance company must compare its surplus held in the United States to a required surplus computed under the new statute. If the required surplus exceeds the actual surplus, the company must increase its income by the product of that excess and its current investment yield.[22]

The bill requires the calculation of required surplus in a manner similar to the calculation of the "minimum figure" under present law. The Secretary of the Treasury is to calculate the percentage used in the taxpayer's calculation in a manner similar to the manner of present law. Taxpayers will calculate current investment yield by dividing net investment income on assets held in the United States by the mean of assets held in the United States. For this purpose only, the taxpayer is to use amounts required to be set forth on the NAIC annual statement.

The bill also provides definitions of surplus held in the United States and total insurance liabilities. Surplus held in the United States is the excess of assets held in the United States over the total insurance liabilities on U.S. business. For the purpose of valuing assets in the determination of surplus, the committee intends that the Secretary promulgate regulations that indicate that taxpayers are not to value assets under the method used in the NAIC statement, but are to use a method similar to the method prescribed under present law. Total insurance liabilities mean the sum of total reserves (as defined in new sec. 816(c)) plus, to the extent

[22] Some have suggested that this imputation of income (rather than a reduction of a deduction, as in present law) may exceed the taxing power granted under the Sixteenth Amendment. Were this or any other provision of this title of the bill found to be unconstitutional, the committee intends sec. 7852(a) to operate to preserve the remainder of the bill's provisions.

not included in total reserves, the items referred to in paragraphs (3), (4), (5), and (6) of new section 807(c). The committee intends that the Secretary adopt regulations governing required surplus attributable to segregated asset accounts similar to the regulations in effect under current law.

As under present law, an increase in tax caused by this adjustment of surplus may be offset by a reduction in the flat-rate tax on investment income not effectively connected with the U.S. business.

The bill provides a new rule for foreign mutual life insurance companies that reflects the equity base concept of the new statute. Each such company that is taxable as a life insurance company in the United States is to increase its equity base by the excess (if any) of its required surplus over its actual surplus.

k. Contiguous country branches of U.S. life insurance companies (new sec. 814)

Present Law

U.S. corporations are taxable on worldwide income, including foreign income (although the foreign tax credit may offset U.S. tax on foreign income). In general, foreign corporations (even those wholly owned by U.S. persons) are not subject to U.S. tax on foreign income. U.S. shareholders of a foreign corporation generally are exempt from U.S. tax on the earnings of the foreign corporation until it pays them a dividend (unless it engages in tax-haven or tax avoidance activity). Foreign branch operations of U.S. taxpayers generally are subject to tax currently.

Branches of mutual companies generally derive their income from the issuance of policies on local risks and from investment income from reserves on local risks. Under the principle of mutuality, this income inures solely to the benefit of local policyholders. Thus, a foreign branch of a mutual life insurance company is similar to a foreign corporation owned by non-U.S. persons. Congress, therefore, provided that a U.S. mutual life insurance company may generally elect to exempt the income of its branches that operate in Canada or Mexico (sec. 819A)[23] so long as the foreign branch does not repatriate its income to the United States. Repatriation of contiguous country branch income results in an increase in life insurance company taxable income. In this respect, the treatment of contiguous country branches corresponds generally to the treatment of foreign subsidiaries of U.S. parent companies.

In general, a transfer of property by a U.S. person to a foreign corporation can qualify for nonrecognition treatment only if the exchange does not have as one of its principal purposes the avoidance of U.S. tax (sec. 367). A special rule applies (1) to elections by U.S. mutual life companies to use the special contiguous country branch rule and (2) to certain incorporations by U.S. stock life companies of contiguous country subsidiaries. In general, in each case, there is a deemed sale of the invested assets and tangible property subject to the election or transferred in the incorporation. The gain that

[23] For the legislative history of these life insurance company provisions, see H.R. Rep. No. 94-658, 94th Cong., 1st Sess. 248-252, and S. Rep. No. 94-938, 94th Cong., 2d Sess. 271-275.

the company must recognize is the excess of the fair market value of those invested assets and that tangible property over their aggregate adjusted basis. The company does not recognize gain attributable to goodwill, since it is an intangible asset.

Explanation of Provision

The bill retains the contiguous country branch rule of present law, with technical modifications. Thus, repatriation of contiguous country branch income will result in an increase in income. As under present law, payments, transfers, reimbursements, credits, or allowances which are made from a separate contiguous country branch account to one or more accounts of the domestic company as reimbursements for costs (e.g., home office services) incurred for or with respect to the insurance (including reinsurance) of risks accounted for in the separate branch account are taken into account by the domestic company in the same manner as if the payment, transfer, reimbursement, credit, or allowance were received from a separate person. For this purpose the rules in the Internal Revenue Code (sec. 482) dealing with reimbursement of costs between related parties continue to apply and the domestic company must establish procedures for billing the branch at arm's length. As under present law, reimbursements under this provision are not treated as repatriation of income.

If amounts are directly or indirectly transferred or credited from a contiguous country branch account to one or more other accounts of the domestic company they are to be added to the income of the domestic company except to the extent the transfers are reimbursements for home office s .vices. The amount added to income cannot exceed the amount by which the aggregate decrease in the tentative LICTI for the taxable year and for all prior taxable years resulting solely from the application of these exclusion provisions with respect to the contiguous country branch exceeds the amount of additions to the tentative LICTI with respect to that branch which were treated as a repatriation of income for all prior taxable years. For this purpose, in the case of a prior taxable year beginning before January 1, 1983, "tentative LICTI" means life insurance company taxable income computed under the law in effect during the earlier taxable year.

Section 113 of the bill provides that an election under section 819A of current law will be treated as an election under new section 814, and that references to new section 814 will be treated as references to the corresponding provision of section 819A of current law.

I. Rules relating to capital gains and losses (new sec. 818)

Present Law

With respect to property used in a trade or business and held for more than 12 months, present law provides, in general, that if the gains from the sale or exchange of such property exceed such losses, then each gain and loss is treated as though it was from the sale or exchange of a long-term capital asset. If the losses exceed the gains, then each gain or loss is considered as not being from the sale or exchange of a capital asset, with the result that ordinary gain or loss is realized.

In the case of life insurance companies, a special rule applies which modifies the general rule by limiting the term "property used in the trade or business" to include only property used in carrying on an insurance business. Further, for purposes of section 1221(2) (excluding certain property from the term "capital assets"), the reference to property used in trade or business is treated as including only property used in carrying on an insurance business. In both cases, the term "property used in carrying on an insurance business" means only those assets used in the operation of the insurance trade or business.

Under present law, the amount of gain that is recognized on the sale or other disposition of certain property acquired before December 31, 1958 is limited. In the case of property acquired after December 31, 1958, having a substituted basis (within the meaning of sec. 1016(b)), the limitation on the gain recognized shall apply if the property or properties were held only by life insurance companies during the relevant periods. The term "property" does not include insurance and annuity contracts (and contracts supplementary thereto) and property described in section 1221 relating to stock in trade or inventory-type property.

Explanation of Provision

The bill continues the present-law treatment relating to capital gains and losses and gains and losses on property used in the trade or business for life insurance companies. These rules are found in new sections 818(b), (c), and (d).

Under the present-law provisions, there are regulations for assumption reinsurance transactions which are generally treated as a sale of a block of business. The bill continues the current distinction between indemnity and assumption reinsurance arrangements.

m. Technical and conforming amendments (sec. 211(b) of the bill)

Section 211(b) of the bill contains 27 technical changes to the provisions of the Internal Revenue Code of 1954 outside of Part I of subchapter L. These amendments conform the existing provisions of the 1954 Code to the new single phase tax system adopted for life insurance companies under the bill.

n. Effective date and transitional rules (secs. 215, 216, and 217 of the bill)

Effective Date

Generally, the life insurance company taxation provisions apply to taxable years beginning after December 31, 1983.

Transitional Rules

Reserves computed on a new basis

As of the beginning of the first taxable year after December 31, 1983, the reserve for any contract shall be recomputed as if the amendments made in this bill had applied to such contract when it was issued. This provision applies to reserves held by any company taxable under subchapter L of the Code (relating to the taxation of insurance companies).

Any change in accounting (e.g., in computing the policyholder dividends deduction) or any change in the method of computing reserves which is required by the amendments made in this bill will not be treated as a change in the method of accounting or in the method of computing reserves, and will not give rise to income or loss. This "fresh start" provision will apply solely to changes made between any company's first taxable year beginning after December 31, 1983, and the preceding taxable year.

Allocation of the "fresh start" in certain cases

The bill provides the "fresh start" benefit shall be allocated between the reinsured or ceding company and the reinsurer with respect to reserves subject to an indemnity reinsurance agreement entered into during 1982 or 1983. Generally, the "fresh start" benefit would be allocated by income recognition or deductions for recaptured reserves upon termination of the reinsurance agreement, making the amounts under the allocation reflect the post-1983 duration of the agreement between the parties. For this purpose, a lapse of a policy covered by a reinsurance agreement will not be considered a termination. Also, the voluntary termination of a reinsurance agreement, by either party, followed by the entering into of a substantially similar agreement between the parties will not be considered a termination. If the amount of the reserves with respect to the recaptured contracts (computed at the date of recapture) that the reinsurer would have taken into account under present law exceeds the amount of the reserves with respect to the recaptured contracts (computed at the date of recapture) taken into account by the reinsurer under the bill, such excess will be taken into account by the reinsurer, in computing life insurance company taxable income, over a ten-year period commencing with the taxable year of termination. However, the excess taken into account by the reinsurer cannot exceed the amount of such excess if computed on January 1, 1984. The same amount of excess, if any, shall be taken into account by the ceding company over a ten-year period commencing with the taxable year of recapture. If the reinsurer does not take any amount into account in computing life insurance company taxable income (for example, if the reinsurer is not a U.S. taxpayer) no amount can be taken into account by the ceding company. This special allocation rule will apply if: (1) insurance and annuity contracts in force on December 31, 1983, are subject to an indemnity reinsurance agreement entered into after December 31, 1981; (2) the provision denying the "fresh start" (described below) does not apply to such contracts; and (3) such contracts are recaptured by the ceding company in any taxable year beginning after December 31, 1983.

Denial of "fresh start" in certain cases

The bill restricts the benefits available under the "fresh start" in certain cases involving events occurring between the announcement of the "fresh start" proposal and the effective date of the bill. Specifically, the bill provides that, for purposes of computing life insurance company taxable income a reinsurance agreement entered into or a modification to a reinsurance agreement (to the extent of the modification) made after September 27, 1983 (and before January 1, 1984), will not be taken into account until the first day of the taxable year beginning after December 31, 1983. The transaction can be taken into account for purposes of determining whether a company qualifies as a life insurance company or whether there has been a distribution from a policyholders' surplus account.

Also, the "fresh start" rule does not apply to any reserve strengthening reported for Federal income tax purposes after September 27, 1983, for a taxable year ending before January 1, 1984. For these purposes, the phrase "any reserve strengthening" includes the computation of reserves on contracts issued in 1983, under plans of insurance in existence on September 27, 1983, on a more conservative basis than was the customary practice of the company for similar contracts, or to the strengthening of reserves for tax purposes, generally, on existing business. An election to revalue reserves under present-law section 818(c) that is made on a return filed after September 27, 1983, and increases the reserves for tax purposes, will be considered general reserve strengthening for tax purposes under this provision to the extent of the benefit received by the taxpayer from the election. However, reserve strengthening resulting from a proper election under section 818(c) of present law will be eligible for a fresh start if more than 95 percent of the section 818(c) amount arises from risks under life insurance contracts issued by the taxpayer under a plan of insurance first filed after March 1, 1982, and before September 28, 1983.

Under the bill, any income arising from the nonapplication of the "fresh start" rule will be taken into account over 10 years and will be added to income ratably in each year after determining the amount of the special life insurance company deduction and the small life insurance company deduction.

If a life insurance company changed its method of computing reserves, which resulted in a decrease in reserves in any taxable year beginning before 1984, the resulting income will not be taken into account in any taxable year beginning after 1983. Thus, a company that changed its reserve method in a manner that reduced the reserves before adoption of the new Federally prescribed reserve rules will not be treated differently from a company whose reserves for tax purposes are reduced by the bill. However, any increase in reserves resulting from a change in a tax year beginning before 1984 shall be taken into account after 1983 to the extent that the amount of the increase that would have been taken into account (under present law) after 1983 exceeds the amount of any fresh start adjustment attributable to contracts for which there was such an increase in reserves. Likewise, no premium will be included in income to the extent such premium is directly related to an increase in a reserve for which a deduction is disallowed under this provision of the bill.

Special Rules

Installment contracts

If, prior to January 1, 1984, an election is made to treat income from an installment obligation as investment income, any income from such obligation shall be treated as attributable to a noninsurance business. Noninsurance business is defined as any trade or business which is not an insurance business; however, any noninsurance business that traditionally has been carried on by life insurance companies for investment purposes shall be treated as an insurance business.

Determination of tentative LICTI in cases of acquisitions in 1980, 1981, 1982, and 1983

In certain specific cases that involve the acquisition of one or more insurance companies, a transitional rule is provided which permits increases in tentative LICTI. In order to qualify, a corporation must be domiciled in Alabama, Oklahoma or Texas and had to acquire the assets of one or more insurance companies after 1979 and before April 1, 1983. In addition, the bases of the acquired assets in the hands of the acquiring corporation had to have been determined under sec. 334(b)(2) (as in effect prior to TEFRA) (relating to the basis of property received in complete liquidation of a subsidiary) or the corporation had to have made an election under sec. 338 (relating to the treatment of stock purchases as asset acquisitions). The date of the acquisition of assets for cases involving a section 338 election is the "acquisition date," as defined in section 338(h)(2); for cases involving section 334(b)(2) (as in effect prior to TEFRA), the date of the acquisition of the assets is the date of the liquidation of the acquired corporation. If these tests are met, then the tentative LICTI of the corporation holding the assets for taxable years after December 31, 1983, shall be increased by the deduction allowable for the amortization of the cost of insurance contracts acquired in the acquisition and for any portion of any operations loss deduction attributable to such amortization.

The effect of the increase in tentative LICTI is to increase the base for the 60 percent (of the first $3 million) small life insurance company deduction and the 20 percent special life insurance company deduction.

Special allocation rule for reinsurance agreements

Any contract that was issued before September 27, 1983, which is reinsured before that date under a reinsurance agreement entered into before September 27, 1983, will not be subject to the allocation and recharacterization authority granted the Secretary of the Treasury in section 811(d) of this bill.

Treatment of a stock-mutual company

Any company that has been operating for a ten-year period ending on December 31, 1983, as a mutual life insurance company with shareholders, as authorized by the law of the State in which it is domiciled, shall be treated as a stock life insurance company.

Waiver of Estimated Tax Penalty

Any penalty for underpayment of estimated tax by an insurance company, for any 1984 period before the date of enactment is waived to the extent the underpayment is due to changes from present-law tax provisions that are made retroactive by the effective date of the bill.

3. Taxation of Life Insurance Products

a. Definition of a life insurance contract (new sec. 7702)

Present Law

Generally, there is no statutory definition of life insurance under present law. A life insurance contract is defined generally in section 1035 (relating to tax-free exchanges) as a contract with a life insurance company which depends in part on the life expectancy of the insured and which is not ordinarily payable in full during the life of the insured.

Income earned on the cash surrender value of a contract is not taxed currently to the policyholder, but it is taxed upon termination of the contract prior to death to the extent that the cash surrender value exceeds the policyholder's investment in the contract, i.e., the sum of all premiums paid on the contract. Gross income does not include amounts received by a beneficiary under a life insurance contract, if the amounts are paid because of the death of the insured.

In TEFRA, Congress enacted temporary guidelines for determining whether flexible premium life insurance contracts (e.g., universal life or adjustable life) qualified as life insurance contracts for purposes of the exclusion of death benefits from income. Violation of the guidelines at any time during the contract causes the contract to be treated as providing a combination of term life insurance and an annuity or a deposit fund (depending on the terms of the contract). In the event of the death of the insured, only the term life insurance component is excluded from gross income.

1982 and 1983 temporary guidelines

Under the temporary guidelines which apply to 1982 and 1983, death proceeds from flexible premium life insurance contracts are treated as life insurance if either of two tests are met.

Alternative 1

Under the first of the two alternative tests, a contract qualifies if:

(a) The sum of the premiums paid for the benefits at any time does not exceed the net single premium (based on interest rates at 6 percent) or the sum of the net level premiums (based on interest rates at 4 percent), assuming the policy matures no earlier than in 20 years or at age 95, (if earlier); and

(b) the death benefit is at least 140 percent of cash value at age 40, phasing down one percentage point each year to 105 percent.

Alternative 2

Under the second of the two alternative tests, a contract qualifies if the cash surrender value does not exceed the net single premium (based on interest rates at 4 percent and the most recent mortality table) for the amount payable at death, assuming the policy matures no earlier than age 95.

Explanation of Provision

The bill adopts a definition of a life insurance contract for purposes of the Internal Revenue Code. This provision extends to all life insurance contracts rules that are similar to those contained in the temporary provisions of TEFRA. Since the committee was concerned with the proliferation of investment-oriented life insurance products, the definition has been narrowed in some respects.

Definition of life insurance

A life insurance contract is defined as any contract, which is a life insurance contract under the applicable State or foreign law, but only if the contract meets either of two alternatives: (1) a cash value accumulation test, or (2) a test consisting of a guideline premium requirement and a cash value corridor requirement. Whichever test is chosen, that test must be met for the entire life of the contract in order for the contract to be treated as life insurance for tax purposes.

The term "life insurance contract" does not include that portion of any contract that is treated under State law as providing any annuity benefits other than as a settlement option. Thus, although a life insurance contract may provide by rider for annuity benefits, the annuity portion of the contract is not part of the life insurance contract for tax purposes and such annuity benefits may not be reflected in computing the guideline premiums. Thus, an insurance arrangement written as a combination of term life insurance with an annuity contract, or with a premium deposit fund, is not a life insurance contract for purposes of the guidelines because all of the elements of the contract are not treated under State law as providing a single integrated death benefit. As a result, only the term portion of any such contract can meet the tests and be treated as life insurance proceeds upon the insured's death. However, any life insurance contract that is treated under State law as a single, integrated life insurance contract and that satisfies these guidelines will be treated for Federal tax purposes as a single contract of life insurance and not as a contract that provides separate life insurance and annuity benefits. For example, for purposes of this definition, a whole life insurance contract that provides for the purchase of paid-up or deferred additions will be treated as a single life insurance contract.

In the case of variable life insurance contracts (as defined in sec. 817), the determination as to whether the contract meets the cash value accumulation test, or the guideline premium requirements, and falls within the cash value corridor shall be made whenever the amount of the death benefits under the contract change, but not less frequently than once during each 12-month period. Further, if a contract is checked to see if it satisfies the requirements once a year, the determination must be made at the same time each year.

Cash value accumulation test

The first alternative test under which a contract may qualify as a life insurance contract is the cash value accumulation test. This test is intended to allow traditional whole life policies, with cash values that accumulate based on reasonable interest rates, to continue to qualify as life insurance contracts. Certain contracts that have been traditionally sold by life insurance companies, such as endowment contracts, will not continue to be classified as life insurance contracts because of their innate investment orientation.

Under this test, the cash surrender value of the contract may not at any time exceed the net single premium which would have to be paid at such time in order to fund the future benefits under the contract assuming the contract matures no earlier than age 95 for the insured. Thus, this test allows a recomputation of the limitation (the net single premium) at any point in time during the contract period based on the current and future benefits guaranteed under the contract at that time. The term future benefits under the bill means death benefits and endowment benefits. The death benefit is the amount that is payable in the event of the death of the insured, without regard to any qualified additional benefits. Cash surrender value is defined in the bill as the cash value of any contract (i.e., any amount to which the policyholder is entitled upon surrender and against which the policyholder can borrow) determined without regard to any surrender charge, policy loan, or a reasonable termination dividend. For these purposes, termination dividends will be considered reasonable based on what has been the historical practice of the industry in paying such dividends. Historically, termination dividends have been modest in amount. For example, the committee understands that New York State prescribes a maximum termination dividend of $35 per $1,000 of face amount of the policy. Just as termination dividends are not reflected in the cash surrender value, any policyholder dividends left on deposit with the company to accumulate interest is not part of the cash surrender value of a contract; interest income on such dividend accumulations is currently taxable to the policyholder because the amounts are not held pursuant to an insurance or annuity contract. Likewise, amounts that are returned to a policyholder of a credit life insurance policy because the policy has been terminated upon full payment of the debt will not be considered part of any cash surrender value because, generally, such amount is not subject to borrowing under the policy.

Whether a contract meets this test of a life insurance contract will be determined on the basis of the terms of the contract. In making the determination that a life insurance contract meets the cash value accumulation test, the net single premium for any time will be computed using a rate of interest that is the greater of an annual effective rate of 4 percent or the rate or rates guaranteed on the issuance of the contract. To be consistent with the definitional test reference to the cash surrender value, the "rate or rates guaranteed on the issuance of the contract" means the interest rate or rates reflected in the contract's nonforfeiture values assuming the use of the method in the Standard Nonforfeiture Law. With respect to variable contracts that do not have a guaranteed rate, the 4-percent rate shall apply. The mortality charges taken into account in computing the net single premium will be those specified in the contract or, if none are specified in the contract, the mortality charges used in determining the statutory reserves for the contract.

The amount of any qualified additional benefits will not be taken into account in determining the net single premium. However, the charge stated in the contract for the qualified additional benefit will be treated as a future benefit, thereby increasing the cash value limitation by the discounted value of such charge. For life insurance contracts, qualified additional benefits are guaranteed insurability, accidental death or disability, family term coverage, disability waiver, and any other benefits prescribed under regulations. In the cas 3 of any other additional benefit which is not a qualified additional benefit and which is not prefunded, neither the benefit nor the charge for such benefit will be taken into account. For example, if a contract provides for business term insurance as an additional benefit, neither the term insurance nor the charge for the insurance will be considered a future benefit.

Guideline premium and cash value corridor test requirements

The second alternative test under which a contract may qualify as a life insurance contract has two requirements; the guideline premium limitation and the cash value corridor. The guideline premium portion of the test distinguishes between contracts under which the policyholder makes traditional levels of investment through premiums and those which involve greater investments by the policyholder. The cash value corridor disqualifies contracts which allow excessive amounts of cash value to build up (i.e., premiums, plus income on which tax has been deferred) relative to the life insurance risk. In combination, these requirements are intended to limit the definition of life insurance to contracts which require only relatively modest investment and permit relatively modest investment returns.

The specifics of these requirements are described below.

Guideline premium limitation.—A life insurance contract will meet the guideline premium limitation if the sum of the premiums paid under the contract does not at any time exceed the greater of the guideline single premium or the sum of the guideline level premiums to such date. The guideline single premium for any contract is the premium at issue required to fund future benefits under the contract. The computation of the guideline single premium must take into account (1) the mortality charges specified in the contract, or used in determining the statutory reserves for the contract if none is specified in the contract, (2) any other charges specified in the contract (either for expenses or for supplemental benefits), and (3) interest at the greater of a 6-percent annual effective rate or the minimum rate or rates guaranteed on the issuance of the contract. The guideline level premium is the level annual amount, payable over a period that does not end before the insured attains age 95, which is necessary to fund future benefits under the contract.[24] The computation is made on the same basis as that for the guideline single premium, except that the statutory interest rate is 4 percent instead of 6 percent.

A premium payment that causes the sum of the premiums paid to exceed the guideline premium limitation will not result in the contract failing the test if the premium payment is necessary to prevent termination of the contract on or before the end of the contract year but only if the contract would terminate without cash value but for such payment. Also, if it is established to the satisfaction of the Secretary that the requirement was not met due to reasonable error and reasonable steps are being taken to remedy the error, the Secretary may waive the first requirement. Premium amounts returned to a policyholder, with interest, within 60 days after the end of a contract year in order to comply with the guideline premium requirement are treated as a reduction of the premiums paid during the year. The interest paid on such return premiums is includible in gross income. This "hold harmless" provision in the event of a timely correction is comparable to similar provisions elsewhere in the Code.

Cash value corridor.—A life insurance contract will fall within the cash value corridor if the death benefit under the contract at any time is equal to at least the applicable percentage of the cash surrender value. Applicable percentages are set forth in a statutory table. Under the table, an insured person, who is 55 years of age at the beginning of a contract year and has a life insurance contract with $10,000 in cash surrender value, must have a death benefit at that time of at least $15,000 (150 percent of $10,000).

As the table shows, the applicable percentage to determine the minimum death benefit starts at 250 percent of the cash surrender value for an insured person up to 40 years of age, and the percentage decreases to 100 percent when the insured person reaches age 95. Starting at age 40, there are 9 age brackets with 5-year intervals (except for one 15-year interval) to which a specific applicable percentage range has been assigned. The applicable percentage will decrease by the same amount for each year in that age bracket. For example, for the 55 to 60 age bracket, the applicable percentage falls from 150 to 130 percent, or 4 percentage points for each annual increase in age. At 57, the applicable percentage will be 142.

[24] To the extent the guideline level premium includes a charge for an additional benefit that is scheduled to cease at a certain age (i.e., there are discrete payment periods for separate policy benefits), the charges for such benefit should be reflected in a level manner over the period such charges are being incurred. This prevents post-funding of the qualified additional benefit.

The statutory table of applicable percentages follows:

The applicable percentage shall decrease by a ratable portion for each full year:

In the case of an insured with an attained age as of the beginning of the contract year of:		**The applicable percentages shall decrease by a ratable protion for each full year:**	
More than:	But not more than:	From:	To:
0	40	250	250
40	45	250	215
45	50	215	185
50	55	185	150
55	60	150	130
60	65	130	120
65	70	120	115
70	75	115	105
75	90	105	105
90	95	105	100

For purposes of applying the cash value corridor and the guideline premium limitation (as well as the computational rules described below), the attained age of the insured means the insured's age determined by reference to contract anniversaries (rather than the individual's actual birthdays), so long as the age assumed under the contract is within 12 months of the actual age.

Computation of benefits

The bill provides three general rules or assumptions to be applied in computing the limitations set forth in the definitional tests. These rules only restrict the actual provisions and benefits that can be offered in a life insurance contract to the extent that they restrict the allowable cash surrender value (under both tests) or the allowable funding pattern (under the guideline premium limitation).

First, in computing the benefits under any contract, the death benefit shall be deemed not to increase at any time during the life of the contract (qualified additional benefits will be treated in the same way). Thus, a contract cannot assume a death benefit that decreases in earlier years and increases in later years in order avoid the guideline premium limitation. Second, the maturity date (including the date on which any endowment benefit is payable) shall be deemed to be no earlier than the day on which the insured attains age 95 and no later than the day on which the insured attains age 100. Thus, the deemed maturity date generally is the termination date set forth in the contract or the end of the mortality table. This rule will generally prevent contracts endowing before age 95 from qualifying as life insurance. The amount of any endowment benefit, or the sum of any endowment benefits, shall be deemed not to exceed the least amount payable as a death benefit at any time under the contract. For these purposes, the term endowment benefits includes the cash surrender value at the maturity date.

Notwithstanding the first computational rule, an increase in the death benefit that is provided in the contract, and which is limited to the amount necessary to prevent a decrease in the excess of the death benefit over the cash surrender value, may be taken into account for purposes of meeting the two definitional tests provided under the bill. Specifically, for a contract qualifying under the guideline premium requirement, this type of increasing death benefit can be taken into account in computing the guideline level premium. Thus, in such a case, the premium limitation will be the greater of the guideline single premium computed by assuming a nonincreasing death benefit or the sum of the guideline level premiums computed by assuming an increasing death benefit. In the case of a contract qualifying under the cash accumulation test, the above described increasing death benefit can be taken into account if the cash surrender value of the contract cannot exceed at any time the net level reserve. For this purpose, the net level reserve will be determined as though level annual premiums will be paid for the contract until the insured attains age 95, and the net level reserve is substituted for the net single premium limitation in the cash accumulation test. These modifications to the computational rules would allow the sale of contracts where the death benefit is defined as the cash surrender value plus a fixed amount of pure life insurance protection.

Adjustments

The bill provides that proper adjustments be made for any change in the future benefits or any qualified additional benefit (or in any other terms) under the contract, which was not reflected in any previous determination made under the definitional section. Changes in the future benefits or terms of a contract can occur at the behest of the company or the policyholder, or by the passage of time. However, proper adjustments may be different for a particular change, depending on which alternative test is being used or on whether the changes result in an increase or decrease of future benefits. In the event of an increase in current or future benefits, the limitations under the cash accumulation test must be computed treating the date of change, in effect, as a new date of issue for determining whether the changed contract continues to qualify as life insurance under the definition prescribed in the bill. Thus, if a future benefit is increased because of a scheduled change in death benefit or because of the purchase of a paid-up addition (or its equivalent), such a change will require an adjustment and new computation of the net single premium definitional limitation. Under the guideline premium limitation, an adjustment will be required under similar circumstances, but the date of change for increased benefits should be treated as a new date only with respect to the changed portion of the contract. Likewise, no adjustment shall be made if the change occurs automatically due, for example, to the growth of the cash surrender value (whether by the crediting of excess interest or the payment of guideline premiums) or due to changes initiated by the company. If the contract fails to meet the recomputed limitations, a distribution of cash to the policyholder may be required. Under the bill, the Secretary of the Treasury has authority to prescribe regulations governing how such adjustments and computations should be made. Such regulations may revise, prospectively, some of the adjustment rules described above in order to give full effect to the intent of the definitional limitations.

Further, for purposes of the adjustment rules, any change in the terms of a contract that reduces the future benefits under the contract will be treated as an exchange of contracts (under sec. 1035). Thus, any distribution required under the adjustment rules will be treated as taxable to the policyholder under the generally applicable rules of section 1031. This provision is intended to apply specifically to situations in which a policyholder changes from a future benefits pattern taken into account under the computational provision for policies with increases in death benefits to a future benefit of a level amount (even if at the time of change the amount of death benefit is not reduced). If the adjustment provision results in a distribution to the policyholder in order to meet the adjusted guidelines, the distribution will be taxable to the policyholder as ordinary income to the extent there is income in the contract. The provision that certain changes in future benefits be treated as exchanges is not intended to alter the application of the transition rules for life insurance contracts (explained below).

Endowment contracts treated as life insurance contracts

Endowment contracts which meet the requirements of the definition of a life insurance contract will receive the same treatment as a life insurance contract.

Contracts not meeting the life insurance definition

If a contract that is life insurance under the applicable State or foreign law does not meet either of the alternative tests under the definition of a life insurance contract, the contract after disqualification will be treated as providing a combination of a term life insurance policy and an annuity as of the date of disqualification. Subsequent to a contract's disqualification as life insurance under the definition, the term protection at any time will be the excess of the amount of the contractual death benefit over the net surrender value of the contract. The net surrender value of the contract will be treated as an accumulation fund under an annuity contract and the investment in the annuity contract will be equal to the lesser of the net surrender value or the investment in the contract at the time of disqualification.

Thus, to the extent annual premiums paid for the contract after disqualification do not cover the cost of the term protection and that cost is charged to the net surrender value of the contract, the charge will be treated as a distribution from an annuity under section 72(e) (that is, as a distribution of income to the policyholder to the extent there is income in the contract).[25] The cost of life insurance protection provided under any contract will be the lesser of

[25] However, because the treatment of the contract as a term policy and an annuity is not retroactive before the date of disqualification of the contract, any charges to the net surrender value of the contract for the cost of insurance protection prior to disqualification will not retroactively be considered distributions from an annuity contract.

the cost of individual insurance on the life of the insured as determined on the basis of uniform premiums, computed using 5-year age brackets, as prescribed by the Secretary by regulations, or the mortality charge stated in the contract.

Upon the death of the insured, the excess of the amount of death benefit paid over the net surrender value of the contract will be treated as paid under a life insurance contract for purposes of the exclusion from income with respect to the beneficiary. The amount of the net surrender value will be treated as an amount paid at death under an annuity contract.

In addition, if a contract that is life insurance under the applicable State or foreign law fails to meet or becomes disqualified under the statutory definition, the company will be liable for an excise tax equal to 10 percent of the net surrender value of the contract as of the date of failure or disqualification. Also, the company will be required to notify the policyholder of the disqualification within 30 days of the occurrence and, if the company does not do so, it will be subject to the usual nonreporting penalty. The bill provides that the excise tax cannot be charged to the policyholder, either directly or through a reduction of the net surrender value or other contractual benefits. The imposition of the excise tax and reporting requirements in this manner is intended to make the issuer of the life insurance policy as well as the policyholder bear the responsibility for meeting the statutory definition or some economic burden for the failure to do so.

Effective Date

General effective date

Generally, the new definition of life insurance applies to contracts issued after December 31, 1984, for plans of insurance in existence on March 15, 1984. However, the general effective date will not apply to any increasing death benefit policies with premium funding that is more rapid than 10-year level premium payments; for such contracts, the new definition will be effective for contracts issued after December 31, 1983. Also, the TEFRA provisions for flexible premium contracts (that is, sec. 101(f)) will be extended through 1984.

Contracts issued in exchange for existing contracts after December 31, 1984 are to be considered new contracts issued after that date. For these purposes a change in an existing contract will not be considered to result in an exchange, if the terms of the resulting contract (that is, the amount or pattern of death benefit, the premium pattern, the rate or rates guaranteed on issuance of the contract, or mortality and expense charges) are the same as the terms of the contract prior to the change. Thus, a change in minor administrative provisions or a loan rate generally will not be considered to result in an exchange.

Contracts issued pursuant to existing plans of insurance.—Under a transition rule, certain qualified contracts under existing plans of insurance will qualify as life insurance contracts under the cash value accumulation test, discussed above, if the contracts would meet the test using 3-percent, instead of 4-percent, as the minimum interest rate. A "qualified contract" will mean any contract that requires at least 20 nondecreasing annual premium payments and is issued pursuant to an existing plan of insurance. An existing plan of insurance is any plan of insurance or policy blank that has been filed by the issuing company in one or more States before September 28, 1983. It is intended that the 20-pay requirement will not be violated by a plan of insurance that provides for the purchase of insurance by means of paid-up additions, if the additional amounts are modest and reasonable compared with the basic benefit under the contract.

b. Treatment of certain annuity contracts (sec. 72)

Present Law

Cash withdrawals prior to the annuity starting date are includible in gross income to the extent that the cash value of the contract (determined immediately before the amount is received and without regard to any surrender charge) exceeds the investment in the contract. A penalty tax of 5 percent is imposed on the amount of any such distribution that is includible in income, to the extent that the amount is allocable to an investment made within 10 years of the distribution. The penalty is not imposed if the distribution is made after the contractholder attains age 59½, when the contractholder becomes disabled, upon the death of the contractholder or as a payment under an annuity for life or at least 5 years. No income is recognized to the recipient of an annuity on the death of the contractholder. However, since the recipient has the same investment in the contract as the deceased contractholder, the recipient is subject to income tax on the income accumulated in the contract prioı to death when it is distributed from the contract.

Explanation of Provision

Penalty on premature distributions

The bill generally retains the present-law provisions for annuity contracts. However, the 5-percent penalty on premature distributions will apply to any amount distributed to the taxpayer, without regard to whether the distribution is allocable to an investment made within 10 years, unless the taxpayer owner has attained age 59½. This is consistent with a general objective of the bill to encourage the use of annuities as retirement savings as opposed to short-term savings.

Distribution in event of annuity holder's death

If the owner of any annuity contract dies before the annuity starting date, the specific distribution rules would apply, depending on decedent's beneficiary with respect to the contract. For these purposes, the "beneficiary" is the person who becomes the new owner of the annuity contract. First, if there is a nonspousal beneficiary, the income in the annuity contract generally will have to be distributed within 5 years after the death of the owner. Second, if the decedent's spouse is the beneficiary, the annuity contract may be continued (together with deferral of tax on the accrued and future income under the contract) until distribution to or the death of the spouse. Thus, a spousal beneficiary steps into the shoes of the decedent owner. Third, if the beneficiary is a minor child, the contract can be continued until the child reaches age 21, after which distribution of the income must be made within 5 years. Fourth, if the beneficiary is a handicapped individual, the contract can be continued until that individual reaches age 21, and then distribution must occur within 5 years, or an annuity for the beneficiary must be commenced covering any period (including the life of the handicapped individual). If, for example, a husband's interest in an annuity contract passes to his wife on his death and to their minor child on her death (both prior to the annuity starting date), the contract can be continued until the child reaches age 26, even if that date is more than 5 years after the wife's death. As with some present-law annuity provisions, to the extent that the terms used refer to individuals (e.g., death, spouse, or age), the provisions are intended to apply only to individual owners of annuity contracts.

This amendment will not apply to amounts received under contracts issued under qualified plans or IRAs. For this purpose, qualified plans are plans that have received employer contributions that were deductible from gross income when made.

Effective Date

These amendments to the annuity rules shall apply to contracts issued after the day which is six months after the date of enactment.

c. Certain exchanges of insurance policies (sec. 1035)

Present Law

Under present law, no gain or loss is recognized on the exchange of (1) a contract of life insurance for another contract of life insurance or for an endowment or annuity contract; (2) a contract of endowment insurance for another contract of endowment with the same or earlier payment date or for an annuity contract; or (3) an annuity contract for an annuity contract.

For purposes of this exchange rule, an endowment contract is defined as a contract with a life insurance company (as defined for tax purposes), which contract depends in part on the life expectancy of the insured, but which may be payable in full in a single payment during his life. A life insurance contract is defined in the same way as an endowment contract, but as being a contract which is not ordinarily payable in full during the life of the insured.

Explanation of Provision

The bill amends the definition of an endowment contract and a life insurance contract to include contracts issued by any insurance company taxable under subchapter L of the Code, rather than just by life insurance companies. This change in present law recognizes that the focus of the exchange rule should be on the character and benefits of the contract rather than the particular tax status of the company issuing the contract.

Effective Date

The amendment will be effective for all exchanges whether before, on, or after the date of enactment.

d. Group-term life insurance purchased for employees (sec. 79)

Present Law

The cost of group term life insurance purchased by an employer for an employee for a taxable year is included in the employee's gross income to the extent that the cost is greater than the sum of the cost for $50,000 of life insurance plus any contribution made by an employee to the cost of the insurance. Among the exceptions to this rule is one that applies to terminated employees who have reached retirement age or are disabled. As a result, an employer may provide group-term life insurance for these two groups of former employees in amounts greater than $50,000 without any portion of the costs being included in their gross income.

If a group-term life insurance plan maintained by an employer discriminates in favor of any key employee, the exclusion for the cost of the first $50,000 of this insurance is not available. In that event the full cost of the group-term life insurance for any key employee is included in the gross income of the employee (based on the uniform cost table).

The cost of an employee's share of group life insurance is determined on the basis of uniform premiums, computed with respect to 5-year age brackets. In the case of an employee who has attained age 64, the cost does not exceed the cost for a 63-year old individual.

Explanation of Provision

The bill effects three changes in the present-law treatment of group-term life insurance. First, the $50,000 limitation on the amount of group-term life insurance that may be provided tax-free to employees also will apply to retired as well as active employees.[26] The amendments do not alter the cost tables under present law, however, so a retired employee's benefit will be computed at the age 63 cost.

Second, the nondiscrimination rules will be applied to plans covering retired employees. Thus, the cost of group-term coverage that is provided to retiring key employees will not be subject to any exclusion from gross income if the plan is found to be discriminatory. For purposes of determining whether a plan is discriminatory, insurance coverage for retired employees would be tested separately from insurance for active employees. The committee believes that this separate treatment of retired and active employees is appropriate because employers often provide lower group-term benefits to retirees. This reduction in benefits under a plan generally reflects a retired employee's reduced need for insurance coverage to replace his or her earning potential. Third, under the bill, if a plan fails to qualify for the exclusion because it is discriminatory, then

[26] The bill would not apply the limitation to those who have terminated employment because of a disability.

the employees and retirees will have to include in income the actual cost of their insurance benefit rather than the table cost prescribed by the Treasury.

Unless a plan is discriminatory, under the bill's provisions, a retired employee's benefit will be computed on the basis of the uniform cost tables. At age 65 the cost is presently $1.17 per thousand of excess insurance. Thus, a retiree age 65 who receives $100,000 of group-term coverage would recognize $702 of income which would have a maximum tax effect of $351. By contrast, the rate schedules of one major company set the premium for $100,000 of individual term coverage for a 65-year old male in excess of $3,000 per year.

Finally, the bill provides a specific exception to the application of section 83 so that the cost of the group-term life insurance coverage will be included in the income of a retired employee for the year in which the coverage is received, whether or not the benefit of retirement coverage vests upon retirement.

Effective Date

In general, the amendments made by this section shall apply to taxable years that begin after December 31, 1983.

The amendments made by this section do not apply to any group-term life insurance plan in existence on January 1, 1984 or to any group-term life insurance plan of the employer (or successor employer) which is a comparable successor to an existing plan, with respect to an individual who retires under the plan and who attained age 55 on or before January 1, 1984. Generally, the term employer may be interpreted broadly to allow employee transfers between comparable plans offered by an affiliated group. Also, for these purposes a successor employer refers to a situation in which an employer assumes the group-term insurance obligations of another employer because of a business merger or acquisition, but does not refer to a new employer when an individual covered by a plan changes jobs and becomes covered by the new employer's group-term insurance plan.

The provision for nonapplication of the new provisions will not itself apply to any plan which is discriminatory after March 15, 1987, with respect to any individual retiring after that date. For purposes of whether a plan meets the nondiscrimination requirements, coverage provided to employees who retired on or before March 15, 1987, will not be taken into account.

4. Studies (sec. 231 of the bill)

Two issues that were of concern to the committee during the entire process of reformulating the tax structure applicable to life insurance companies were (a) the amount of Federal income tax paid by the companies in the life insurance industry and (b) the relative income tax burden borne by mutual and stock companies. The committee decided that it would be necessary to maintain close scrutiny of these two matters, and instructed that analytical reports be prepared on these two subjects.

Revenue reports

Each year on July 1, beginning in 1984, the Secretary of the Treasury is instructed to submit a report on the revenues received under the provisions of part 1, subchapter L for the most recent taxable year. The report is to be submitted to the Committee on Ways and Means and the Committee on Finance. Each report will present the aggregate amount of revenue received for the most recent taxable year for which data are available. The revenues are to be compared with the revenue estimates anticipated as a result of the changes made by TEFRA in 1982 and this bill. The reasons for any difference between the actual aggregate revenues and the revenues anticipated when the Acts were adopted are to be presented and analyzed.

Report on segment balance and other issues

The impact of new part 1, subchapter L on the different segments and products of the life insurance industry needs to be examined. The Secretary of the Treasury is instructed to conduct a full and complete study of the effects of the provisions in this bill to examine the operation of the new tax provisions during 1984, 1985 and 1986.

The report shall include an analysis of the relative shares of life insurance company taxes paid by mutual and stock life insurance companies. The report also will consider any other data considered to be relevant by either stock or mutual life insurance companies in determining appropriate segment balance. Among the relevant variables for consideration are the amounts of the following items held by each segment of the industry: equity; life insurance reserves; other types of reserves; dividends paid to policyholders and shareholders; pension business; total assets, and gross receipts.

The study also is to include an analysis of life insurance products and their taxation. In addition, an analysis of whether the tax provisions in part I of subchapter L operate as a disincentive to growing companies will be included. The committee also instructed the Secretary to include in the report an analysis of the extent that taxes paid by stockholders of life insurance companies affect proper evaluation of segment balance.

In order to be able to conduct the study with as complete a fund of information that is possible, the Secretary of the Treasury is given authority to require reporting of data necessary for the study by life insurance companies with respect to the companies and their products.

The final report is to be submitted by January 1, 1989, to the Committee on Ways and Means and the Committee on Finance. Interim reports are to be submitted to the committees not later than July 1, 1986, 1987, and 1988.

5. Revenue Estimates Relating to Life Insurance Provisions

These provisions will decrease fiscal year budget receipts by $120 million in 1984, $353 million in 1985, $397 million in 1986, $476 million in 1987, $529 million in 1988, and $603 million in 1989.

TITLE III—REVISION OF PRIVATE FOUNDATION PROVISIONS

A. Limitations on Deduction for Contributions to Private Foundations (Sec. 302 of the bill and Code sec. 170)

Present Law

Percentage limitations

Under present law (Code sec. 170), contributions of cash and ordinary-income property by an individual to public charities or private operating foundations are deductible up to 50 percent of the donor's adjusted gross income. (The 50-percent limitation applies to such contributions made to a private nonoperating foundation only if the donee either redistributes all contributions within a specified period after receipt or qualifies as a "pooled fund" foundation.) For contributions of certain capital-gain property to organizations otherwise qualifying for the 50-percent limitation, the limitation generally is 30 percent. In the case of contributions to private nonoperating foundations (other than the two categories eligible for the 50-percent/30-percent limitations), present law retains the lower percentage (20 percent) that has generally been applicable to private foundations since the 1954 Code (sec. 170(b)(1)(B)).

Contributions by individuals which exceed the 50-percent/30-percent limitations may be carried forward and deducted over the following five years, subject to applicable percentage limitations in those years (sec. 170(d)). Under present law, there is no carryover of excess deduction amounts if the 20-percent limitation applies.

Contributions of appreciated property

Under present law, in the case of donations by individuals of capital-gain property to private nonoperating foundations as to which the 20-percent limitation applies, the amount deductible equals the asset's fair market value reduced by 40 percent of the unrealized appreciation (i.e., by 40 percent of the amount by which the value exceeds the donor's basis in the property). In the case of donations by individuals of certain capital-gain property to public charities, etc., where the 30-percent limitation applies, there is no reduction from fair market value.

Reasons for Change

The committee believes that grantmaking foundations play an important and substantial role in private philanthropy, and that the same tax incentives should apply for donations to grantmaking foundations as for donations to operating foundations or public charities.

Explanation of Provisions

Under the bill, the income tax treatment of contributions by individuals to private nonoperating foundations will be the same as that of contributions by individuals to private operating foundations or public charities.

Effective Date

The amendments made by section 302 of the bill apply to contributions made after December 31, 1984.[1]

[1] Accordingly, if a contribution made in 1984 to a private nonoperating foundation exceeds the present-law 20 percent deduction limitation, the excess does not constitute a carryover allowable in 1985 under the new deduction rules added by the bill, since the bill applies only to contributions first made after 1984.

B. Exemption for Certain Operating Foundations from Excise Tax on Investment Income and Expenditure Responsibility Rules (Sec. 303 of the bill and Code secs. 4940 and 4945)

Present Law

Under present law, a private foundation is subject to a two-percent excise tax on the sum of its gross investment income (including interest and dividends) plus net capital gain, less the expenses of earning such amounts (Code sec. 4940). No similar tax is imposed on investment income of public charities.

In the case of grants to organizations other than public charities, a private foundation must exercise expenditure responsibility over the grant in order to avoid the excise tax on taxable expenditures (sec. 4945).

Reasons for Change

The committee believes that private operating foundations which exhibit certain characteristics reflecting substantial public involvement should be exempted from the two-percent excise tax on net investment income, and that foundations making grants to such organizations should not be required to comply with the expenditure responsibility rules. These changes will assist such operating foundations in making direct expenditures for the active conduct of their charitable activities. At the same time, these foundations will remain subject to other private foundation rules, such as the prohibitions on self-dealing and taxable expenditures.

Explanation of Provisions

The bill provides that exempt operating foundations are not subject to the two-percent excise tax on investment income (sec. 4940), and that grants from other foundations to exempt operating foundations are not subject to the expenditure responsibility requirements under section 4945.

The bill defines exempt operating foundation to mean, with respect to any taxable year, any private operating foundation[2] (1) which either has been publicly supported (under secs.

[2] In general, a private operating foundation is defined (sec. 4942(j)(3)) as a foundation that expends directly for the active conduct of its exempt activities at least 85 percent of the lesser of (a) its adjusted net income or (b) its minimum investment return (i.e., five percent of the value of its investment assets). Also, the foundation must meet one of three tests relating to its use of assets, operating expenditures, or support.Under the first test, 65 percent or more of the assets of the foundation must be devoted directly to the active conduct of its exempt activities or to functionally related businesses. Under the second test, the organization must normally spend an amount not less than two-thirds of its minimum investment return directly for the active conduct of its exempt activities. Under the third alternative test, the organization must receive at least 85 percent of its support from five or more exempt organizations and from the general public, and not more than 25 percent of the foundation's support may be received from any one exempt organization.

170(b)(1)(A)(vi) or 509(a)(2)) for at least 10 taxable years, or qualified as an operating foundation on January 1, 1983; (2) the governing body of which, at all times during the taxable year, consists of individuals at least 75 percent of whom are not disqualified individuals, and also is broadly representative of the general public; and (3) no officer of the foundation is, at any time during the taxable year, a disqualified individual.

The bill defines disqualified individual as an individual who is (i) a substantial contributor to the foundation; (ii) an owner of more than 20 percent of the total combined voting power of a corporation, the profits interest of a partnership, or the beneficial interest of a trust or unincorporated enterprise, which corporation, partnership, or enterprise is a substantial contributor to the foundation; or (iii) a member of the family of any individual described in (i) or (ii). For this purpose, the term substantial contributor means a person who is described in section 507(d)(2), and the term family has the meaning given to such term by section 4946(d). In determining ownership in a corporation, etc., for purposes of the definition of disqualified individual, the constructive ownership rules of sections 4946(a)(3) and (4) apply.

Effective Date

The exemption from the section 4940 excise tax for certain operating foundations applies to taxable years beginning after December 31, 1984. The exemption from the expenditure responsibility rules applies to grants made after 1984.

C. Abatement of First-Tier Excise Taxes in Certain Cases (Sec. 304 of the bill and Code secs. 4942-4945)

Present Law

First-tier sanctions

Under present law, any violation of the foundation rules (secs. 4941-4945) results in imposition of an initial excise tax on the foundation (or in the case of self-dealing, on the disqualified person who entered into the prohibited transaction with the foundation). For example, a violation of the prohibitions on self-dealing transactions or jeopardizing investments triggers an excise tax equal to five percent of the amount involved in the self-dealing transaction (sec. 4941) or the jeopardizing investment (sec. 4944), payable for each year (or part thereof) in the taxable period. This means that the tax under section 4941 or 4944 continues to be imposed each year beginning when the prohibited act occurs and ending only when the Internal Revenue Service issues a deficiency notice or assesses tax on the act, or when the prohibited act is "corrected."

In general, the first-tier excise tax on the foundation (or on the disqualified person engaged in self-dealing) applies automatically when a foundation rule is violated. However, where a foundation fails to satisfy the section 4942 payout requirements solely as a result of an incorrect asset valuation which was due to reasonable cause, the excise tax under that section is excused if the payout deficiency is made up during a specified period.

If there is a violation of the prohibitions on jeopardizlng investments, taxable expenditures, or self-dealing, an initial excise tax is imposed on any foundation officer, director, trustee, or responsible employee who knowingly participated in the prohibited act, unless the manager had reasonable cause to excuse participation in the act. This first-level tax on the manager cannot exceed $5,000 ($10,000 in the case of self-dealing) for any one such violation.

Second-tier sanctions

If a violation of the foundation rules (secs. 4941-4945) is not "corrected" within a specified period, an additional excise tax is imposed on the foundation (or in the case of self-dealing, on the disqualified person). For example, a second-tier tax equal to 200 percent of the amount involved in a self-dealing transaction would be imposed on the disqualified person unless (1) the prohibited transaction is undone to the extent possible and (2) the foundation is placed in a financial position not worse than it would be had the disqualified person dealt with the foundation under the highest fiduciary standards.

Similarly, an additional excise tax is imposed on a foundation manager who refuses to agree to correct a violation of the prohibitions on self-dealing, jeopardizing investments, or taxable expenditures. The second-tier tax on the manager cannot exceed $10,000 for any one such violation.

Additional penalties

If a foundation rule violation is willful and flagrant,[3] or if there has been a prior violation of any foundation rule, the excise tax sanctions are doubled, unless the violation was due to reasonable cause (sec. 6684). In addition, a termination tax (sec. 507) may be imposed on the foundation if the violation was willful and flagrant or there have been "willful repeated"[4] violations.

Reasons for Change

The committee believes that in those instances where it can be shown that there was reasonable cause for the violation (other than self-dealing) and there was no willful neglect of the rules, the Internal Revenue Service should have discretionary authority to relieve the foundation from the first-tier penalty tax, provided that the foundation corrects the violation. The committee finds no justification for extending such an abatement mechanism to acts of self-dealing, particularly since the penalty tax for such violations is payable by the self-dealer, not by the foundation, and since under current law commercial transactions between disqualified persons and foundations are generally prohibited.

Explanation of Provision

The bill provides discretionary authority to the Internal Revenue Service to abate first-tier chapter 42 private foundation taxes, other than the section 4941(a) tax on self-dealing, if it is established to the satisfaction of the Service that the violation of the foundation rules (1) was due to reasonable cause and not to willful neglect and (2) has been corrected within the appropriate correction period. A violation which was due to ignorance of the law is not to qualify for such abatement.

Effective Date

The amendments made by section 304 of the bill apply to taxable events occurring after December 31, 1984.

[3] An act or failure to act violating a foundation rule is deemed willful and flagrant if it is "voluntarily, consciously, and knowingly" committed in violation of any said rule and if it "appears to a reasonable man to be a gross violation ***" (Treas. Reg. sec. 1.507-1(c)(2)). No motive to avoid the foundation restrictions is necessary to make an act or failure to act willful. However, an act or failure to act is not willful if the foundation (or a manager, if applicable) does not know that it is an act to which the foundation rules apply (Treas. Reg. sec. 1.507-1(c)(5)).

[4] For this purpose, the term willful repeated violations means at least two acts or failures to act both of which are "voluntary, conscious, and intentional" (Treas. Reg. sec. 1.507-1(c)(1)).

D. Reliance on IRS Classifications (Sec. 305 of the bill and new sec. 4946(e) of the Code)

Present Law

Private foundations must exercise expenditure responsibility with respect to grants made to another private foundation (sec. 4945(d)). In addition, distributions to a private nonoperating foundation generally may not be used to satisfy the grantor foundation's minimum distribution requirements (sec. 4942). Therefore, in order to avoid violations of the expenditure responsibility and minimum distribution rules, a private foundation must determine whether a potential donee is a private foundation or public charity.

In many cases, the public charity status of a donee is determined by the percentage of its support that is received from the general public. The Internal Revenue Service issues determination letters to all section 501(c)(3) organizations relating to their status as public charities or private foundations. For new organizations without four years of support history, advance rulings are issued based on a determination of whether the charity can reasonably be expected to meet the public support test during an advance ruling period of either two or five years.

In general, a donor is permitted to rely on a determination by the Internal Revenue Service of a donee's public charity status until publication of notice of a change of status. However, a donor foundation may not rely on the donee organization's classification if the donor foundation is responsible for or aware of a "substantial and material' change in the donee organization's sources of support that results in the organization's loss of classification as a publicly supported organization. In general, the donor foundation will not be considered responsible for or aware of such a change in support (and hence may rely on a published classification) if the grant is made in reliance on a detailed written statement by the grantee organization that the grant will not result in loss of public charity status, and the information in such statement would not give rise to a reasonable doubt as to the effect of the grant (Treas. Reg. sec. 1.509(a)-(3)(c)).

To facilitate reliance on published classifications, the Internal Revenue Service has issued guidelines specifying circumstances under which a donor foundation will not be considered responsible for a "substantial and material" change in support of the donee organization.[5] In addition, the Service has published guidelines speci-

[5] Under these guidelines, a donor organization generally will not be considered responsible for a substantial and material change in support if the aggregate of gifts, grants, and contributions received from the donor organization for a taxable year does not exceed 25 percent of the aggregate support received by the donee organization from all other sources for the four taxable years immediately preceding the year of the grant (Rev. Proc. 81-6, 1981-1 C.B. 620). In such circum-

Continued

fying circumstances under which a grant will be considered "unusual" and hence will not cause the donee organization to lose its status as publicly supported.[6]

Reasons for Change

The committee is concerned that private foundations may hesitate to make grants to new organizations that may have little support from the general public in the first two or three years of their existence, or in similar situations, because it may be difficult under present law for the foundation to obtain assurance that the grant will not cause the organization to fail to qualify for public charity status.

Explanation of Provision

The bill provides that a grant to an organization which the Internal Revenue Service has determined to be a public charity (or private operating foundation) will be treated as a grant to such an organization, even though the donee organization loses such status, if (1) the grant was made prior to the earlier of the date of publication by the Service that the donee organization has lost its qualified status, or the date on which the foundation acquires actual knowledge that the donee organization has been notified by the Service of loss of its qualified status, and (2) the donor foundation was not responsible for (other than by making grants) or aware of the change in the donee's status.

Effective Date

The provision applies to grants made after December 31, 1984.

stances, the donor foundation can rely on the classification of the donee organization as publicly supported without risk that its grant will later be treated as causing the donee organization to lose its public charity status (thereby subjecting the donor foundation to excise tax penalties for failure to exercise expenditure responsibility).

[6] Under these guidelines, a grant generally will be considered unusual where six conditions are met: (1) the grant is not made by a donor foundation which created the donee organization or was a substantial contributor to the donee organization; (2) the grant is not made by a donor organization which is in a position of authority to the donee organization; (3) the grant is made in cash, readily marketable securities, or assets that directly further the exempt purpose of the donee organization; (4) the donee organization has received an advance or final ruling that it is classified as a publicly supported organization; (5) there are no material restrictions imposed on the grant; and (6) if the grant is intended to pay for the operating expenses of the donee organization, the grant is expressly limited to one year's operating expenses (Rev. Proc. 81-7, 1981-1 C.B. 621).

E. Definition of Family Member (Sec. 306(a) of the bill and Code sec. 4946(d))

Present Law

The tax rules applicable to private foundations in effect prohibit certain transactions or holdings involving a disqualified person and a private foundation. Under present law, the term disqualified person includes substantial contributors to a foundation, foundation officers, directors, or trustees, and members of the family of such an individual, plus certain other related entities. The disqualified family members are the individual's spouse, ancestors, and all lineal descendants (and their spouses) (sec. 4946(d)).

Reasons for Change

The committee believes that, weighing the difficulties of keeping track in perpetuity of all lineal descendants of a disqualified person against the need to preserve the integrity of the foundation rules, it is appropriate to include only children and grandchildren (and their spouses) in lineal descendants who are disqualified persons by reason of being members of a disqualified person's family.

Explanation of Provision

The bill provides that lineal descendants of a disqualified person who are considered members of the family of that individual, and as such, disqualified persons, are the individual's children and grandchildren, and the spouses of such descendants.

Effective Date

The amendment made by section 306(a) takes effect on January 1, 1985.

F. Public Disclosure and Accessibility of Information on Foundations to Grant Applicants (Sec. 306(b) of the bill and Code sec. 6104(d))

Present Law

Annual returns

A private foundation must file an annual information return (Form 990-PF) with the Internal Revenue Service and furnish a copy of the return to the Attorney General (or other official) in the relevant State (sec. 6033).

The Form 990-PF includes the following information for the taxable year: gross income and related expenses, disbursements, a balance sheet showing assets, liabilities, and net worth, total contributions and gifts received, the names and addresses of all substantial contributors, the names and addresses of the foundation managers and highly compensated employees, and the compensation and other amounts paid to the foundation managers and highly compensated employees. Also, the return currently requests certain information regarding applications for grants from the foundation (name, address, and telephone number of the person to whom applications should be addressed; any required format, information, and materials; deadlines for submitting applications; and any limitations on the types of awards that the foundation makes, such as by geographical areas, charitable fields, kinds of donee institutions, etc.).

The failure to file a timely exempt organization information return (unless reasonable cause is shown) results in a sanction of $10 per day, up to a maximum of $5,000 as to any one return, imposed on the organization (sec. 6652(d)). Failure to file a return after a reasonable demand by the Internal Revenue Service (unless reasonable cause is shown) results in an additional sanction of $10 per day, up to a maximum of $5,000 as to any one return, imposed on the exempt organization officer or employee who fails to file the information return.

Disclosure requirements

Under present law, all information required to be furnished on the private foundation annual return must be made available to the public by the Internal Revenue Service (sec. 6104).

In addition, a copy of the private foundation annual return must be made available, at the principal office of the foundation, to any citizen who requests to inspect the return within 180 days after a notice of availability has been published (sec. 6104(d)). This notification must be published in a newspaper with general circulation, in the county in which the foundation's principal office is located, not later than the due date for filing the return. The published notice must state the address of the private foundation's principal office and the name of its principal manager.

Finally, the Internal Revenue Service is required to notify the Attorney General (or other official) of the relevant State in the event of (1) denial of tax-exempt status to an organization, (2) the operation of a charitable organization in a manner that fails to meet the requirements for tax-exempt status, or (3) the mailing of a notice of deficiency regarding taxes imposed on private foundations (sec. 6104(c)). In addition, the Service is to make available to such State officials information about the preceding items that are relevant to any determination under State law.

Reasons for Change

The committee believes that the private foundation reporting and disclosure requirements provide valuable information both for public information purposes and for tax administration purposes. Because the General Accounting Office has concluded that the Internal Revenue Service has not fully been attentive to enforcing the annual return requirements relating to information primarily beneficial to the public, the committee believes that the Service should intensify its enforcement activities to ensure availability of this information.

Also, the committee believes that the required newspaper notice should include the foundation's telephone number, as an aid to grant applicants.

While the committee is aware of the various resources presently available to grant applicants, the general public may still experience difficulties in obtaining all information needed about foundation grantmaking. This problem would be alleviated if all private foundations provided the public with information in an accessible and understandable format, for example, through annual reports.

Explanation of Provision

The bill provides that the annual notice of availability of the private foundation annual return, which is required to be published in a newspaper, must contain the telephone number for the foundation's principal office.

Also, the committee directs the Internal Revenue Service to enforce fully the present law rules relating to private foundation annual information returns (Form 990-PF), including the imposition, in appropriate cases, of penalties for failure to file a (complete) return where the return as filed fails to provide all required information. The committee also calls upon the Service to facilitate the flow of appropriate information to those State officials who are entitled to such information, and to coordinate more closely with the States to maximize the benefits to be derived from such information.

Effective Date

The amendment made by section 306(b) of the bill takes effect on January 1, 1985.

G. Amendments to Excess Business Holdings Rules (Secs. 307-311, 314(c) and 314(d) of the bill and Code sec. 4943)

Present Law

General rules

In 1969, the Congress was concerned that managers of foundations which owned large holdings in a business tended to be relatively unconcerned about producing income to be used in charitable activities, that their attention and interest would be devoted to the operation, maintenance, and improvement of the business while neglecting exempt activities, and that businesses owned by exempt organizations may be operated in a way that provides those businesses with a competitive advantage over businesses owned by taxable persons. In general, the Congress concluded that a private foundation should be limited in the amount of a business which it may control.

The Tax Reform Act of 1969, in effect, generally limited the combined ownership of a business corporation by a private foundation and disqualified persons (for this purpose, including certain related foundations) to not more than 20 percent of the voting stock.[7] (For example, if the disqualified person's holdings are five percent, the foundation itself may hold only 15 percent.) If persons other than disqualified persons have effective control of the corporation, the combined foundation/disqualified person holdings are limited to 35 percent. A private foundation may not conduct any business as a proprietorship.

Under a de minimis rule, there are no excess business holdings if a private foundation (together with related foundations) owns not more than two percent of the voting stock and not more than two percent of the value of all classes of stock, regardless of the extent of ownership by disqualified persons. Also, there are no percentage limitations on foundation ownership of a business which is functionally related to the foundation's charitable programs, or of a business deriving 95 percent of its gross income from certain passive sources.

Holdings in excess of permitted limits which are acquired after May 26, 1969 other than by purchase (e.g., by gift or bequest) must be disposed of by the foundation within five years after acquisition (sec. 4943(c)(6)). Post-May 26, 1969 purchases of stock by a founda-

[7] If all disqualified persons together do not own more than 20 percent of the voting stock of a corporation, there is no limit on the nonvoting stock which may be held by the private foundation. To determine permitted holdings in a partnership, the foundation's "profits interest" is aggregated with the profits interests of all disqualified persons and substituted for the voting stock limitation applicable to corporations, and "capital interest" is used in place of nonvoting stock. In computing the holdings of any business enterprise, stock or other interests owned, directly or indirectly, by a corporation, partnership, estate, or trust are considered as owned proportionately by the beneficial owners.

tion or a disqualified person which create or increase aggregate holdings beyond permitted limits do not qualify for the five-year grace period, and may immediately result in excise tax penalties on the foundation (subject to a 90-day grace period for a foundation to reduce its holdings as required after purchases by a disqualified person).

Grandfathered holdings

The 1969 Act provided special rules applicable where the business holdings of a private foundation (combined with disqualified persons) exceeded the 20-percent/35-percent limitation on May 26, 1969. These special rules also apply to holdings acquired under trusts irrevocable on that date, or certain wills executed by that date, even though the actual transfer to the foundation occurs later. In general, grandfathered holdings are permitted to be retained, but are subject to gradual reduction over several phases.

Under the first phase, by the deadlines shown below the combined foundation/disqualified person holdings cannot exceed 50 percent of the voting stock of the corporation or, if less, 50 percent of the value of all outstanding shares—

Ownership on 5/26/69:	Deadline to reach 50% combined holdings:
More than 95% by foundation alone	May 26, 1989.
More than 75% combined holdings	May 26, 1984.
More than 50% combined holdings	May 26, 1979.

After expiration of the first phase, a second set of divestiture requirements becomes operational—

(1) If disqualified persons do not own more than two percent of the corporate voting stock at any time during the second phase (the 15 years after the close of the first phase), the combined foundation/disqualified person holdings must be reduced to not more than 35 percent by the end of that period (i.e., for a foundation which itself owned 95 percent of the stock on May 26, 1969, by May 26, 2004); and if at any time after the end of the second phase the holdings of disqualified persons exceed two percent, then the foundation itself cannot hold more than 25 percent of the voting stock.

(2) If the holdings of disqualified persons exceed two percent at any time during the second phase, then at all times thereafter the combined foundation/disqualified person holdings are limited to 50 percent, with no more than 25 percent of the voting stock being held by the foundation.

Grandfathered holdings are subject to reduction by operation of the "downward ratchet" rule. The rule, in effect, provides that if there is any reduction in the holdings of a private foundation or in combined private foundation/disqualified person holdings, then these holdings can never go up again to the former grandfathered or otherwise permitted level over 20 percent (35 percent, if applicable).

Reasons for Change

Although the committee believes that in general, the principles underlying the excess business holdings rules enacted in 1969 continue to be valid today, the committee has concluded that certain modifications to those rules are desirable.

The committee believes that the rules which require divestiture within five years of excess business holdings acquired by a private foundation after 1969 other than by purchase may not provide sufficient time to dispose of holdings which are exceptionally large or complex. Accordingly, the bill provides the Internal Revenue Service with discretionary authority to extend the normal five-year divestiture period for an additional five years in appropriate cases, involving an unusually large gift or bequest of diverse or complex business holdings.

Also, the committee believes that the operation of the "downward ratchet" rule is too harsh in certain situations. For example, since the enactment of the 1969 Act, it is now possible for a business enterprise to adopt an employee stock ownership plan (ESOP) to which the stock of the enterprise is contributed for the benefit of its employees. Often this stock is later redeemed from the ESOP as those employees terminate their employment. Under the downward ratchet rule, the private foundation's relative holdings decrease when the stock is transferred to the plan; as a result, when the stock is redeemed from the plan, the private foundation is forced to sell some of its otherwise permitted holdings to reduce its relative holdings to the new lower limit. The committee believes that the downward ratchet rule should not apply where the reductions in the relative holdings of the private foundation result from new issuances of stock so long as the reduction is relatively minor. Accordingly, the bill provides an exception to the downward ratchet rule where the reduction of the relative holdings of the private foundation are reduced by less than two percent by reason of changes in the number of outstanding shares.

In addition, the committee believes that certain modifications to the rules governing pre-1969 holdings are appropriate.

First, under the 1969 Act divestiture rules for grandfathered holdings, the 10-year and 15-year periods for the first phase are determined by reference to the combined holdings of the private foundation and disqualified persons, while the 20-year period is determined by reference only to the holdings of the private foundation. The committee does not find any reason for this different basis for measuring the length of the first phase. Accordingly, the bill provides that the 20-year period also is to be determined by reference to the combined holdings of the private foundation and disqualified persons.

Second, during the second and third phases of the divestiture rules for pre-1969 holdings, private foundations have a lower limit (i.e., 25 percent of voting stock) for direct holdings if disqualified persons own more than two percent of the business enterprise. Where disqualified persons first acquire more than two percent during those phases, the present statute does not permit any time for the private foundation to reduce its holdings to the lower limit and avoid excise taxes. Accordingly, the bill provides that in such circumstances, the private foundation has five years to reduce its holdings to the lower limit.

Third, the committee believes that foundations should be allowed to retain business holdings acquired prior to May 26, 1969, if certain conditions are met. The committee believes that the divestiture requirements should be waived, only for such grandfathered holdings, provided that (1) the management of the foundation and the management of the business enterprise are sufficiently unrelated, (2) there is sufficient independence between the foundation and its substantial contributors, (3) no disqualified person receives compensation (other than reasonable directors' fees) from both the foundation and the business enterprise, (4) the foundation continues to meet the payout rules of present law, and (5) the foundation complies with the section 4943 rules if either the foundation or any disqualified person acquires additional interests in the business enterprise. Where all of the conditions set forth in the bill are met, the committee believes that it is appropriate to allow the continuation of business holding arrangements which were established prior to the 1969 Act.

Fourth, the bill makes a technical correction to the 1969 Act to allow the Herndon Foundation to continue to hold a majority interest in certain business holdings.

Fifth, the committee believes that a qualified employee stock ownership plan should be excepted from the definition of a disqualified person, only for purposes of section 4943, with respect to business holdings of a foundation acquired under a pre-1969 will.

Explanation of Provisions

Disposition of certain post-1969 gifts or bequests

The bill gives the Internal Revenue Service discretionary authority to grant an extension of an additional five years to dispose of certain business holdings acquired by a private foundation after 1969 by gift or bequest. This provision applies only in the case of an unusually large gift or bequest of either diverse business holdings or holdings with complex corporate structures.

The extension will be available only if (1) prior to the close of the initial five-year period, the private foundation submits a plan to the Service for disposition of the business holdings, and (2) the Service determines that such plan can reasonably be expected to be carried out before the end of the extension period.[8] (Under a transitional rule, any plan for disposition submitted to the Service on or before the 60th day after the date of enactment of the bill is treated as if submitted before the close of the initial five-year period.) Before the Service can grant the extension, the foundation must establish (1) that disposition within the initial five-year period was not possible (except at a price substantially below fair market value[9]) because of the large fair market value of the hold-

[8] The plan must also be submitted to the Attorney General of the relevant State for his or her consideration, and any comments which the Attorney General may make as to the plan must be submitted to the IRS.

[9] For purposes of this provision in sec. 307 of the bill, a price which is at least five percent below fair market value is to be considered a price which is substantially below fair market value.

ings, the complex structure or diversity of the underlying business enterprise, or a law or court order which effectively prevented timely disposition, and (2) that the foundation has made diligent efforts to dispose of those business holdings within the initial five-year period.

This provision of the bill applies to business holdings as to which the initial five-year period (sec. 4943(c)(6)) ends on or after November 1, 1983.

Exception to downward ratchet rule

The bill provides an exception to the downward ratchet rule under which decreases in the percentage holdings of a private foundation are disregarded if (1) the decreases are due solely to the issuance of stock (or to issuance of stock coupled with subsequent redemptions of stock) of the business enterprise, (2) the net percentage decrease does not exceed two percent, and (3) the number of shares held by the private foundation is not affected by the issuance of stock or any redemption of stock which was coupled to the issuance of stock.[10]

If the exception applies, the limits on the maximum permitted holdings of the private foundation and on the maximum permitted combined foundation/disqualified person holdings will not be reduced by the amount of the net decrease. If the net percentage decrease exceeds two percent, the exception does not apply and, as under present law, the limit on the maximum holdings of the private foundation is permanently reduced by the amount of the decrease.

This amendment is effective for decreases and subsequent increases occurring after the date of enactment.

Eligibility for 20-year first phase

The bill modifies the divestiture rules of present law to provide that the 20-year first phase period to reduce pre-1969 excess business holdings applies if the combined holdings of the private foundation and disqualified persons exceeded 95 percent on May 26, 1969. This amendment is effective as if included in the Tax Reform Act of 1969.

Modification of second and third phases

The bill provides that if a private foundation's maximum business holdings must be reduced to 25 percent of the voting stock by reason of the acquisition by disqualified persons of more than two percent of the business enterprise during either the second or third phase of the divestiture rules, the private foundation is given five years to dispose of the excess over 25 percent. This five-year period cannot be extended pursuant to the provision of the bill (sec. 308) relating to the divestiture period for certain post-1969 gifts or bequests. This amendment applies to acquisitions made after the date of enactment.

[10] For purposes of this provision in section 308 of the bill, an increase in the number of shares held by the foundation which results solely from a stock split applicable to all holders of the same class of stock is to be disregarded.

Exemptions for certain grandfathered holdings

The bill provides that the section 4943 divestiture requirements will be modified for grandfathered excess business holdings (i.e., where held by the foundation on May 26, 1969, or treated as so held by reason of sec. 4943(c)(5)), if all of the following conditions are met on and after the otherwise applicable divestiture date:

(1) Disqualified persons (other than persons who are disqualified persons solely as foundation managers) and officers, directors, or employees of any business enterprise in which such foundation has such excess business holdings do not together constitute more than 25 percent of the governing board of such foundation;

(2) Directors, trustees, or officers of the foundation do not together constitute more than 25 percent of the governing board of any such business enterprise;

(3) No disqualified person (other than a person having such status solely as a foundation manager) is a director, trustee, or officer of the foundation (or has powers or responsibilities similar to those of a director, trustee, or officer) unless the disqualified person had such director, etc. status on March 12, 1984;

(4) No disqualified person receives compensation (or payment or reimbursement of expenses) from both the foundation and any such busines enterprise, other than director fees (and the payment or reimbursement of expenses incident thereto) which are not excessive;

(5) The foundation does not incur liability for any taxes for failure to comply with the section 4942 payout requirements;

(6) The foundation does not incur liability for any taxes imposed under Code section 4943 with respect to holdings in any business enterprise in which the foundation has holdings subject to the excess business holdings rule as modified by this special rule.

The modification to the excess business holdings divestiture requirements of section 4943 made by section 311 of the bill generally allows foundations that meet the above requirements to maintain the level of the excess business holdings held on May 26, 1969, but applies the normal divestiture rules if the foundation or disqualified persons acquire additional holdings.

Technical correction in description of Herndon Foundation

The bill makes a technical correction to clarify that the Herndon Foundation is permitted to continue to hold a majority of the stock of certain business enterprises. This amendment applies as if included in section 101(*l*)(4) of the Tax Reform Act of 1969.

Special rule concerning qualified plan

The bill excepts a plan described in Code section 4975(e)(7) from the definition of a disqualified person, only for purposes of the section 4943 rules, with respect to excess business holdings of a foundation acquired pursuant to the provisions of a pre-May 26, 1969 will. This amendment applies to taxable years beginning after the date of enactment.

H. Exception to Self-Dealing Rules for Certain Stock Transactions (Sec. 312 of the bill and Code sec. 4941)

Present Law

The Tax Reform Act of 1969 in effect prohibited certain transactions between a private foundation and disqualified persons (including substantial contributors), and imposed excise taxes for violations of these rules. The transactions prohibited as "self-dealing" generally include (1) the sale, exchange, or leasing of property between a private foundation and a disqualified person and (2) the lending of money or other extension of credit between a private foundation and a disqualified person (sec. 4941).

Reasons for Change

Under present law, once a contributor to a foundation is treated as a substantial contributor, that person retains status as a disqualified person forever, regardless of the relative value of the person's contributions (sec. 507(d)). As indicated in the description below of section 314 of the bill, the committee believes that this rule should be changed so that the disqualified person status of a person whose relative contributions have become insignificant will terminate in appropriate cases.

In general, the committee believes that this change should apply prospectively. However, it has come to the attention of the committee that the rule that substantial contributors retain their status as disqualified persons forever has resulted in the application of the self-dealing rules in a case involving the sale of publicly traded stock of Murphy Motor Freight Lines, Inc. (the "Company") by the Wasie Foundation to the Company. In that case, the Company was treated as a disqualified person because of contributions of less than $10,000 early in the life of the Wasie Foundation. As a result, the sale of stock by the Wasie Foundation to the Company pursuant to the settlement of a court case involving the control of the Company was treated as an act of self-dealing. The committee believes that this transaction should not be subject to section 4941 taxes so long as the total consideration paid to the Wasie Foundation (i.e., the amount of any cash and the fair market value of any notes received for the stock by the Wasie Foundation in connection with such purchase) was equal to or exceeded the value of the stock at the time of the sale.

Explanation of Provision

The bill provides that Code section 4941 is not to apply to the purchase during 1978 of stock from a private foundation (and to any note issued in connection with such purchase) if (1) consideration for the purchase equaled or exceeded the fair market value of the stock; (2) the purchaser of the stock did not make any contribution to the foundation at any time during the five-year period ending on the date of the purchase; (3) the aggregate contributions to the foundation by the purchaser before such date were less than $10,000 and less than two percent of the total contributions received by the foundation as of that date; and (4) the purchase was pursuant to the settlement of litigation involving the purchaser. That is, under the bill Code section 4941 is not to apply in the case of the 1978 sale of stock of Murphy Motor Freight Lines, Inc. by the Wasie Foundation to Murphy Motor Freight Lines, Inc. and the related financing by the Wasie Foundation if the total consideration received (i.e., the sum of the cash and the value of the notes) equaled or exceeded the fair market value of the stock to Wasie Foundation.

Effective Date

The provision applies retroactively for 1978 and subsequent years. In addition, section 313 of the bill provides for a refund or credit of any section 4941 taxes previously paid if claim for refund or credit is filed within one year from the date of enactment.

I. Termination of Status as Substantial Contributor (Sec. 313 of the bill and Code sec. 507(d))

Present Law

Under present law, status as a disqualified person is relevant for several private foundation provisions, including the prohibitions on self-dealing between a disqualified person and the foundation and on excess business holdings. The term disqualified person generally includes substantial contributors, foundation officers, directors, or trustees, and members of the family of such an individual, plus certain other related entities (sec. 4946).

The term substantial contributor means a person whose contributions to the foundation exceeded two percent of all contributions received by the foundation before the close of the year in which the contribution is made, but only if the person's contributions exceed $5,000 (sec. 507(d)(2)). Once a person becomes a substantial contributor, that person retains that status forever.

Reasons for Change

The committee believes that the rule under which persons retain their status as substantial contributors forever is unnecessarily restrictive and may lead to unintended harsh consequences in certain circumstances. The committee believes that an individual may sufficiently terminate connection with and control over a private foundation, so that he or she no longer should be treated as a disqualified person, if there has been a sufficiently long time since that person had made any contribution to or had any relationship with the foundation, and if there have been much larger contributions from another person to the foundation. This often may be the case where a person makes relatively small contributions near the date of creation of the foundation and an unrelated person makes a substantially larger contribution later.

Explanation of Provision

The bill provides that a person will not continue to be treated as a substantial contributor as of the close of a taxable year of a foundation if three requirements are met.[11]

First, neither the person nor any related person[12] made a contribution to the foundation at any time within the 10-year period

[11] Where a person loses substantial contributor status pursuant to this provision of the bill, family members of such person then cease to be disqualified persons by virtue of their relationship to such person.

[12] For purposes of this provision, the term related person means any other person who would be a disqualified person (within the meaning of sec. 4946) by reason of his or her relationship to the substantial contributor. In the case of a contributor which is a corporation, the term also includes any officer or director of the corporation.

ending at the close of the taxable year. Second, at no time during the 10-year period was that person or any related person a foundation manager of the private foundation. Third, the aggregate contributions (adjusted for the growth of the contributions in the foundation) made by such person and related persons are determined by the Internal Revenue Service to be insignificant when compared to the aggregate amount of contributions to that foundation by one other person. The committee intends that such contributions generally are to be considered insignificant if they are less than one percent of the contributions by the other person (adjusted for growth).[13]

Effective Date

The amendment made by section 313 applies to taxable years beginning after December 31, 1984.

[13] For example, a gift of $250,000 in cash in 1969 would be considered insignificant in comparison to a gift of $100 million made by another person in 1979. Similarly, a gift of $250,000 of stock in 1969 would be considered insignificant in comparison to a gift of $107 million in 1979, even assuming the value of the stock (originally worth $250,000 when made) had appreciated in value to $1.2 million as of the date on which the $107 million gift was made. However, a gift of $250,000 of stock in 1969 which had appreciated in value to $15 million would not be considered insignificant in comparison to another's gift of $107 million in 1979.

J. Technical Amendments to Section 4942 Rules (Secs. 314(a) and 314(c) of the bill and Code sec. 4942)

In ERTA, section 4942 was amended to define the required minimum payout as five percent of the value of the foundation's net investment assets (rather than the higher of that figure or net income). The ERTA amendment failed to add back to the newly defined payout amount the previously applicable modifications set forth in section 4942(f)(2)(C), relating to (i) repayment to the foundation of amounts previously treated as qualifying distributions (e.g., scholarship loans); (ii) amounts received on disposition of assets previously treated as qualifying distributions; and (iii) amounts previously set aside for a charitable project but not so used.

The bill adds to the required minimum payout the amounts specified in Code section 4942(f)(2)(C) (certain loan repayments, proceeds from asset dispositions, and unused set-asides), effective for post-1984 taxable years. Also, the bill corrects certain cosss-references, effective on enactment.

K. Review of Treasury Regulations on Expenditure Responsibility (Code sec. 4945)

Present Law

In the case of grants to organizations other than public charities, a private foundation must exercise "expenditure responsibility" over the grant (sec. 4945(d)). To ensure that such grants will be properly used by the recipient for charitable purposes, the grantor must make reasonable efforts, and establish adequate procedures, to see that the grant is spent solely for proper uses, to obtain full reports from the grantee, and to make full reports to the Internal Revenue Service on the grants.

Treasury regulations expressly state that the expenditure responsibility rules do not make donor foundations insurers or guarantors of the activities of donee organizations, and set forth guidelines under which donor foundations may satisfy the section 4945 rules (Reg. sec. 53.4945-5(b)). For example, the regulations state that a private foundation considering a grant request should conduct a limited inquiry concerning the potential donee, complete enough to give a reasonable person assurance that the grant would be used for charitable purposes. The scope of the inquiry would vary with factors such as the dollar amount of the grant. No such pre-grant inquiry would be required if the donee organization had received prior grants from the donor foundation and had submitted to the donor the required reports substantiating proper use of the earlier grant funds.

The donor foundation must obtain a written commitment from the donee foundation that the latter will use the grant funds solely for charitable purposes and will submit reports as to whether the funds have been used in compliance with the grant terms. The grantor foundation need not conduct any independent verification of such reports unless it has reason to doubt their accuracy or reliability (Reg. sec. 53.4945-5(c)(1)). In meeting its own reporting requirements to the Internal Revenue Service, the grantor foundation may rely on statements from the donee organization or other records showing the information which the grantor, in turn, must report to the Service (Reg. sec. 53.4945-5(c)(4)).

Reasons for Committee Action

The committee reaffirms the central purpose of the expenditure responsibility rules—to ensure that foundation grants will be properly used by the recipient organization solely for exempt purposes. At the same time, the committee is concerned whether implementation of the statutory requirements in Treasury regulations may have added unduly burdensome or unnecessary requirements in some respects, which may operate to deter grants by some foundations to newly formed, community-based organizations.

Committee Action

The committee directed the Treasury Department to review its expenditure responsibility regulations for purposes of modifying requirements which are found to be unduly burdensome or unnecessary. As part of its review, Treasury is to modify the required grantor reports to the Internal Revenue Service. The Treasury Department is to report to the committee on its review and modifications.

L. Revenue Effect of Private Foundation Provisions

The amendments made by Title III of the bill are estimated to reduce fiscal year budget receipts by $21 million in 1985, $24 million in 1986, $26 million in 1987, $29 million in 1988, and $32 million in 1989.

TITLE IV—ENTERPRISE ZONE PROVISIONS

A. Present Law

Targeted jobs tax credit

The targeted jobs tax credit, which applies to wages paid to eligible individuals who begin work for the employer before January 1, 1985, is available on an elective basis for hiring individuals from one or more 9 target groups. The target groups are (1) vocational rehabilitation referrals; (2) economically disadvantaged youths aged 18 through 24, (3) economically disadvantaged Vietnam-era veterans; (4) Supplemental Security Income (SSI) recipients; (5) general assistance recipients; (6) economically disadvantaged cooperative education students; (7) economically disadvantaged former convicts; (8) AFDC recipients and WIN registrants; and (9) economically disadvantaged youths aged 16 or 17 for summer employment.

The credit generally is equal to 50 percent of the first $6,000 of qualified first-year wages and 25 percent of qualified second-year wages paid to a member of a targeted group. Thus, the maximum credit is $3,000 per individual in the first year of employment and $1,500 per individual in the second year of employment. With respect to disadvantaged summer youth employees, however, the credit is 85 percent of up to $3,000 of wages for a maximum credit of $2,550. The employer's deduction for wages, however, must be reduced by the amount of the credit.

The credit is subject to several limitations. For example, wages may be taken into account for purposes of the credit only if more than one-half of the wages paid during the taxable year to an employee are for services in the employer's trade or business. In addition, wages for purposes of the credit do not include amounts paid to an individual for whom the employer is receiving payments for on-the-job training under a Federally-funded program.

For purposes of determining the years of employment of an employee and whether the $6,000 cap has been reached with respect to any employee, all employees of any corporation that are members of a controlled group of corporations are treated as if they are employees of a single corporation. Under the controlled group rules, the amount of credit allowed to the group is generally the same which would be allowed if the group were a single company. Comparable rules are provided for partnerships, proprietorships, and other trades or businesses (whether or not incorporated) under common control.

The credit may not exceed 90 percent of the employer's tax liability after being reduced by other nonrefundable credits. Excess credits may be carried back three years and carried forward fifteen years.

Investment tax credit

Under present law, a regular investment tax credit is allowed for investment in tangible personal property and other tangible property (generally not including buildings or structural components) used in connection with manufacturing, production, or certain other activities. For eligible property in the 3-year recovery class, a 6-percent regular investment tax credit is allowed. For other eligible property, a 10-percent regular investment tax credit is allowed.

Buildings and their structural components generally do not qualify for the regular investment tax credit. However, in the case of qualified rehabilitation expenditures, a 15-percent tax credit is allowed for nonresidential buildings at least 30 years old, a 20-percent tax credit is allowed for nonresidential buildings at least 40 years old, and a 25-percent tax credit is allowed for certified historic buildings. The rehabilitation credit generally is allowed only for property that otherwise is not eligible for the investment tax credit. Unused investment tax credits may be carried back 3 years and carried forward for 15 years.

The basis of the asset, for such purposes as capital cost recovery deductions, is reduced by the full amount of the 15-percent or 20-percent rehabilitation tax credit and by half the investment tax credit for other types of property.

Capital gains taxation

In general

Under present law, gain or loss from the sale or exchange of a capital asset receives special tax treatment. For this purpose, the term "capital asset" generally means any property held by the taxpayer. However, capital assets generally do not include (1) inventory, stock in trade, or property held primarily for sale to customers in the ordinary course of the taxpayer's trade or business, (2) depreciable or real property used in the taxpayer's trade or business, (3) specified literary or artistic property, (4) business accounts or notes receivable, or (5) certain U.S. publications. Although depreciable personal property and real property used in a trade or business are not capital assets, gains from sales or exchanges of those assets may be treated as capital gains under certain circumstances.

Noncorporate capital gains deduction

Noncorporate taxpayers may deduct from gross income 60 percent of the amount of any net capital gain (the excess of net long-term capital gain over net short-term capital loss) for the taxable year. (Long-term capital gain is defined as gain from the sale or exchange of a capital asset held for more than one year.) The remaining 40 percent of the net capital gain is included in gross income and taxed at the otherwise applicable regular income tax rates. As a result, the highest tax rate applicable to a noncorporate taxpayer's entire net capital gain is 20 percent, i.e., 50 percent (the highest individual tax rate) times the 40 percent of the entire net capital gain includible in adjusted gross income.

Corporate capital gains tax

An alternative tax rate of 28 percent applies to a corporation's net capital gain (the excess of net long-term capital gain over net short-term capital loss) if the tax computed using that rate is lower than the corporation's regular tax. (The highest regular corporate tax rate is 46 percent for taxable income over $100,000.)

Minimum taxes

"Add-on" minimum tax

Present law imposes an "add-on" minimum tax for corporations on certain tax preference items. $\frac{18}{46}$ths of a corporation's net capital gain is a tax preference subject to the minimum tax.

Alternative minimum tax

Under present law, noncorporate taxpayers are subject to an alternative minimum tax to the extent that it exceeds their regular income tax. The alternative minimum tax is based on the taxpayer's adjusted gross income, as reduced by allowed deductions, and increased by tax preference items, including the 60 percent of net capital gains deducted in computing the regular tax. The alternative minimum tax rate is 20 percent for amounts in excess of a specified exemption amount.

Industrial development bonds

Interest on State and local government obligations generally is exempt from Federal income tax (obligations issued after June 30, 1983, must be in registered form to be exempt). However, subject to certain exceptions, interest on State and local issue of industrial development bonds is taxable. An obligation constitutes an industrial development bond (IDB) if (1) all or a major portion of the proceeds of the issue are to be used in any trade or business of a person other than a governmental unit or tax-exempt organization described in sec. 501(c)(3) and (2) payment of principal or interest on the obligation is secured by an interest in, or derived from payments with respect to, property or borrowed money used, or to be used, in a trade or business.

Present law provides an exception which exempts from tax interest on IDBs that are issued to finance the following types of exempt activities: (1) projects for low-income residential rental property, (2) sports facilities, (3) convention or trade show facilities, (4) airports, docks, wharves, mass commuting facilities, and parking facilities, (5) sewage and solid waste disposal facilities, and facilities for the local furnishing of electricity or gas, (6) air or water pollution control facilities, (7) certain facilities for the furnishing of water, (8) qualified hydroelectric generating facilities, and (9) qualified mass commuting vehicles. In addition, the interest on certain IDBs issued for the purpose of acquiring or developing land as a site for an industrial park is exempt from taxation.

Present law also provides an exception for certain "small issues" to the general rule of taxability of interest paid on industrial development bonds. This exception is not available for bond proceeds used for golf courses, country clubs, racetracks and other specified types of facilities. This exception applies to issues of $1 million or less if the proceeds are used for the acquisition, construction, or improvement of land or depreciable property.

At the election of the issuer, the $1 million limitation may be increased to $10 million. If the election is made, the exception is restricted to projects where the aggregate amount of outstanding exempt small issues and capital expenditures (financed otherwise than out of the proceeds of exempt small issues) made over a six-year period does not exceed $10 million. Both the $1 million and $10 million limitations are determined by aggregating the face amount of all outstanding related issues, plus, in the case of the $10 million limitation, certain capital expenditures for all facilities used by the same or related principal users which are located within the same county or same incorporated municipality.

In general, the small issue exemption will not apply with respect to obligations issued after December 31, 1986.

Under present law, to the extent that certain facilities are financed by an IDB and the property is placed in service after December 31, 1982, such property generally is allowed cost recovery deductions at a slower rate than those allowed under ACRS or other accelerated cost recovery provisions of the code. In lieu of deductions under ACRS, the cost of property financed with IDBs must be recovered using the straight-line method over the ACRS life for the property involved. This limitation applies to both the first owner of the property and to any subsequent owners who acquire the property while the IDBs (including any refunding issues) are outstanding.

However, the cost of the following types of facilities financed in whole or in part with IDBs may continue to be recovered under ACRS: low-income rental housing, municipal sewage and solid waste disposal facilities, air or water pollution control facilities used in connection with a plant or other property in operation before July 1, 1982, and facilities for which a UDAG grant equaling or exceeding 5 percent of the total capital expenditures on the facility is made.

Regulatory flexibility

The Regulatory Flexibility Act (5 USC secs. 602-612) requires Federal regulatory agencies to publish analyses of the economic impact on entities under its coverage of any proposed regulations and to discuss alternatives to those regulations. The Act requires Federal regulatory agencies to undertake a periodic review of their regulations to determine whether they should be changed to minimize their economic impact on the entities covered by the Act.

In general, the purpose of the Regulatory Flexibility Act is to require Federal agencies to fit regulatory and informational requirements to the scale of the businesses, organizations, and governmental jurisdictions subject to regulation. To achieve this goal, agencies are required to solicit and consider flexible regulatory proposals and to explain the rational for their actions to assure that such proposals are given serious consideration. The Act requires that special attention is to be given to small entities. For example, in its initial regulatory flexibility analysis, an agency must describe the impact of a proposed rule on small entities.

Small entities, for purposes of the Regulatory Flexibility Act, are small businesses (generally independently owned and operated business enterprises that are not dominant in their fields of operation), small organizations (independently owned and operated not-for-profit enterprises that are not dominant in their fields), and small governmental jurisdictions (governments of cities, towns, townships, villages, school districts, or special districts, with populations of less than fifty thousand).

Foreign trade zones

Foreign trade zones are secure areas under U.S. Customs supervision that are considered outside the U.S. Customs Territory. Each port of entry is entitled to at least one foreign trade zone. In a foreign trade zone, foreign and domestic merchandise may be stored, sold, repaired, assembled, distributed, manufactured and displayed within the zone, and then exported or sent into the U.S. Customs Territory. Only when sent into Customs territory for domestic consumption do the goods become subject to the laws affecting imported merchandise, such as the levy of customs duties. The importer has the choice of paying duties on the original foreign materials or on the finished product. Domestic goods moved into the zone for export are considered exported upon entry into the zone for purposes of excise tax rebates and duty drawback.

Foreign trade zones are authorized by the Foreign Trade Zone Board, a Federal agency chaired by the Secretary of Commerce. Such zones typically consist of specific factories, warehouses, or industrial parks.

B. Reasons for Change

A dynamic economy constantly experiences change. Markets shift, companies expand and decline, and there are changes in the composition of consumer products and in the combination of labor, materials, and plant and equipment used in production. In a country as large and diverse as the United States, industrial change also means geographic change—movement among the major regions from rural to urban areas, and from central city to suburbs. Unless mobile or failed businesses are replaced by new enterprises, local areas decay, and unemployment tends to become endemic.

Most Federal Government programs directed at the unemployed and distressed local areas have been directed at alleviating the burdens on the individuals and communities. Generally, the belief has been that alleviation and basic support would suffice until economic activity in these areas was revived.

Some programs to stimulate local enterprise and farming have been put into effect, and loans have been made available through the Small Business Administration and Farmers Home Administration. In addition, grants to local governments have been made so that they can initiate community development programs that would stimulate local business.

Federal, State and local government resources, however, have not been adequate to overcome the inertia of distress, and a new approach has been developed that will place primary emphasis on the abilities of private enterprise to create employment and economic activity. The keynote of this program is to select a limited number of distressed urban and rural areas in which private enterprise could expand after being relieved of as much government restraint as possible. These new areas are called enterprise zones, and they are in part modeled after the free trade zones that stimulate international trade in various p. rts of the world.

Consequently, the establishment of enterprise zones is designed to create jobs in depressed areas, with an emphasis on jobs for disadvantaged workers, and also to redevelop and revitalize these geographic areas themselves.

The intent of the program is to create a freer environment in which new businesses can start and prosper. The target is to stimulate business that would not have been started anywhere else rather than to encourage relocations of existing businesses. Instead, it is intended that the market will decide what activities should take place in the enterprise zones.

Federal participation in creating the new economic environment will take the form of designating the eligible areas and providing various tax benefits: investment credits in addition to those already available; employment credits; and relief from capital gains taxation for gains due to enterprise zone activity. In addition, Federal regulatory agencies will be encouraged to reduce the restraints of their regulatory processes to the maximum reasonable extent without abrogating statutory requirements.

Local and State governments will be required, when nominating local areas for designation as enterprise zones, to make commitments such as reductions or relief from taxes or regulatory burdens or to increase the scope or amount of governmental services. Local private organizations also are encouraged to make commitments to foster the success of enterprise zones; such as the provision of venture capital or small business expertise.

Thus, the enterprise zone concept involves the commitment of Federal, State and local governments and local private organizations to create a freer economic environment in which new private business may prosper in depressed areas.

The committee believes that these provisions will successfully implement these significant and innovative ideas on an experimental basis.

C. Explanation of Provisions

1. Designation of enterprise zones

Definition of enterprise zone

Under the bill, an enterprise zone is any area which is nominated as an enterprise zone by one or more local governments and the State or States in which it is located, and which is approved by the Secretary of Housing and Urban Development (Secretary) after consultation with the Secretaries of Agriculture, Commerce, Labor, and the Treasury, the Director of the Office of Management and Budget, and the Administrator of the Small Business Administration. In the case of an enterprise zone on an Indian reservation, the Secretary of the Interior also must be consulted.

The term "State" includes Puerto Rico, the Virgin Islands, Guam, American Samoa, the Northern Mariana Islands, and any other possession of the United States. The term "local government" includes any county, city, town, township, parish, village or other general purpose political subdivision of a State, any combination of these subdivisons that is recognized by the Secretary, and the District of Columbia. In the case of a nominated area on an Indian reservation, the reservation governing body, as determined by the Secretary of the Interior, is deemed to be both the State and local government.

Before designating any area as an enterprise zone, the Secretary must promulgate regulations, after consultation with the above Federal officials, describing (1) the nominating procedures, (2) the size and population characteristics of an enterprise zone, and (3) the procedures for comparing nominated areas using the criteria specified below for evaluating commitments made by State and local governments and for establishing priorities to be applied in making designations.

The Secretary may designate enterprise zones only during a 36-month period that begins on January 1, 1985, or the first day of the first month after the effective date of the regulations, whichever is later (the "commencement date"). No announcement of proposed designations could be made before that date. No more than 25 zones may be designated during each 12-month period beginning with the commencement date, so that no more than 75 enterprise zones may be designated during the entire 36-month period. At least one-third of the zones designated must be areas which are outside a standard metropolitan statistical area, are within a jurisdiction or jurisdictions of local government that have a population of less than 50,000, or are found by the Secretary (after consultation with the Secretary of Commerce) to be rural.

The Secretary may not designate an area as an enterprise zone unless the local government and the State in which the nominated area is located have the authority to nominate, to make commitments with respect to the zone, and to assure that the commitments will be fulfilled. Nominations must be submitted in the form, and with the information, required in the Secretary' regulations. The Secretary also would have to determine that the information submitted with a nomination is reasonably accurate and that no portion of the nominated area was already included in an enterprise zone or an area nominated as an enterprise zone.

Period of effect of designation

Under the bill, any enterprise zone designation remains in effect from the date of designation to the earliest of December 31 of the calendar year 24 years later, the date stipulated by the State and local governments in their nomination application, or the date the zone designation is revoked by the Secretary. The Secretary, after consulting with the same Federal officials who must be consulted in designating enterprise zones, may revoke a zone designation if he determines that the State or local government is not substantially complying with the required State or local government commitments (described below).

Within 60 days after the Secretary designates any area as an enterprise zone, the relevant State or local government must submit to the Secretary an inventory of historic properties within the area. For purposes of the tax and regulatory provisions of the bill, the zone designation will not be deemed to be in effect until this inventory is submitted.

Area requirements

The Secretary may designate an area nominated as an enterprise zone only if it meets requirements concerning size, population, area boundaries, unemployment, poverty, and other signs of economic distress. A description of these requirements follows:

a. The area must be within the jurisdiction of the local government seeking the designation and have a continuous boundary.

b. The most recent census must show that the area's population is at least 1,000 (4,000 if any part of the area, other than a rural area, is located in a metropolitan statistical area with 50,000 or more people) or the area must be entirely within an Indian reservation (as determined by the Secretary of the Interior).

c. The nominating governments must certify and the Secretary accept that the area is one of pervasive poverty, unemployment and general distress, and is located wholly within an area which meets the requirements for Federal assistance under section 119 of the Housing and Community Development Act of 1974, as in effect on the date of enactment.[1]

d. The nominating governments must certify and the Secretary accept that at least one of four additional requirements is satisfied: (1) the rate of unemployment, as determined by the appropriate available data, is at least 1½ times the national unemployment rate; (2) according to the most recent census data, each census tract in the area has a 20 percent or higher poverty rate (or each census county division, where not tracted; (3) at least 70 percent of the households living in the area have income below 80 percent of the median income of the households of the area within the jurisdiction of the local government which nominates the area (determined in the same manner as under section 119(b)(2) of the Housing and Community Development Act of 1974); or (4) the population of the area had decreased by 20 percent or more between 1970 and 1980, as determined from the most recent census available.

Required State and local government commitments

Under the bill, no area may be designated as an enterprise zone unless the local government and the State in which it is located agreed in writing that, during any period that the area was an enterprise zone, these governments will follow a specified course of action designed to reduce the various burdens borne by employers or employees in the area.

[1] Section 119 establishes a program of urban development action grants (UDAG) to severely distressed cities and urban counties to alleviate physical and economic deterioration through reclamation of neighborhoods. The eligibility of a city, or area within a city, generally is based on some or all of the city's or area's poverty rate, age of housing stock, growth in per capita income growth in population, growth in retailing and manufacturing employment, unemployment rate, and income distribution.

This course of action may be implemented by the State and local governments and private nongovernmental entities, and may be funded from the proceeds of any Federal program. The course of action may include, but is not limited to, (1) a reduction of tax rates or fees applying within the enterprise zone, (2) an increase in the level or efficiency of local services within the enterprise zone, (3) elimination, reduction or simplification of governmental requirments applying within the enterprise zone, (4) program involvement by private entities, organizations, neighborhood associations and community groups, particularly those within the nominated area, including commitments from private entities to provide technical, financial or other assistance to, and jobs or job training for, employers, employees and residents of the area, and (5) mechanisms to increase the equity ownership of residents and employees in the zone. Under (5), a State or local government could, for example, establish a revolving fund to help with the financing of employee buyouts of businesses within the zone. With respect to item (1), reduction of tax rates or fees, it is the committee's understanding that such reductions would not be an important factor in evaluating applications for designation as an enterprise zone for areas that have a limited or declining tax base.

The Secretary may, be regulation, prescibe procedures for modifying, after zone designation, a course of action to which the State and local governments have committed themselves. The committee intends that these regulations will permit aspects of the course of action to be modified, except for those conditions on which businesses and employees have substantially relied in making their decisions to invest, employ or work in the zone. For example, the Secretary might allow a reduction in police protection if the crime rate in the zone goes down, but should not allow a property tax abatement to be revoked with respect to a business that relied on the continued availability of this abatement in making its investment decision. However, the committee believes that commitments in a course of action could be revoked prospectively with respect to businesses and employees that may locate in the zone after the modification of a course of action is approved. In no case is it the committee's intention to authorize the Secretary to permit the withdrawal of a commitment from the course of action without the substitution of a commitment of equal value.

Priority of designation

The committee amendment provides criteria for the Secretary to use in choosing areas nominated to be enterprise zones. The Secretary is required to give special preference to those nominated areas for which the strongest and highest quality contributions to a course of action (as described above) have been promised by the nominating governments, taking into account their fiscal ability to provide tax relief. The Secretary also is required to give preference to nominated areas with the following characteristics: (1) strongest and highest quality contributions in addition to contributions under item 4 above; (2) most effective and enforceable guarantees provided by nominating State and local governments that proposed courses of action actually would be carried out for the duration of the designation; (3) high levels of poverty, unemployment and general distress, particularly areas near concentrations of disadvantaged workers or long-term unemployed individuals for whom employment would be a strong likelihood if the area were designated a enterprise zone; (4) zone size and location that primarily stimulate new economic activity and minimize unnecessary Federal tax losses; (5) most substantial commitments by private entities of additional resources and contributions, including creation of new or expanded business activities; and (6) nominated zones which best exhibit such other factors, to be determined by the Secretary, consistent with the program's intent and important to minimizing unnecessary loss of Federal tax revenues.

Evaluation and reporting requirements

The Secretary of Housing and Urban Development must prepare and submit to Congress a report on the effects of designating qualifying areas as enterprise zones in accomplishing the purposes of the legislation. The first report must be submitted not later than the close of the fourth calendar year after the year in which areas are first designated as enterprise zones. Subsequent reports will be submitted at four-year intervals.

Interaction with other Federal programs

Tax reductions

Any reduction of taxes under any required program of State and local commitments under the enterprise zone program will be disregarded in determining the eligibility of a State or local government for, or the amount or extent of, any assistance or benefits under any law of the United States, including general revenue sharing payments.

For example, under the general revenue sharing program, as authorized by the State and Local Fiscal Assistance Amendments of 1980 (P.L. 96-604), payments are made to local governments under formulas based on various factors, including income tax and total tax collections of the areas. Thus, under the bill, tax reductions attributable to a required commitment to a course of action for an enterprise zone will not be taken into account in calculating the distribution of revenue sharing payments.

Uniform Relocation Assistance and Real Property Acquisition Policies Act of 1970

Designation of an enterprise zone will not constitute approval of a Federal or federally assisted program or project as those terms are used in the Uniform Relocation Assistance and Real Property Acquisition Policies Act of 1970. No person displaced from real property located in an area designated as an enterprise zone will, by virtue of that designation, have any rights or be entitled to any benefit pursuant to that Act, such as moving expenses, reimbursement of business losses, or provision of replacement housing.

National Environmental Policy Act

Designation of an area as an enterprise zone does not constitute a Federal action for the purposes of applying the requirements of the National Environmental Policy Act or other provisions of Federal law relating to the protection of the environment. As a result, none of the Federal procedural requirements relating to environmental assessments and impact statements need to be met on account of the designation of an enterprise zone.

Although the bill waives certain procedural requirements associated with environmental laws in connection with the designation of enterprise zones, the committee intends that the designation of an area as an enterprise zone is not to be an indication that the substantive provisions of these environmental laws are to be enforced differently within the zone than outside the zone.

2. Tax credit for zone employers

In general

Under the bill, enterprise zone employers are eligible to claim a tax credit equal to the sum of two parts—(1) an amount based on the increase in annual wages paid to employees working in the zone relative to wages paid to area employees in the period immediately before the area was designated as an enterprise zone, and (2) an amount based on wages paid in the current period to disadvantaged individuals working in the zone. The credit is limited to the taxpayer's tax liability, and unused credit amounts are carried back for 3 years or carried forward for the longer of 15 years or the remainder of the period during which the enterprise zone designation is in effect.

Qualified wages and qualified employees

The computation of the credit is based on a definition of qualified wages paid to qualified employees.

Under the amendment, a qualified employee is any employee 90 percent or more of whose services directly relate to the conduct of the employer's trade or business located in an enterprise zone and who performs at least 50 percent of his service for the emplolyer in an enterprise zone. A qualified employee does not include an employee with respect to whom the employer claims the targeted jobs credit. Further, under rules similar to those applicable to the targeted jobs, credit, qualified employees do not include individuals who are related to, or are dependents of, the employer or who work other than in a trade or business of the employer.

Qualified wages generally are defined to include amounts subject to FUTA (Federal Unemployment Tax Act), without regard to any dollar limit (currently $7,000 per year per employee). Special rules similar to those used in the targeted jobs credit provide for wages paid in connection with agricultural and railway labor not covered by FUTA. Qualified wages for any period do not include any amount of federally funded on-the-job training payments the employer receives or is entitled to receive for a qualified employee for the period.

Increased enterprise zone employment

The first part of the credit is equal to 10 percent of the excess of qualified wages paid or incurred during the taxable year to qualified employees in all enterprise zones over base period wages with respect to all zones. However, qualified wages are not taken into account if they are taken into account in determining the amount of credit based on wages paid to economically disadvantaged individuals.

Base period wages, for any enterprise zone, is the amount of wages which is paid during the 12-month period prior to zone designation, or, if earlier, the date on which the enterprise zone is designated under State law enacted after January 1, 1981, and which would have been qualified wages paid to individuals who would have been qualified employees if the designation had been in effect during this 12-month period. If the employer had no active trade or business in an area for which an enterprise zone designation was in effect for the taxable year for which the credit computation is made, base period wages for that enterprise zone are zero.

Qualified wages taken into account for this portion of the credit may not exceed 2½ times the FUTA wage base in effect for the calendar year ending in the taxable year for which the credit computation is made. This limit is used for the computation of base period wages as well as for the computation of current period qualified wages. If the FUTA wage base is increased, from one year to the next, then the amount of base period wages used in computing the credit in the second year must be recomputed to reflect the higher limit on the amount of wages per employee which may be taken into account.

The increased enterprise zone employment portion of the credit is phased out starting in the taxable year of the taxpayer in which falls the twenty-first anniversary of the enterprise zone designation or, if earlier, the date 4 years before the date the zone designation was to expire. For this taxable year, the credit is reduced to 7½ percent of qualified wages. The credit is then reduced by 2½ percentage points for each succeeding year until fully terminated.

Disadvantaged individuals

The second part of the credit is computed with respect to qualified wages paid to qualified employees who are qualified disadvantaged individuals.

This portion of the credit is allowable for a total of seven years with respect to any qualified employee. The credit is 50 percent of qualified wages paid to a qualified economically disadvantaged individual for services performed during the 36-month period beginning the day the individual began work in an enterprise zone for an employer. The credit is then reduced 10 percentage points during each of the succeeding twelve-month periods, to 40 percent of qualified wages attributable to services rendered in the fourth year, 30 percent of qualified wages attributable to services rendered in the fifth year, 20 percent of qualified wages attributable to services rendered in the sixth year, and 10 percent of qualified wages attributable to services rendered in the seventh year. The credit with respect to any one employee is not available after the seventh year of employment. These time periods do not take into account any period of time during which the individual is unemployed or any period of time during which the individual is employed by a taxpayer in an enterprise zone designated under a State law enacted after January 1, 1981, if this designation occurred prior to the Federal designation.

A qualified disadvantaged individual is anyone who is hired during the period an enterprise zone designation is in effect for the area in which the services which qualify the individual as a qualified employee are performed and who is either a member of an economically disadvantaged family or a general assistance or AFDC recipient as defined for purposes of the targeted jobs credit. Thus, in the first alternative, the individual has to be certified by the designated local agency as being a member of a family that had an income, including the cash value of food stamps, during the 6 months immediately preceding the month in which the determination occurs, which, on an annual basis, is equal to or less than the combined Aid to Families with Dependent Children (AFDC) and food stamp benefits available to a family of the same size with no countable income or resources. This combined benefit amount is computed first by determining the highest amount ordinarily paid under the AFDC program, in the State in which the family resides, to a family of the same size as the family being considered for tax credit eligibility. A family need not be of a type normally eligible for AFDC for the purposes of applying this standard. For example, the tax credit eligibility of a married couple with no children would be determined on the basis of the AFDC payment available to a single parent and one child, even though childless couples are not eligible for AFDC payments. Determinations throughout the entirety of each State are to use the highest benefit amount available in any locality in the State to an assistance unit with no income and resources and with maximum need. The food stamp portion of the combined benefit amount then will be computed by assuming that the household's only income consists of AFDC benefits in the amount just determined, that the household consists only of the AFDC unit for which the computation is made (e.g., that there are no unrelated individuals living in the household), and that the family is entitled to the standard deduction and the maximum amount of other deductions which ordinarily are allowed to a household, the income of which consists entirely of AFDC benefits.

Alternatively, to be eligible for this portion of the tax credit, the individual must be certified as having been placed in employment under a work incentive program, or as receiving assistance under either the AFDC program for the 90-day period preceding the hiring date or under a general assistance program for not less than 30 days ending within the 60-day period ending on the day the individual is hired by the employer. Only those general assistance programs designated by the Secretary of the Treasury as consisting of money, voucher, or scrip payments based on need are to be taken into account for this purpose. The Secretary is not to designate any program designed specifically by a State or local government for enterprise zone residents in order to determine eligibility for this credit.

The credit amount is reduced 25 percent in the first year in which the increased employment credit begins to phase out, and this reduction factor is increased by 25 percent each year thereafter.

Other rules

Rules analogous to those contained in the present targeted jobs and research and experimental expenditures tax credits control certification procedures (such as the rule requiring certification on or before the date on which the individual begins work for the employer) and allocation and computation of the credit for controlled groups of businesses, for subchapter S corporations and their shareholders, for estate and trusts and their beneficiaries, and for employers affected by acquisitions and dispositions. Special rules also are provided for taxpayers for which a zone designation is in effect only part of the taxable year or with a short taxable year.

Any credit taken with respect to an economically disadvantaged employee is recaptured if the employee is terminated at any time during the first 270 days after the employee begins work for the employer, with certain exceptions, including voluntary termination, disability, or misconduct of the employee, or substantial reduction of the business. However, if the major portion of a trade or business, or the major portion of a separate unit of a trade or business of an employer is acquired by another employer, than employment of any qualified employee is not terminated for purposes of this credit if the employee continues to be employed in that trade or business.

No deduction is allowable to an enterprise zone employer for that portion of wages paid or incurred for the taxable year equal to the amount of credits allowable under this provision for the taxable year.

3. Tax credit for zone employees

Under the bill, qualified employees are entitled to a nonrefundable tax credit equal to 5 percent of qualified wages for the taxable year. For purposes of this credit, qualified wages are equal to all remuneration paid for services of a qualified employee, but not including any compensation received from the Federal Government or any State or subdivision of a State, up to 1½ times the wage base in effect for the purpose of the Federal Unemployment Tax Act (FUTA) (currently $7,000). Thus, the maximum credit for any taxable year until the FUTA base is changed is 5 percent of $10,500 or $525.

For purposes of this credit, a qualified employee is an individual at least 90 percent of whose services are directly related to an enterprise zone trade or business and at least 50 percent of whose services are performed in an enterprise zone, and who is not an employee of the Federal Government or any State or local subdivision of any State. The determination of whether an individual is a qualified employee is to be made separately with respect to each of the individual's employers.

The credit phases out starting in the taxable year of the employee in which falls the twenty-first anniversary of enterprise zone designation, or, if earlier, the date 4 years before the date the zone designation is to expire, and phases out completely in 4 years.

Employers are required to report to qualified employees the amount of wages paid to such employees.

4. Investment tax credit for zone property

Under the bill, an additional investment tax credit is allowed for certain capital investments in an enterprise zone.

Zone personal property

For recovery property (other than 20-year real property) an additional 3-percent credit is available for 3-year recovery property, and an additional 5-percent credit is available for 5-year property, 10-year property and 15-year public utility property. Recovery property that does not meet the general eligibility requirements under section 48(a)(1) for the investment credit or that is not eligible for the investment credit because the property is used in connection with lodging (sec. 48(a)(3)) is eligible for the additional 3- or 5-percent credit, but not for the regular investment credit.

In order to be eligible for this additional credit, property has to be acquired and first placed in service by the taxpayer in an enterprise zone during the period the designation as a zone is in effect. The property must be eligible for ACRS but does not have to be new property. The taxpayer has to use the property predominantly in the active conduct of a trade or business within an enterprise zone and may not acquire the property from a related person. Property used or located outside the enterprise zone on a regular basis is not eligible for the additional credit. In order to facilitate enforcement of this rule, the Secretary may prescribe by regulation that certain types of mobile equipment are ineligible for the credit.

The credit rate is reduced by 25 percent in the first year in which the employment credit begins to be phased out, and by an additional 25 percent each year thereafter. The basis of property eligible for the additional 3- or 5-percent credit is reduced by one-half of that credit.

New zone construction property

An additional 10-percent tax credit is available for 15-year real property (including lodging) located in an enterprise zone if the property is acquired or constructed by the taxpayer and used predominantly in the active conduct of a trade or business, including the rental of real estate, within the enterprise zone. The credit is in addition to any investment credit to which the property is entitled under present law (e.g., the rehabilitation tax credit in the case of qualified rehabilitation expenditures and the regular credit for elevators and escalators).

In the case of property acquired by the taxpayer, the additional credit is available only if the property is acquired after designation of the zone and only if the original use of the property commences with the taxpayer. In the case of property constructed, reconstructed, or erected by the taxpayer, the credit is available only to the extent of any construction, reconstruction or erection after designation of the enterprise zone. The credit rate is reduced by 25 percent in the first year in which the employment credit begins to be phased out, and by an additional 25 percent each year thereafter.

The basis of property eligible for this additional 10-percent tax credit is reduced by the full amount of the additional credit allowable.

Recapture

If property for which an enterprise zone credit was claimed by a taxpayer ceases to be enterprise zone property of the taxpayer (other than by expiration or revocation of the designation of the zone), a portion of the enterprise zone credit is recaptured. Property would cease tc be enterprise zone property of a taxpayer if, for example, the taxpayer disposed of the property, removed the property from the enterprise zone, or ceased to use the property in the active conduct of a trade or business within the enterprise zone.

The amount of the enterprise zone credit subject to recapture is the difference between the amount of credit allowed for the property and a recomputed credit based on the amount of time the property was enterprise zone property of the taxpayer. The recomputed credit bears the same ratio to the amount of credit originally allowed as the number of taxable years in which the property was enterprise zone property of the taxpayer bears to the number of years over which the property is depreciated for purposes of computing earnings and profits. The recapture periods are as follows:

	Years
3-year property	5
5-year property	12
10-year property	25
15-year public utility property	35
20-year real property	35

Thus, for example, no enterprise zone credit is recaptured with respect to 3-year recovery property if it remains enterprise zone property of the taxpayer for 5 taxable years. If this property were enterprise zone property of the taxpayer for only 4 taxable years, 20 percent of the enterprise zone credit is recaptured.

Carryover period

Unused investment tax credit amounts attributable to the additional enterprise zone percentage may be carried forward for the remaining life of the enterprise zone or 15 years, whichever is longer.

5. Elimination of capital gains taxation

The bill eliminates taxes on net long-term capital gains resulting from the sale or exchange of (1) property used in an enterprise zone in the active conduct of a trade or business or (2) an interest in a "qualified enterprise zone business." Additionally, the bill excludes net long-term enterprise zone capital gains from classification as a tax preference item for purposes of the noncorporate and corporate minimum taxes.

Qualified property and qualified business

The amendment eliminate tax on net gain from sales or exchanges of "qualified enterprise zone property" otherwise eligible for long-term capital gain treatment. For this purpose, the term "qualified enterprise zone property" would mean (1) tangible personal property used predominantly by the taxpayer in an enterprise zone in the active conduct of a trade or business in a zone, (2) real property located in an enterprise zone and which is used predominantly by the taxpayer in the active conduct of a trade or business in a zone and (3) an interest in a corporation, partnership, or other entity if, for the two most recent taxable years of the entity ending before the date of disposition of the interest and beginning after the date on which the zone was designated, the entity was a "qualified enterprise zone business."

Under the provision, the term "qualified enterprise zone business" means any person (1) actively engaged in the conduct of a trade or business (including rental of real estate) during the two taxable years described in the previous sentence, (2) at least 80 percent of the gross receipts of which for the taxable year are attributable to the active conduct of a trade or business within an enterprise zone, and (3) substantially all of the tangible assets of which are located within an enterprise zone.

Under the bill, gains and losses from the sale or exchange of qualified enterprise zone property are taken into account only to the extent they are properly allocable to periods during which the property is qualified enterprise zone property or, in the case of an interest in a zone business, periods during which the business is a qualified enterprises zone business. Thus, a determination of the fair market value of the property must be made as of the date the property begins to be used in the active conduct of a trade or business in a zone, in the case of tangible property, or as of the date on which a business begins to be qualified enterprise zone business, in the case of an interest in a qualified enterprise zone business. In addition, net gain from the sale or exchange of an interest in a qualified enterprise zone business is not treated as gain from the sale or exchange of qualified property to the extent the gain is attributable to (1) any property contributed to the qualified business within the previous 12 months, (2) any interest in a business which is not a qualified business, or (3) any other intangible property not properly attributable to an active trade or business within an enterprise zone. Intangible property includes, but is not limited to, items described in section 936(h)(3)(B), such as patents, copyrights, trademarks and franchises. In determining whether intangible property is attributable to active trade or business within a zone, the Secretary is to take into account factors such as whether or not the intangible was acquired in an arm's-length transaction and the extent to which the intangible was developed within the zone.

Under the bill, the special tax treatment for gain from sales or exchanges of qualified enterprise zone property does not cease to be available upon the termination or revocation of an area's designation as an enterprise zone. However, the treatment does not apply after the first sale or exchange of any item of qualified enterprise zone property after the designation ceases to apply.

Noncorporate capital gains deduction

The bill allows a noncorporate taxpayer to deduct from gross income 100 percent of any net long-term capital gain from qualified enterprise zone property.

Corporate capital gains tax

The bill allows a corporation to exclude from taxation all net long-term capital gain from qualified enterprise zone property.

Tax preferences for minimum tax purposes

The bill eliminates net capital gains attributable to qualified enterprise zone property from classification as a tax preference item for purposes of the corporate and noncorporate minimum taxes.

6. Industrial development bonds

The committee bill provides that the provision of present law which restricts the cost recovery deductions for property financed with tax-exempt bonds will not apply to enterprise zone property eligible for the additional investment credit described above.

The bill also provides that the provision of present law which terminates the small issue exception after December 31, 1986, does not apply to any obligation which is part of an issue substantially all of the proceeds of which are used to finance facilities placed in service in an area for which an enterprise zone designation is in effect.

7. Tax simplification

The committee bill provides that it is the sense of the Congress that the Internal Revenue Service should, in every way possible, simplify the administration and enforcement of the tax provisions added to the Internal Revenue Code by this bill.

8. Regulatory flexibility

Designation of zone entities of small entities for purposes of analysis of regulatory functions

The committee bill expands the definition of a small entity, for purposes of the Regulatory Flexibility Act, to include any qualified zone business, any government designating an area as an enterprise zone to the extent any regulatory rule would affect the zone, and any not-for-profit enterprise operating within an enterprise zone.

Waiver or modification of agency rules in enterprise zones

Under the committee bill, Federal agencies and regulatory bodies are given discretionary authority to relax or eliminate any regulatory requirements within enterprise zones except those affecting civil rights, safety and public health, or those required by statute, including any requirement of the Fair Labor Standards Act. This authority is to be exercised only upon request of State and local governments.[2] Agencies are to make their determinations on requests not later than 90 days after their receipt. Such waivers or determinations will not be considered a rule, rulemaking, or regulations under the Administrative Procedure Act.

[2] Examples of regulations which could be relaxed include regulations governing exports, regulations affecting accounting treatment of loans made by national banks, regulations affecting inventory accounting for tax purposes, regulations affecting issuance of securities, and regulations affecting various energy performance, coal conversion, and conservation regulations.

Coordination of housing and urban development programs in enterprise zones

The committee bill provides that the Secretary of Housing and Urban Development is required to promote the coordination of programs under his jurisdiction and carried on in an enterprise zone and to consolidate requirements for related applications and reports required under these programs.

9. Establishment of foreign trade zones in enterprise zones

The committee bill requires the Foreign Trade Zone Board to expedite on a priority basis the processing and approval, to the maximum extent practicable, of any application involving the establishment of a foreign trade zone within an enterprise zone. The Secretary of the Treasury is required to give the same urgent consideration to an application for establishment of a port of entry necessary to permit the establishment of a foreign trade zone within an enterprise zone.

D. Effective Date

The provisions relating to designations of enterprise zones, regulatory flexibility and foreign trade zones are effective on the date of enactment although no zone designations or announcement of proposed designations may be made before January 1, 1985.

The provisions for tax credits for enterprise zone employers and employees are effective for taxable years beginning after December 31, 1984.

The extra investment tax credit for enterprise zone property is effective for periods after December 31, 1984, under rules similar to section 48(m) of the Internal Revenue Code.

The provisions eliminating capital gains taxation are effective for sales or exchanges after December 31, 1984.

The provisions related to industrial development bonds apply to obligations issued after December 31, 1984, in taxable years ending after such date.

E. Revenue Effect

The effect of the enterprise zone provisions on budget receipts will depend on the number, size, and characteristics of the zones designated by the Secretary of Housing and Urban Development. Because the amendment provides the Secretary with wide latitude in his choice, the committee is unable to provide specific cost estimates for these provisions.

The Treasury Department estimates that these provisions will reduce fiscal year receipts by, $98 million in 1985, $420 million in 1986, $775 million in 1987, $1,017 million in 1988 and $1,051 million in 1989. These estimates are based on particular assumptions about the size and characteristics of the zones. However, these assumptions are not mandated by the provisions of this amendment, and thus, these figures may either underestimate or overestimate the actual revenue loss by a considerable degree.

Treasury's estimates are based on the assumption that the zones selected by the Secretary of Housing and Urban Development would have, at the time of designation, average employment, other than in governments and non-profit institutions, of 6,700 and a mix of economic activities similar to those of a sample of distressed areas in several large cities and rural areas. The language of the amendment does not require this average employment and economic mix, however, so that the above figures may not estimate the actual revenue loss. If the average zone has, for example, only 3,500 employees, then actual revenue losses would be $0.05 billion, $0.2 billion, $0.4 billion, $0.5 billion, and $0.6 billion in fiscal years 1985 through 1989, respectively, if the assumptions about the economic mix were correct.

On the other hand, several factors could make the actual revenue loss higher than the Treasury estimates. First, the actual mix of economic activities in the zone or attracted to the zone could be very payroll intensive and have a high ratio on investment to payroll, substantially increasing the cost of the tax incentives relative to what was assumed. Second, because of data limitations, the Treasury estimates do not take into account losses associated with investments by public utilities. Third, the average size of zones when they are actually designated by the Secretary could be much larger than an average taxable employment of 6,700. If, for example, employment in designated zones were to average 35,000 and the economic mix were the same as assumed by Treasury, fiscal year revenue losses would be $0.5 billion in 1985, $2.2 billion in 1986, $4.1 billion in 1987, $5.3 billion in 1988, and $5.5 billion in 1989.

TITLE V—FOREIGN SALES CORPORATIONS

(New secs. 921-927 of the Code)

A. Present Law

Tax treatment of DISCs generally

The tax law provides 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 are not taxed to the DISC but are taxed to the shareholders of the DISC when distributed or deemed distributed to them. Each year, a DISC is deemed to have distributed a portion (discussed below) of its income, thereby subjecting that income to current taxation in the shareholders' hands.[1] Federal income tax can generally be deferred on the remaining portion of the DISC's taxable income until the income is actually distributed to the DISC shareholders, a shareholder disposes of the DISC stock, the DISC is liquidated, distributed, exchanged, or sold, the corporation ceases to qualify as a DISC, or the DISC election is terminated or revoked.

Prior to the Tax Reform Act of 1976, a DISC was deemed to have distributed income representing 50 percent of its export profits and 100 percent of its non-export profits, thus, the tax deferral available under the DISC provisions was limited to 50 percent of the export income of the DISC. The 1976 Act modified DISC so that the deferral is available only for incremental export income. DISC benefits (deferral of tax on 42.5 percent of profits) are limited to income attributable to export gross receipts in excess of 67 percent of average export gross receipts in a 4-year base period. These provisions are known as the incremental provisions. The base period years are the fourth, fifth, sixth, and seventh preceding years. For example, the base period is 1973 through 1976 for taxable years beginning in 1981. If the taxpayer does not have a DISC in any year which would be included in the base period for the current year, the taxpayer is to calculate base period export gross receipts by attributing a zero amount of export gross receipts to that base period year. A DISC with adjusted taxable income of $100,000 or less is exempt from the incremental rule. This exemption is phased out as adjusted taxable income increases from $100,000 to $150,000.

The incremental provisions include special rules to deal with situations where a corporation has an interest in more than one DISC, or where a DISC and the underlying trade or business giving rise to the DISC income have been separated. The purposes of these rules are, first, to ensure that in every year the base period export

[1] In the typical case, a DISC is a wholly owned subsidiary of a U.S. corporation, so distributions and deemed distributions from DISCs are typically subject to corporate tax and, eventually, to shareholder level tax when distributed to individuals.

gross receipts which are attributable to a DISC for purposes of deemed distributions in the current year are appropriately matched with the current period export receipts of the DISC and, second, to prevent taxpayers from creating multiple DISCs, or swapping DISCs, to avoid the effect of the incremental rule.

To qualify for the deferral, a DISC must be incorporated under the laws of any of the States or the District of Columbia, have only one class of stock, have outstanding capital stock with a par or stated value of at least $2,500, elect to be treated as a DISC, and satisfy the gross receipts and gross assets tests.

The gross receipts test requires that at least 95 percent of the corporation's gross receipts 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. Certain managerial services performed by a DISC for an unrelated DISC are qualified export receipts provided that at least 50 percent of the gross receipts of the DISC performing the services are qualified gross receipts. Interest on any obligation which is a qualified export asset is also an export receipt. Export property must be manufactured, produced, grown, or extracted in the United States. Generally, exports subsidized by the U.S. Government or exports intended for ultimate use in the United States do not qualify as export property. The President has the authority to exclude from export property any property which he determines (by Executive order) to be in short supply. Energy resources, such as oil and gas and depletable minerals, are denied DISC benefits under the Tax Reduction Act of 1975. That Act also eliminated DISC benefits for products the export of which is prohibited or curtailed under the Export Administration Act of 1969 by reason of scarcity. The Tax Reform Act of 1976 reduced DISC deferral on sales of military goods to half the amount which would otherwise be allowed.

The gross assets test requires that at least 95 percent of the corporation's assets qualify as export assets. Qualified export assets include inventories, export property, necessary operational equipment and supplies, trade receivables from export sales (including certain commissions receivable), producers' loans, working capital, obligations of domestic corporations organized solely to finance export sales under guaranty agreements with the Export-Import Bank, and obligations issued, guaranteed, or insured by the Export-Import Bank or the Foreign Credit Insurance Association. In certain situations, nonqualified assets and receipts may be distributed in order to satisfy these qualification requirements.

If a DISC fails to meet the qualifications for any reason, the DISC provisions provide for recapture of the DISC benefits received in previous years. Recapture of accumulated DISC earnings (because the DISC has become disqualified) is to be spread out over a period equal to two years for each year that the DISC was in existence (up to a maximum of 10 years).

The DISC provisions include special elective intercompany pricing rules, which may be used in lieu of the general intercompany pricing rules of the Code, in order to determine the profits which a DISC may earn on products which it purchases from a related company and then resells for export or which it sells on a commission basis. In general, a DISC may earn up to 4 percent of gross export receipts from a transaction or 50 percent of combined taxable income of the DISC and its related party; in either case, the DISC also earns 10 percent of export promotion expenses. Export promotion expenses include freight expenses to the extent of 50 percent of the cost of shipping export property aboard airplanes owned and operated by U.S. persons or ships documented under the laws of the United States in those cases where the law does not require use of such airplanes or ships. (Alternatively, the DISC and its related party may choose a price determined under the usual arm's-length rules.) Neither the 4-percent method nor the 50-50 method can be applied to cause a loss to the related supplier while the DISC is earning a net profit.

Under marginal costing rules, if the 50-50 method is used by the DISC, only the marginal or variable production and sales costs for the export property need be included in the computation of combined taxable income. In general, the benefits of marginal cost pricing are limited to instances where the variable cost margin on the DISC's export sales of a product is less than the full cost margin on the combined product sales by the DISC and the related supplier.

A DISC's taxable year need not conform to the taxable year of any of its shareholders. A wholly owned DISC will frequently have a taxable year ending one month after its parent's taxable year ends. This difference in taxable years allows an additional 11 months of deferral of income that is deemed distributed to the parent.

Source of income from export sales

The United States taxes U.S. taxpayers on their U.S. and foreign source income, but allows a foreign tax credit for foreign taxes on foreign source income. The foreign tax credit limitation reflects the principle that the credit cannot exceed U.S. tax on foreign source income. In general, in calculating the limitation, most foreign source income is grouped together in a general category known as the "all other" category; a separate limitation or "basket" applies to certain income from deemed DISC distributions (and, separately, to certain interest). In most cases, an export sale will not attract foreign tax so long as the U.S. seller does not maintain a fixed place of business or perform substantial activities in the country of destination. The reason for the separate limitation is that Congress, in enacting the original DISC legislation, did not intend to enable taxpayers to reduce U.S. tax on low or untaxed distributions from DISCs by crediting foreign taxes on non-DISC income against the U.S. tax on distributions from DISCs.

Income of a U.S. person that exports property produced in the United States directly (without using a DISC) is treated as income partly from within and partly from without the United States (sec. 863(b)). This income is not subject to the separate foreign tax credit limitation applicable to DISC income. To the extent that the income is from sources without the United States, it increases the taxpayer's foreign tax credit limitation in the general "all other" category, and thus the foreign taxes that the taxpayer may credit.

An approximation of the portion of income from a typical direct export sale that is foreign source income is 50 percent (see Treas. Reg. sec. 1.863-3(a)(2) (Example (2)). Therefore, a taxpayer with substantial excess foreign tax credits who can make an export sale directly (rather than through a DISC) without incurring foreign tax on the transaction may be subject to tax on only half the income from the export sale.

For example, a U.S. exporter who can make an export sale at a profit of $100 may be able to treat $50 of that income as foreign source. The taxpayer may be able to arrange the sale so that the $50 of foreign source income attracts no foreign tax. Given sufficent excess foreign tax credits, the sale will attract no U.S. tax, either. In that case, the taxpayer will be taxable on only the $50 of income that is U.S. source income.

By contrast, that exporter with excess foreign tax credits may be taxable on $58 of income if it routes the export sale through a DISC. The following table assumes a 17-percent deferral rate for combined taxable income (CTI) of DISC and parent.

CURRENT LAW—DISC—50/50 SPLIT OF CTI—SEC. 863(b)

(Exporter With Excess Foreign Tax Credits)

Parent		*DISC*	
U.S. source (taxable)	$25	Deferred	$17
Foreign source (exempt)	25	Deemed distribution	33
	$50		$50

Taxable:	
U.S. source income of parent	$25
Deemed distribution—separate basket	33
	$58
Exempt:	
Foreign source income of parent	$25
Deferred in DISC	17
	$42

Therefore, some exporters with excess foreign tax credits may choose not to route their export transactions through DISCs.

B. Reasons for Change

Since its enactment, the DISC has been the subject of an ongoing dispute between the United States and certain other signatories of the General Agreement on Tariffs and Trade (GATT), who contend that DISC amounts to an illegal export subsidy that violates the GATT. In 1976, a GATT panel determined that the DISC, as well as certain export tax practices of Belgium, France, and the Netherlands, had some characteristics of an illegal export subsidy. In the case of DISC, the Panel Report pointed to the failure to charge interest on deferred taxes as the offending export subsidy. While the United States has not conceded that DISC violates the GATT, in December 1981 the United States agreed to the adoption of the GATT Panel Reports on the DISC and the related tax practices of Belgium, France, and the Netherlands subject to a GATT Council decision which was understood to qualify the findings in the panel reports ("the 1981 Decision").

The 1981 Decision provided that GATT signatories are not required to tax export income attributable to economic processes located outside their territorial limits. Furthermore, the 1981 Decision also stated that arm's-length pricing principles should be observed in transactions between exporting enterprises and foreign buyers under common control. Finally, the 1981 Decision stated that the GATT does not prohibit the adoption of measures to avoid the double taxation of foreign source income.

A debate in the GATT Council, the ruling body of the GATT, ensued in early 1982 on the interpretation of the 1981 Decision as it applied to the DISC. This debate delayed progress on other issues of critical interest to the United States.

The European Community (EC) argued that the DISC was an illegal export subsidy because it allowed indefinite deferral of direct taxes on income from exports earned in the United States. The United States defended the DISC on the grounds that its effect on trade as an incentive for exports approximated the effect of the territorial system of taxation used by our European trading partners and found to be consistent with the GATT in the 1981 resolution. The majority of the GATT Council members urged the United States to bring the DISC clearly into conformity with the GATT. The EC went one step further to request authorization from the GATT Council to take retaliatory action against the United States. The EC alleged that the DISC had provided more than $2 billion in subsidies for U.S. exports to member countries of the EC over the previous 10 years. Also, other countries expressed an interest in receiving compensation for the DISC.

The DISC debate in the GATT Council highlighted the potential danger of a breakdown in the GATT dispute-settlement process, and the isolation of the United States over the DISC issue. To remove the DISC as a contentious issue and to avoid further disputes over retaliation, the United States made a commitment to the GATT Council on October 1, 1982, to propose legislation that would address the concerns of other GATT members. In March 1983, the Administration approved the general outlines of a proposal to replace the DISC with a territorial-type system of taxation for U.S. exports designed to comply with GATT.

The committee does not find the GATT arguments against DISC persuasive and believes the EC has made no credible showing of any injury resulting from DISC exports. Nonetheless, in the interest of resolving the GATT dispute over DISC and assisting the Administration in fulfilling its commitment to the GATT Council, the committee has favorably reported legislation that is consistent with the general outlines of the Administration's proposal. Under GATT rules, a country need not tax income from economic processes occurring outside its territory. Accordingly, the committee believes that certain income attributable to economic activities occurring outside the United States should be exempt from U.S. tax in order to afford U.S. exporters treatment comparable to what exporters customarily obtain in territorial systems of taxation. The committee intends that the activities related to that income will be undertaken by a foreign sales corporation outside the U.S. customs territory. A foreign tax credit will not be available with respect to such income; international double taxation is avoided by use of the exemption method. The committee intends that the bill will result in approximately the same revenue cost to the U.S. Treasury as the DISC.

The committee recognizes that this legislation will affect current DISCs in different ways, and that some DISCs may have difficulty meeting the foreign presence requirements of foreign sales corporations. Small business exemptions have been included to mitigate the effects of the new legislation on such entities. Nonetheless, the committee considers the foreign presence requirements of the legislation to be essential in responding to the GATT rules which form the background of this legislation.

Although it is aware that the EC has again raised questions about the GATT-compatibility of certain aspects of this proposal, the committee has reported this legislation based on its own assessment, and that of the Administration, that the legislation satisfies GATT rules. In light of the considerable effort required to replace the DISC and the new burdens placed on the U.S. exporters, the committee expects the Administration to vigorously defend this legislation against any GATT challenge and to inform the committee immediately of all GATT developments relating to this legislation.

C. Explanation of Provisions

1. Overview

The bill provides that a portion of the export income of an eligible foreign sales corporation (FSC) will be exempt from Federal income tax. It will also allow a domestic corporation a 100 percent dividends-received deduction for dividends distributed from the FSC out of earnings attributable to certain foreign trade income. Thus, there will be no corporate level tax imposed on a portion of the income from exports.

Under the GATT rules, an exemption from tax of export income is permitted only if the economic processes which give rise to the income take place outside the United States. In light of these rules, the bill provides that a FSC must have a foreign presence, it must have economic substance, and that activities that relate to the export income must be performed by the FSC outside the U.S. customs territory. Furthermore, the income of the foreign sales corporation must be determined according to transfer prices specified in the bill: either actual prices for sales between unrelated, independent parties or, if the sales are between related parties, formula prices which are intended to comply with GATT's requirement of arm's-length prices.

The bill provides that the accumulated tax-deferred income of existing DISCs will be deemed previously taxed income and, therefore, exempt from taxation.

The committee recognizes that small exporters may find it difficult to comply with certain of the foreign presence and economic activity requirements. The bill provides, therefore, two options to alleviate the burden of the foreign presence and economic activity requirements to eligible small businesses: the interest-charge DISC and the small FSC.

In general, where the provisions of the bill are identical or substantially similar to the DISC provisions under present law, the committee intends that rules comparable to the rules in regulations issued under those provisions will be applied to the FSC.

2. Foreign sales corporation generally

General rule

To qualify as a FSC, a foreign corporation must have adequate foreign presence. In order to determine whether a corporation has adequate foreign presence, the bill provides that the corporation must satisfy each of the following six requirements:

(1) A FSC must be a corporation created or organized under the laws of any foreign country (which meets certain requirements) or possession of the United States. In other words, the corporation must be formed under the laws of a jurisdiction outside U.S. customs territory. For purposes of this provision, a possession of the

United States includes Guam, American Samoa, the Commonwealth of the Northern Mariana Islands, and the Virgin Islands of the United States, but does not include Puerto Rico. If a FSC is organized in a foreign country, that country must be either (a) a party to an exchange of information agreement that meets the standards of the Caribbean Basin legislation (sec. 274(h)(6)(A)(i)), or (b) an income tax treaty partner of the United States if the Secretary of the Treasury certifies that the exchange of information program with that country under the treaty is satisfactory.

The committee is aware that exchange of information with certain countries, such as Switzerland, is limited because of restrictions of their domestic law. The committee is also aware that exchange of information programs may be ineffective if corporate stock may be issued in bearer share form. The committee expects that the Secretary of the Treasury will take such factors into account in determining whether to qualify a country under this provision.

A foreign entity classified as a corporation under section 7701(a)(3) (relating to the definition of "corporation") will be considered a corporation for purposes of this requirement.

(2) A FSC may have no more than 25 shareholders at any time during the taxable year. A member of the corporation's board of directors that holds qualifying shares required to be owned by a resident of the country under whose laws the FSC is organized will not be counted as a shareholder for this purpose.

(3) A FSC may not have any preferred stock outstanding during the taxable year. The committee intends that a FSC will be allowed to create more than one class of common stock for bona fide business purposes. However, one or more of the rights of a class of stock may be disregarded if the right has the effect of avoidance of Federal income tax. For instance, dividend rights may not be used to direct dividends from exempt foreign trade income to shareholders that have taxable income and to direct other dividends to shareholders that have net operating loss carryovers.

(4) A FSC must maintain an office located outside the United States, and maintain a set of the permanent books of account at such office. The committee intends that the office must constitute a "permanent establishment" under income tax treaty concepts to satisfy this requirement. More than one FSC may share an office, however. The office need not be located in the country in which the FSC is organized. The permanent books of account must include at least the quarterly income statements and a year-end balance sheet of the FSC. "United States" means the 50 States, the District of Columbia, and the Commonwealth of Puerto Rico.

In addition, a FSC must maintain at a location in the United States such books and records as are sufficient under Code section 6001 to establish the amount of gross income, deductions, credits or other matters required to be shown in the FSC's tax return.

(5) At all times during the taxable year, the FSC must have a board of directors which includes at least one individual who is not a resident of the United States. However, the nonresident member of the FSC's board of directors may be a citizen of the United States.

(6) A FSC may not be a member at any time during the taxable year of any controlled group of corporations of which a DISC is a member. (After December 31, 1984, the only DISCs will be "interest charge DISCs.")

Small FSC

A FSC may elect to be a small FSC with respect to a taxable year (and succeeding years) provided that it is not a member at any time during the taxable year of a controlled group of corporations which includes a FSC (unless the other FSC has also made a small FSC election).

3. Exempt foreign trade income

Under the bill, a portion of the foreign trade income of a FSC may be exempt from Federal income tax. To achieve this result, the exempt foreign trade income is treated as foreign source income which is not effectively connected with the conduct of a trade or business within the United States. The portion of foreign trade income that is treated as exempt foreign trade income depends on the pricing rule used to determine the amount of foreign trade income earned by the FSC. If the amount of income earned by the FSC is based on arm's-length pricing between unrelated parties, or between related parties under the rules of section 482, then exempt foreign trade income is 34 percent of the foreign trade income derived from a transaction. For this purpose, foreign trade income will not include any income attributable to patents and other intangibles which do not constitute export property. If the income earned by the FSC is determined under the special administrative pricing rules, then the exempt foreign trade income is 17/23 of the foreign trade income derived from the transaction.

Exempt foreign trade income is an exclusion from gross income of the FSC. Any deductions of the FSC properly apportioned and allocated to the foreign trade income derived by the FSC from a transaction will be allocated on a proportionate basis between exempt and nonexempt foreign trade income. Thus, deductions allocable to exempt foreign trade income may not be used to reduce the taxable income of the FSC.

4. Foreign trade income

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 or services exported by others.

Foreign trade income, other than exempt foreign trade income, (nonexempt foreign trade income), generally will be treated as income effectively connected with the conduct of a trade or business conducted through a permanent establishment within the United States. Furthermore, nonexempt foreign trade income, generally will be treated as derived from sources within the United States rather than as foreign source income. Thus, nonexempt foreign trade income generally will be taxed currently and treated as U.S. source income for purposes of the foreign tax credit limitation. If, however, nonexempt foreign trade income is earned in a transaction with an unrelated party or using a pricing method described in section 482 (sec. 923(a)(2) nonexempt income), the source and taxation of such income (including the creditability of a foreign tax with respect to such income) will be determined in the same manner as under present law. Nonexempt foreign trade income will be either 6/23 or 66 percent of foreign trade income, depending on the pricing method used in arriving at foreign trade income.

A FSC will generally not be allowed a foreign tax credit or a deduction for foreign income, war profits, or excess profits taxes paid or accrued with respect to exempt or nonexempt foreign trade income (other than sec. 923(a)(2) nonexempt income). Thus, it is intended that a shareholder of a FSC generally will not be eligible for a foreign tax credit with respect to a foreign withholding tax imposed on a dividend attributable to foreign trade income.

Two new categories of income will each be subject to separate foreign tax credit limitations (like DISC distributions under current law): (1) taxable income attributable to foreign trade income (at the FSC level), and (2) distributions from a FSC or former FSC out of earnings and profits attributable to foreign trade income (at the level of the shareholder). By virtue of these separate limitations, no increase in the FSC's foreign source income in the general "all other" category of a FSC or its shareholder would result from foreign trade income. (See also "Other definitions and special rules," below.)

5. Foreign trading gross receipts

In general

In general, foreign trading gross receipts will mean the gross receipts of a FSC which are attributable to the export of certain goods and services (similar to the qualified gross receipts of a DISC under present law). Except for certain receipts not included in foreign trading gross receipts, foreign trading gross receipts mean the gross receipts of any FSC that are attributable to:

(1) *The sale of export property.*—This generally means receipts from the sale, exchange, or other disposition by a FSC, or by any principal for whom the FSC acts as a commission agent, of export property, such as inventory produced in the United States which is sold "for direct use, consumption, or disposition outside the United States." (See Treas. Reg. sec. 1.993-1(b).)

(2) *The lease or rental of export property.*—Leases or rentals of export property by a FSC, or by any principal for whom the FSC acts as a commission agent, to unrelated persons using such property outside the United States will produce foreign trading gross receipts. (See Treas. Reg. sec. 1.993-1(c).)

(3) *Services related and subsidiary to the sale or lease of export property.*—Gross receipts from the performance of services which are related and subsidiary to the sale or lease of export property, for which the FSC, or a principal for whom the FSC acts as commission agent, receives foreign trading gross receipts also qualify as foreign trading gross receipts. (See Treas. Reg. sec. 1.993-1(d).)

(4) *Engineering and architectural services.*—Receipts from engineering or architectural services on foreign construction projects which are either located abroad or proposed for location abroad

qualify as foreign trading gross receipts. (See Treas. Reg. sec. 1.993-1(h).)

(5) *Export management services.*—Receipts for certain export management services provided for unrelated FSCs (or DISCs) to aid them in deriving export receipts will qualify as foreign trading gross receipts, whether or not the FSC performing the services is itself engaged in exporting. The Committee intends that managerial services will include activities relating to the operation of an unrelated FSC (or DISC) which derives foreign trading gross receipts from the sale or lease of export property. Management services will include, for example, activities such as preparing export market studies and contacting potential foreign purchasers. (See Treas. Reg. sec. 1.993-1(i) without regard to the 50-percent export receipts limitation.)

For the FSC to have foreign trading gross receipts, two additional requirements must be met—the foreign management and foreign economic process requirements. (These requirements do not apply to small FSCs, described below.) A FSC will be treated as having foreign trading gross receipts only if the management of the corporation during the taxable year takes place outside the United States, and only if certain economic processes with respect to particular transactions take place outside the United States. (The management test applies to functions of the FSC for the taxable year. In contrast, the economic process test generally applies to every transaction on a transaction-by-transaction basis. Certain groupings of transactions will be allowed, however, as described below.)

Foreign management

The requirement that the FSC be managed outside the United States will be treated as satisfied for a particular taxable year if (1) all meetings of the board of directors of the corporation and all meetings of the shareholders of the corporation are outside the United States, (2) the principal bank account of the corporation is maintained outside the United States at all times during the taxable year, and (3) all dividends, legal and accounting fees, and salaries of officers and members of the board of directors of the corporation paid during the taxable year are disbursed out of bank accounts of the corporation outside the United States.

Foreign economic processes

The foreign economic process requirements relate to the place where all or a portion of certain economic process activities are performed; the first requirement relates to the sales portion of the transaction, and the second requirement relates to the direct costs incurred by the FSC.[2] In all cases where a FSC or its agent must perform certain activities, the FSC may contract with its U.S. parent or with any other party, related or unrelated, to act as its agent.

[2] The administrative transfer pricing rules may be used to determine the transfer price of property purchased by a FSC from a related supplier (or to determine the FSC's commission by reference to such pricing rules) only if the FSC or its agent performs *all* of the economic process activities that are conducted in connection with the transaction.

Sales portion of the transaction

A FSC will not be considered to earn foreign trading gross receipts from a transaction unless the FSC, or a person under contract with the FSC, participates outside the United States in the solicitation (other than advertising), negotiation, or making of the contract relating to the transaction. This requirement will be satisfied if the FSC, or its agent, performs any one of the three activities with respect to a transaction outside the United States.

The sales requirement will be tested on a transaction-by-transaction basis. However, this requirement will be considered to have been met with respect to sales to a single customer during any taxable year if (1) the export property consists of either fungible products, or products which are substantially similar (i.e., enumerated in a product category of the *Standard Industrial Classification Manual* and for manufactured products, a seven-digit level in the Bureau of the Census, *Numerical List of Manufactured Products*); (2) the products are sold by the FSC (or its agent) under a single contract; (3) the contract has a term of one year or less which specifies the material terms of each such sale; and (4) if the FSC or its agent performs any one of the three activities once with respect to all such sales.

For purposes of this provision, "solicitation" refers to the communication (either by telephone, telegraph, mail, or in person) by the FSC, or its agent, to a specific, targeted, potential customer regarding a transaction. "Negotiation" includes any communication by the FSC, or its agent, to a customer or potential customer of the terms of sale, such as the price, credit, delivery, or other specification. The term "making of a contract" includes the performance by the FSC, or its agent, of any of the elements necessary to complete a sale such as making an offer or accepting the offer. In addition, the written confirmation by the FSC, or its agent, to the customer of an oral agreement which confirms variable contract terms or specifies (directly or by cross-reference) additional contract terms will be considered the "making of a contract." The FSC may act upon standing instructions from its principal. The location of a solicitation, negotiation, or making of the contract is determined by the place where the activity is initiated by the FSC, or its agent.

Direct cost tests

A FSC may not earn foreign trading gross receipts from a transaction unless the foreign direct costs incurred by the FSC attributable to the transaction equal or exceed 50 percent of the total direct costs incurred by the FSC with respect to the transaction (or the FSC meets an alternative 85-percent test, described below).

The term "total direct costs" means, with respect to any transaction, the total direct costs incurred by the FSC attributable to the activities relating to the disposition of export property (five categories of activities are considered). The activities are those performed at any location within or without the United States by the FSC or any person acting under contract with the FSC. The term "foreign direct costs" means the portion of the total direct costs incurred by the FSC which are attributable to activities performed outside the United States. Although the activities must be performed outside the United States, either the FSC or any person acting under contract with the FSC may perform the activities.

The requirement that the foreign direct costs incurred by the FSC equal or exceed 50 percent of the total direct costs incurred by the FSC attributable to a transaction may be met by an alternative 85-percent test. Under this alternative test, a corporation would be treated as satisfying the requirement that economic processes take place outside the United States if the foreign direct costs incurred by the FSC attributable to any two of the five activities relating to disposition of the export property equal or exceed 85 percent of the total direct costs of at least two of those five activities.

Only the direct costs paid or accrued by the FSC or its agent will be taken into consideration in meeting the direct cost test. It is not necessary to incur expenses in all categories to use either the 50-percent or the 85-percent tests. If no costs are incurred with respect to the activities in a category, that category will not be taken into account in meeting the requirement. The direct cost tests will be applied on a transaction-by-transaction basis or by alternative groupings based on product lines or recognized industry or trade usage. A different direct cost test may be used for different transactions or groupings, that is, the 50-percent test can be used in one transaction, while the 85-percent test can be used in another. Furthermore, the committee intends that, generally, a FSC will be allowed to group transactions differently for the various purposes for which grouping is permitted.

The committee recognizes that certain foreign military sales must be made through the United States Government typically to foreign governments. Accordingly, because of negotiation and other activities with the United States Government, many of the expenses incurred by the FSC in connection with such sales are incurred within the United States. The committee intends, therefore, that for purposes of the foreign presence and economic process tests such expenses (and the expenses of the United States Government in connection with the sale) will not be taken into account.

Categories of activities

The five categories of activities are as follows:

(1) *Advertising and sales promotion.*—This category includes two distinct activities, "advertising" and "sales promotion." "Advertising" is an appeal, related to a specific product or product line made through any medium and directed at all or a part of the general population of potential export customers. Advertising not related to a specific product or product line, such as the cost of corporate image building, is not included in the definition of advertising. Advertising primarily directed at customers in the United States will not be considered advertising for purposes of this section.

"Sales promotion" is an appeal made in person to a potential export customer for the sale of a specific product or product line made in the context of trade shows or annual customer meetings. The cost of trade shows and annual customer meetings shall be included in the total direct cost of sales promotion. However, the cost of trade shows and customer meetings will not include the cost of salaries and commissions of direct sales people, but will include payments to organizers or other persons hired for the event.

For determining foreign direct costs, the location of the advertising activity will be determined by the place where it is aired, displayed, published, or otherwise presented to the potential customer. With respect to broadcast media, such as radio or television, the location will be determined by the place to which the signal is transmitted. In the case of print media, the location will be determined by where the publication is distributed, not where it is printed. The location of trade promotion activity will be determined by where the customer meeting or trade show is held.

(2) *Processing customer orders and arranging for delivery.*—This category includes two separate activities: "processing customer orders" and "arranging for delivery." "Processing customer orders" means notifying the related supplier of the order and of the requirements for delivery of the export property.

"Arranging for delivery" means taking necessary steps to ship the export property to the customer in accordance with the requirements of the order, but does not include packaging, crating, and similar pre-transportation costs. The direct costs of "arranging for delivery" will not include shipping expenses. They will include the cost of salaries for clerks, telephone, telegraph, and documentation. Delivery can occur within or outside the United States. For example, a FSC will be considered to have arranged for delivery if the FSC or its agent contacted a trucking company and shipping line to provide transportation for a particular shipment from an interior point in the United States to Rotterdam where the buyer assumes title.

For example, in the case of certain property, where the normal industry practice is to make delivery at or near the place of manufacture of such property within the United States, a FSC will be considered to have arranged for delivery if the FSC or its agent notifies the buyer of the time and place of delivery.

(3) *Transportation.*—Transportation is the activity undertaken by the FSC or its agent for shipping the export property during the period it owns such property. If the FSC is acting as a commission agent, this transportation is the activity that is undertaken to ship the export property after the commission relationship begins, even if the relationship begins after the property leaves the U.S. customs territory.

Total direct costs of "transportation" will include expenses incurred by the FSC or its agent for transporting the export property. The FSC or its agent will not be considered to undertake transportation activity if the customer pays the cost of transportation directly.

The amount of total direct costs treated as foreign direct costs will be determined on the basis of the ratio of mileage outside the U.S. customers territory to total transportation mileage. For example, if 50 percent of the mileage associated with a particular shipment is outside the U.S. customs territory, 50 percent of the transportation expenses will be considered foreign direct costs. The cost of "arranging for delivery," defined above, is not included in the definition of total direct costs of transportation. With respect to fungible commodities, total direct costs will include only those transportation costs which are incurred after goods have been identified to a contract.

(4) *Determination and transmittal of a final invoice or statement of account and the receipt of payment.*—This category includes two separate activities: the "determination and transmittal" of the final invoice, and the "receipt of payment." "Determination and transmittal" means the assembly of the final invoice or statement of account and the forwarding of the document to the customer. The "final invoice" is the invoice upon which payment is made by the customer. An invoice transmitted after payment is made, as a receipt for payment, would satisfy this definition. The "statement of account" is any summary statement transmitted to a customer giving the status of transactions occurring within an accounting period that does not exceed one taxable year. A single final invoice or statement of account can cover more than one transaction with one customer.

The costs of office supplies, office equipment, clerical salaries, mail, etc., directly attributable to the assembly and transmittal of a final invoice or statement constitute direct costs for this activity. For example, the cost of assembling the final invoice at the FSC's foreign office and mailing it from that office to the customer would meet this definition. This activity does not include the engineering or cost accounting functions involved in the establishment of a price.

"Receipt of payment" means the crediting of the FSC's bank account by the amount of proceeds associated with the transaction. Initial payment may be received in the United States as long as the proceeds are transferred immediately to a bank account of the FSC outside the United States. The total direct costs for this activity include all the expenses incurred by the FSC for maintaining a bank account in which the payment is deposited.

(5) *Assumption of credit risk.*—This category of activity consists of bearing the economic risk of nonpayment with respect to a sale, lease, or contract for the performance of services. A FSC will be considered to bear such risk if it contractually bears such risk and if either a debt becomes uncollectible within the accounting period or an addition is made to the bad debt reserve of the FSC that is allowed as a deduction under present law (sec. 166). If a debt becomes uncollectible within the accounting period or an addition is made to the bad debt reserve of the FSC, the FSC must subtract from its foreign trade income the appropriate percentage of the FSC's (and related supplier's) bad debt expense. The appropriate percent is 34 percent for transactions in which no administrative pricing rule is used. If the FSC uses the combined taxable income pricing method for a transaction, the appropriate percentage is 23 percent. If the FSC uses the gross receipts pricing method for a transaction, the reduction must be an amount determined by multiplying the bad debt expense of the FSC and its related supplier by the ratio of the FSC's taxable income from the transaction (before exclusion of exempt foreign trade income and associated deductions) to the combined taxable income from the transaction. The combined bad debt expense upon which this adjustment is based must be related to foreign trading gross receipts.

In some circumstances, a taxpayer may not have any receivables that become uncollectible within the taxable year; even though the taxpayer is contractually assuming the risk of loss, there is no actual loss or bad debt expense. In such cases, the FSC will be considered to bear the risk of loss, only if it incurs an actual loss (or is allowed to deduct an addition to a bad debt reserve under present law) in at least one year within a three-year period. For example, if an FSC contractually assumes the risk of loss but incurs no bad debt expenses in the first two years of operations as a FSC, it cannot satisfy the assumption of credit risk activity in the third year unless it actually incurs a loss in that year. However, even if the FSC does not incur a loss in the third year, it would still be treated as having satisfied the assumption of credit test in the first two years. If the FSC then incurs a loss in the fourth year, it could use the credit test in the fourth, fifth and sixth years. When the FSC actually incurs a bad debt expense will be determined under present-law rules.

Burden of proof

The burden of proof with respect to the foreign management and economic process requirements will be shifted to the Secretary of the Treasury if a written statement addressing the issue has been filed by an officer of the corporation. The statement to be filed with the Secretary must be made by an officer of the FSC who is a citizen and resident of the United States, and must be made under penalty of perjury. Furthermore, the statement must declare that the corporation meets the economic process requirements and the foreign management requirements, and must specify how the requirements have been met for the particular transactions.

Excluded receipts

Certain receipts are not included in the definition of foreign trading gross receipts. The first category of excluded receipts are receipts excluded on the basis of use, subsidized receipts, and certain receipts from related parties. Examples of such receipts include the receipts of a FSC from a transaction (1) if the export property or services are for ultimate use in the United States, or are for use by the United States and the use by the United States is required by law or regulation; (2) if the transaction is accomplished by a subsidy granted by the United States; or (3) if the receipts are from another FSC which is a member of the same controlled group. Gross receipts from sales between related FSCs will be excluded from the definition of foreign trading gross receipts, however, sales between unrelated FSCs may qualify. The committee intends excluded receipts to be the same as excluded receipts under the present-law DISC rules, with the following two exceptions.

To provide rules that are comparable with the DISC rules for a deemed distribution of one-half of the DISC income attributable to military property, one-half of the receipts from military property is excluded from the definition of foreign trading gross receipts. "Military property" means any property which is an arm, ammunition or implement of war designated in the munitions list published pursuant to section 38 of the International Security Assistance and Arms Export Control Act of 1976.

Investment income and carrying charges are excluded from the definition of foreign trading gross receipts. Investment income includes dividends, interest, royalties, rents other than from the lease of export property for use outside the United States, gains from the sale or exchange of stocks or securities, and certain other passive income (see "Other definitions and special rules," below). Carrying charges include any amount in excess of the price for an immediate cash sale and any other unstated interest.

Income attributable to excluded receipts would not be foreign trade income and, therefore, no portion of such income would be exempt. Furthermore, a corporate shareholder would not get a dividends-received deduction for distributions attributable to such income. For example, investment income and carrying charges will be included in the taxable income of the FSC and, therefore, subject to full U.S. tax. Distributions to a corporate shareholder from earnings and profits attributable to the investment income and carrying charges will be fully taxed again (to the corporate shareholder) because there would be no dividends-received deduction. In other words, the investment income and carrying charges will be subject to tax at the FSC level, the corporate shareholder level and, like all other dividends from the corporate shareholder to its individual shareholders, also at the individual level. At the FSC level, investment income will be eligible for foreign tax credits.

6. Transfer pricing rules

The committee intends that the pricing principles that govern the determination of the taxable income of a FSC comply with the GATT rules. If export property is sold to a FSC by a related person (or a commission is paid by a related principal to a FSC with respect to export property), the taxable income of the FSC and related person is based upon a transfer price determined under an arm's-length pricing approach or under one of two formulae which are intended to approximate arm's-length pricing.

Conditions on use of administrative transfer pricing rules

In order to use the special administrative pricing rules, a FSC must perform significant economic functions with respect to the transaction. Accordingly, a FSC must meet two requirements. The first requirement is that all of the five activities ("economic process activities") with respect to which the direct costs are taken into account for the 50 percent foreign direct costs test must be performed by the FSC or by another person acting under contract with the FSC. These five activities are advertising and sales promotion, processing of customers orders and arranging for delivery of the property, transportation, billing and receipt of payment, and the assumption of credit risk. The second requirement for use of the administrative pricing rules is that all of the activities relating to the solicitation (other than advertising), negotiation, and making of the contract for the sale must be performed by the FSC (or by another person acting under contract with the FSC). These two requirements can be met wherever the activities are performed—the activities do not have to be performed outside the United States. It is only necessary that the activities be performed by the FSC or by another person acting under contract with the FSC.

Example:

The interaction of this condition for the use of the administrative pricing rule and the foreign economic process requirements may be illustrated as follows: P, a domestic corporation, owns all of the stock of S, a corporation organized under the laws of a foreign country that qualifies as a FSC for the taxable year. P manufactures product A, which it sells to S for resale to export customers. During S's taxable year, S sells 10 units of A to P, a foreign customer. The terms of sale are FOB P's plant in Seattle. P, acting as agent for S, performed all of the solicitation and negotiation activities with respect to the transaction with F. S accepted F's offer of purchase at its office in the foreign country. S incurred expenses of $90 for the cost of advertising, $85 of which was attributable to print advertising in the Asian editions of trade magazines. S also incurred $10 of direct costs for trade shows in the United States promoting sales of A to domestic and foreign customers, and $25 of direct costs (incurred outside the United States) in processing P's order. No costs are associated with arranging for the delivery of the transportation of the product because of the terms of sale. S incurred all of the credit costs associated with the transaction. S compensated P on an arm's-length basis for its services.

S will be allowed o use one of the two administrative pricing rules to determine its transfer price from P for the units of A sold in the transaction, because S or an agent of S performed all of the economic process activities with respect to the transaction. S will also satisfy the foreign economic process requirements with respect to the transaction because (i) S participated in making the contract outside of the United States, and (ii) 85 percent of S's direct costs for two of the five categories of activities subject to the direct cost tests (advertising and sales promotion and processing of customer orders and arranging for delivery) were attributable to activities occurring outside the United States. (S's direct costs include paymnts to P for services rendered.)

To summarize, to be treated as having foreign gross receipts and hence foreign trade income, the foreign costs of certain activities relating to the disposition of export property must be substantial (either 50 percent of the cost of all five activities or 85 percent of the cost of two of the activities). To use the administrative pricing rules, all five of the activities must be performed by the FSC or by another person acting under contract with the FSC. Furthermore, other activities (solicitation, negotiation, and making of the contract of sale) must be performed by the FSC or by another person acting under contract with the FSC.

Determination of transfer price

For purposes of applying the administrative pricing rules, combined taxable income is determined without regard to the exclusion of exempt foreign trade income. Taxable income may be based upon a transfer price that allows the FSC to derive taxable income attributable to the sale in an amount which does not exceed the greatest of (1) 1.83 percent of the foreign trading gross receipts derived from the sale of the property; (2) 23 percent of the combined taxable income of the FSC and the related person (these two pricing rules are termed the administrative pricing rules); or (3) taxable income based upon the actual sales price, but subject to the rules provided in section 482.

Example:

An example of the calculations to determine a transfer price using the section 482 method and the alternative administrative pricing method is as follows: A FSC purchases export property from a related supplier and sells the property for $1,000 of foreign trading gross receipts. The FSC incurs expenses attributable to the sale of $225. The related supplier's cost of goods sold attributable to the export property is $550. The related supplier's expense incurred in connection with the sale of the export property is $125. For purposes of this example, it is assumed that the related supplier has no other deductible expenses. It also is assumed that if the related supplier sold the export property to the FSC for $720, the price could be justified as satisfying the standards of section 482, which would allow the FSC to earn $55 on the sale. Under the facts assumed, the FSC may earn, under the more favorable of the two administrative pricing rules, a profit of $23 on the sale.

The FSC's taxable income and the transfer price to the FSC from the transaction, using the administrative pricing methods, and the FSC's taxable income if the transfer price is determined under section 482, would be as follows:

(a) *Combined taxable income:*	
FSC's foreign trading gross receipts	$1,000.00
Cost of goods sold of related supplier	(550.00)
Combined gross income	$450.00
Less expenses:	
Direct expenses of related supplier	$125.00
Direct expenses of FSC	225.00
Total expenses	$(350.00)
Combined taxable income	$100.00
(b) *FSC's taxable income and transfer price under combined taxable income method:*	
Transfer price to FSC	23.00
Sales price	1,000.00
Less:	
FSC expense	$(225.00)
FSC profit	(23.00)
Total	$(248.00)
Transfer price	$752.00
(c) *FSC's taxable income and transfer price under gross receipts method:*	
FSC taxable income—lesser of 1.83% of foreign trading gross receipts ($18.30) or two times amount in (b) above ($46.00)	$18.30

Transfer price to FSC:	
Sales price	1,000.00
Less:	
FSC expenses	$(225.00)
FSC profit	(18.30)
Total	$(243.30)
Transfer price	$756.70

(d) *FSC's taxable income under section 482:*

FSC profit:	
Sales price	$1,000.00
Less:	
FSC cost of goods sold	$720.00
FSC expenses	225.00
Total	$(945.00)
FSC profit	$55.00

Other transfer pricing matters

The same intercompany allocation to the FSC will be permitted whether the FSC takes title as principal or acts as a commission agent. The committee intends that the administrative pricing rules will be applied under rules which will prevent pricing at a loss to the related supplier. In this regard, the committee believes that the Secretary of the Treasury should consider whether the present regulations accomplish this purpose. The committee also intends that regulations allow the grouping of transactions and marginal costing. Under the administrative pricing rules, the transfer price from the related supplier to the FSC may be computed after the FSC sells the goods to a customer. Furthermore, the FSC and its related supplier may make adjustments upwards or downwards following the close of the taxable year in which the FSC sells the goods.

The transfer pricing rules only apply to determine the price of a sale to a FSC (or FSC commissions). A FSC, or a principal for which the FSC is acting as commission agent, must sell to a related purchaser on an arm's-length basis, under the provisions of section 482 of the Internal Revenue Code, viewing the FSC and any related supplier as a single entity which sells to the purchaser.

While the committee believes that it is appropriate to provide special FSC pricing rules for purposes of administrative convenience, it does not intend for such rules to be applied by the Internal Revenue Service or claimed by taxpayers in transactions not involving a FSC. The committee believes that the Internal Revenue Service should continue its efforts to improve the administration of the section 482 transfer pricing rules.

Taxation of the FSC

As described above, a FSC will not be subject to U.S. tax on exempt foreign trade income. The following example illustrates the determination of exempt foreign trade income using the three transfer pricing methods.

Example:

A FSC sells export property for $1,000 of foreign trading gross receipts. The FSC purchases the property from a related supplier. The FSC's cost of goods sold, based on the transfer prices derived in the previous example, would be $752 under the combined taxable income method, $756.70 under the gross receipts method, and $720 under section 482. The FSC incurs expenses attributable to the sale of $225.

The FSC's foreign trade income, exempt foreign trade income, and expenses properly apportioned and allocated to foreign trade income from the transaction, using the three transfer prices derived in the previous example, would be as follows:

(a) If the transfer price to the FSC was determined under the combined taxable income method:

Foreign trading gross receipts	$1,000.00
Cost of goods sold	(752.00)
Foreign trade income	$248.00
Exempt foreign trade income (17/23×$248)	$183.30
Expenses allocable to exempt foreign trade income (183.30/248×$225)	(166.30)
Taxable income of FSC not subject to U.S. tax ($183.30−$166.30)	$17.00

(b) If the transfer price to the FSC was determined under the gross receipts method:

Foreign trading gross receipts	$1,000.00
Less cost of goods sold	(756.70)
Foreign trade income	$243.30
Exempt foreign trade income (17/23×$243.30)	$179.83
Expenses allocable to exempt foreign trade income (179.83/243.30 × $225)	(166.30)
Taxable income of FSC not subject to U.S. tax ($179.83−$166.30)	$13.53

(c) If the transfer price to the FSC was determined under section 482:

Foreign trading gross receipts	$1,000.00
Less cost of goods sold	(720.00)
Foreign trade income	$280.00
Exempt foreign trade income (34%×$280)	$95.20

Expenses allocable to exempt foreign trade income (95.20/280 × $225)	(76.50)
Taxable income of FSC not subject to U.S. tax ($95.20 − $76.50)	$18.70

A FSC's nonexempt foreign trade income will be subject to U.S. tax unless it is determined without reference to an administrative pricing rule, in which case it will be taxed in the same manner and to the same extent as income earned by a foreign corporation that is not a FSC. Interest, dividends, royalties, other investment income and carrying charges will be subject to U.S. tax.

A FSC will not be allowed an investment tax credit or certain other credits. A foreign tax credit will not be allowed with respect to foreign taxes on foreign trade income (other than nonexempt foreign trade income determined without reference to an administrative pricing rule), but will be allowed with respect to other foreign taxes. Foreign trade income (other than nonexempt foreign trade income determined without reference to an administrative pricing rule) will be taken into account under a separate limitation for purposes of determining the foreign tax credit limitation of a FSC.

If a foreign corporation elects to be taxed as a FSC, it must waive any rights it could otherwise claim under a U.S. income tax treaty. Except as described above, a FSC will generally be subject to U.S. tax in the same manner and to the same extent as a foreign corporation that is not a FSC.

7. Distributions to shareholders

A FSC will not be required or deemed to make distributions to its shareholders. Actual distributions to shareholders must be made first out of foreign trade income; the FSC may have income that is not foreign trade income, for example, investment income. Distributions will be treated as being made first out of earnings and profits attributable to foreign trade income, and then out of any other earnings and profits. Any distribution made by a FSC which is made out of earnings and profits attributable to foreign trade income to a shareholder which is a foreign corporation or a nonresident alien individual will be treated as a distribution which is effectively connected with the conduct of the trade or business conducted through a permanent establishment of the shareholder within the United States, and as U.S.C source income. Thus, such distributions will be subject to Federal income tax.

Foreign trade income and investment income of a FSC will not be subject to the rules of subpart F. In addition, the Secretary of the Treasury is authorized to exclude property related to the export activities of the FSC from the subpart F rules relating to investments by controlled foreign corporations in U.S. property.

8. Dividends received from a FSC

A domestic corporation will generally be allowed a 100 percent dividends-received deduction for amounts distributed from a FSC out of earnings and profits attributable to foreign trade income. Thus, there will be no corporate level tax on exempt foreign trade income and only a single-level corporate tax (at the FSC level) on foreign trade income other than exempt foreign trade income. However, a 100 percent dividends-received deduction will not be allowed for nonexempt foreign trade income determined without reference to an administrative pricing rule (sec. 923(a)(2) nonexempt income) or a dividend received by a cooperative with respect to foreign trade income that is treated as exempt foreign trade income. The committee expects that FSC dividends attributable to foreign trade income will not be treated as foreign personal holding company income. This would correspond to the treatment of certain DISC dividends under present law.

Foreign taxes on FSC dividends attributable to foreign trade income (other than nonexempt foreign trade income determined without reference to an administrative pricing rule) will be treated as noncreditable foreign taxes. In addition, such dividend income will be taken into account for purposes of the foreign tax credit limitation under a separate limitation.

To the extent a corporate shareholder of a FSC distributes dividends attributable to foreign trade income to its individual shareholders, the amounts will be taxed. Likewise, distributions to a noncorporate shareholder of a FSC that are not attributable to foreign trade income will be subject to tax in the same manner as distributions from a foreign corporation that has not elected to be treated as a FSC.

A dividends-received deduction will not be allowed, however, for distributions attributable to other earnings and profits. These distributions will therefore be taxed currently to the shareholders, corporate or noncorporate, of the FSC.

9. Other definitions and special rules

Export property

In general, the term export property means property manufactured, produced, grown or extracted in the United States by a person other than a FSC, held primarily for sale, lease, or rental in the ordinary course of trade or business for direct use or consumption outside the United States, and not more than 50 percent of the fair market value of which is attributable to articles imported into the United States.

The committee intends that the destination test (whether "use, consumption, or disposition occurs outside the United States") will be considered satisfied if the FSC delivers the property to a carrier or freight forwarder for ultimate delivery, use, or consumption outside of the United States. This rule will apply without regard to (1) the F.O.B. point or place of passage of title, (2) whether the purchaser is a United States or foreign purchaser, or (3) whether the property is for use of the purchaser or for resale.

For purposes of this provision, the fair market value of any article imported into the United States will be its appraised value as determined by the Secretary under section 402 of the Tariff Act of 1930 (19 U.S.C. 1401a) in connection with its importation. The committee intends that the Secretary of the Treasury may prescribe regulations for the determination of foreign content of any product, without necessarily following current regulations. In considering this issue, the committee expects the Secretary will take into account the effect of any change on revenue, location of employment, and neutrality between similarly situated taxpayers.

The term export property does not include (1) property leased or rented by a FSC for use by any member of a controlled group of which the FSC is a member, (2) patents and other intangibles, (3) oil or gas (or any primary product) thereof, or (4) products the export of which is prohibited. Export property also excludes property designated by the President as being in short supply. Coal and uranium products, and other depletable products (other than oil and gas), specifically excluded from the definition of export property under the DISC rules will not be excluded under this bill, however.

Cooperatives

Agricultural products marketed through cooperatives are subject to special rules. First, the bill provides that for purposes of computing the foreign trade income of the FSC under the combined taxable income method, the combined taxable income of the cooperative and the FSC will be computed without taking into account patronage dividends and per-unit retain allocations, and certain deductions for nonpatronage distributions under section 1382. Thus, the cooperative will not be required to distribute the income attributable to exempt foreign trade income (generally 17/23 of foreign trade income) to benefit from the exemption from corporate level tax on this income. This special rule will only apply to the cooperative shareholder of the FSC and not to members or patrons of the cooperative that may be cooperatives themselves (higher tier cooperatives).

The second rule provides that the foreign trade income (other than exempt foreign trade income) will be treated as exempt income to the FSC, but only if such income is distributed currently to the cooperative shareholder. If such income is not distributed currently, it will be taxed at the FSC level. Distributions from the FSC to the cooperative shareholder that are attributable to foreign trade income treated as exempt foreign trade income will be includible in the taxable income of the cooperative (i.e., income eligible for distribution as a patronage dividend as defined in section 1388(a)(3)). Thus, the nonexempt foreign trade income (generally 6/23 of foreign trade income) will not be taxed at the FSC level, but instead will be generally taxed at the member or patron level. In other words, the nonexempt foreign trade income will be subject to a single level of tax (as is provided for cooperatives under subchapter T) as if the cooperative had exported directly rather than through a FSC. Distributions attributable to foreign trade income will be considered attributable first to nonexempt foreign trade income (even if such income is treated as exempt income).

The final rule provides that the cooperative shareholder of a FSC will not be allowed a dividends-received deduction for distributions from the FSC that are attributable to nonexempt foreign trade income. The bill provides this rule because although the nonexempt foreign trade income is treated at the FSC level as exempt in this case, the committee intends that this portion of the income be includible in the income of the members and patrons without the deferral accorded to exempt foreign trade income. Like other corporations, the cooperative will be allowed a dividends-received deduction for distributions attributable to exempt foreign trade income but not for distributions attributable to passive income.

The special rules for agricultural commodities marketed through cooperatives will be available only if the income of the cooperative eligible for FSC benefit is based on arm's-length transactions between such cooperative and its members or patrons. The committee intends that this rule should prevent the cooperative and its members or patrons from getting additional FSC benefits from transfer prices that do not reflect the fair market value of the property sold to or through the cooperative by its members or patrons.

Gross receipts

In general, the term gross receipts means the total receipts from the sale, lease, or rental of property held primarily for sale, lease, or rental in the ordinary course of a trade or business, and gross income from all other sources.

In the case of commissions on the sale, lease, or rental of property, the amount taken into account for purposes of these provisions as gross receipts will be the gross receipts on the sale, lease, or rental of the property on which the commissions arose.

Investment income

For purposes of these provisions, the term investment income means dividends, interest, royalties, annuities, rents (other than rents from the lease or rental of export property for use by the lessee outside the United States), gains from the sale or exchange of stock or securities, gains from futures transactions in any commodity, amounts includible in computing the taxable income of the corporation under the estate and trust rules, and gains from the sale or disposition of any interest in an estate or trust.

Grouping of transactions

Many of the tests required under the foreign management and economic processes requirement will be applied on a transaction-by-transaction basis. However, the committee intends that regulations could provide that transactions may be grouped based upon product lines or recognized industry or trade usage. The regulations could permit different groupings for different purposes. Such flexibility may be important when grouping transactions for purposes of the direct-cost test, for example.

Controlled group of corporations

A controlled group of corporations is defined as in section 1563(a) except that a more than 50 percent ownership test is substituted for the "at least 80 percent" test, and section 1563(b) does not apply.

Other affiliated entities

Under the bill, Webb-Pomerene export organizations may be shareholders of a FSC. Members of a Webb-Pomerene organization will be allowed to sell products through a FSC to the Webb-Pomerene organization and, thus, benefit from the FSC provisions as well as the special provisions under the 1918 Webb-Pomerene Export Trade Act.

Foreign tax credit limitation of related parties

The bill provides a special rule governing the source of income earned by a person related (within the meaning of sec. 482) to a FSC from transactions giving rise to foreign trading gross receipts of a FSC. That related person's foreign source income from such a transaction may not exceed the amount which would be treated as foreign source income earned by that person if the analogous DISC pricing rule applied. For this purpose, the DISC gross receipts pricing rule of Code section 994(a)(1) is analogous to the bill's gross receipts pricing rule in proposed section 925(a)(1); the DISC combined taxable income pricing rule of Code section 994(a)(2) is analogous to the bill's combined taxable income pricing rule in proposed section 925(a)(2); and the DISC section 482 pricing rule of Code section 994(a)(3) is analogous to the bill's section 482 pricing rule in proposed section 925(a)(3).

The committee intends that this special rule governing the source of income, and thus the foreign tax credit limitation of parties related to a FSC, result in foreign source income that is comparable to the foreign source income on the same transaction under present law.

This special rule governing the source of income and thus the foreign tax credit limitation of parties related to a FSC is necessary to prevent revenue loss. The table below illustrates the application of the bill (absent this special rule) to a FSC's parent with excess foreign tax credits that exports by selling to its FSC. The table presupposes that the 50 percent of the parent's income from the export sale is foreign source income (as might be the case under Code sec. 863(b) absent the bill's special rule). It presupposes that the parent has sufficient excess foreign tax credits to offset U.S. tax on all the foreign source income from the export sale. It also presupposes that the export sale is subject to the bill's combined taxable income (CTI) rule (proposed section 925(a)(2)).

FSC—77/23 Split of CTI Absent Resourcing Rule

(Exporter With Excess Foreign Tax Credits)

Parent		*FSC*	
U.S. source (taxable)	$38.50	Exempt	$17
Foreign source (exempt)	38.50	Taxable	6
	$77.00		$23

Taxable:	
U.S. source income of parent	$38.50
Taxable income of FSC	6.00
	$44.50

Exempt:	
Foreign source income of parent	$38.50
Exempt in FSC	17.00
	$55.50

Under current law, the parent's share of combined taxable income is $50 (as illustrated in the table in the Present Law section). The parent's foreign source income might be $25 under present law. Exemption of $55.50 under the bill (absent the special rule) would exceed the combination of exemption and deferral of $42 for a parent of a DISC with excess credits under current law (with a 17 percent deferral rate).[1] To maintain parity with DISC, the bill would reduce the foreign source income of the parent in the example above from $38.50 to $25, which would result in an exemption of $42 (comparable to present law). The parent's U.S. source income would increase, under the special rule of the bill, from $38.50 to $52. The following table illustrates the effect of the bill's resourcing rule.

FSC—77/23 SPLIT OF CTI WITH RESOURCING RULE

(Exporter With Excess Foreign Tax Credits)

Parent		*FSC*	
U.S. source (taxable)	$52	Exempt	$17
Foreign source (exempt)	25	ECI	6
	$77		$23

Taxable:	
U.S. source income of parent	$52
ECI of FSC	6
	$58

Exempt:	
Foreign source income of parent	$25
Exempt in FSC	17
	$42

[1] In the Present Law section of this report, the taxpayer with excess credits was taxable on $58: $25 of U.S. source income plus a $33 deemed DISC distribution, but paid no tax on $25 of foreign source income or on $17 deferred in the DISC.

Participation in international boycotts

The exempt foreign trade income of a FSC will be limited if the FSC participates in or cooperates with international boycotts (as defined in sec. 999(b)(3)) and to the extent that any illegal bribe, kickback, or other payment is made to an official employee or agent of a government. Regulations may provide rules similar to those that apply to the deemed distributions of a DISC under section 995(b)(1)(F).

Other

The bill provides that no tax may be imposed on foreign trade income by any possession of the United States. In addition, to the extent provided in regulations, property that is otherwise U.S. property which is held by a FSC and which is related to the export activities of the FSC, will not be treated as an investment in U.S. property (under sec. 956).

Election

A corporation may elect to be treated as a FSC, or a small FSC, for a taxable year at any time during the 90-day period immediately preceding the beginning of the taxable year. The committee intends that a newly formed corporation will be permitted to make an election on or before the 90th day after the beginning of its first taxable year. The bill provides that the Secretary of the Treasury has authority to consent to the making of an election at other designated times. The election must be made in a manner prescribed by the Secretary. The election will be valid only if all shareholders as of the first day of the first taxable year for which the election is effective consent in writing to the election. Once an election is made, it will, unless revoked by the corporation, continue in effect for subsequent years in which the corporation qualifies to be a FSC, unless the corporation fails for five consecutive years to qualify as a FSC (e.g., because of a failure to maintain a foreign office or to have a director that is not resident in the United States).

An election to be treated as a FSC may be revoked by the corporation any time after the first taxable year it is in effect. To be effective for a given taxable year, however, the revocation must be made on or before the 90th day of that year. A revocation made after the expiration of the 90-day period will not be effective until the following taxable year. A properly made revocation relating to a taxable year of the FSC is effective beginning the first day of that year. If the corporation fails to qualify as a FSC for a period of five consecutive taxable years, the FSC election will terminate automatically. A corporation whose FSC election has been terminated may again elect to be a FSC.

10. Small businesses

In order to provide relief for small businesses who may find the foreign presence and economic activity burdensome, the bill provides two alternatives to the FSC: the interest charge DISC and the small FSC.

Interest charge DISC

A DISC may continue to defer income attributable to $10 million or less of qualified export receipts. Deemed distributions relating to base period exports (the incremental rule) and to one-half of the DISC's income will be eliminated; thus, substantially all of the DISC's income attributable to $10 million or less of qualified export receipts may be deferred. However, unlike the present-law DISC, an interest charge will be imposed on the shareholders of the DISC. The amount of the interest will be based on the tax otherwise due on the deferred income computed as if the income were distributed. The interest rate will be tied to the T-bill rate.

The tax that would otherwise be due on the deferred income, termed the shareholder's DISC-related deferred tax liability, means, with respect to the year of the shareholder, the excess of the tax liability for the year computed as if the deferred DISC income were included in income over the actual tax liability for the year. This amount will be computed without regard to carrybacks to such taxable year. The Secretary of the Treasury is directed to prescribe regulations to provide any adjustments necessary or appropriate in the case of net operating losses, credits, and carryovers.

Deferred DISC income generally means the excess of accumulated DISC income at the beginning of the taxable year over the amount by which actual distributions out of accumulated DISC income exceed the current year's DISC income (termed distributions-in-excess-of-income). For shareholders of the DISC whose taxable year is different from that of the DISC, deferred DISC income is measured from the computation year; with respect to any taxable year of the shareholder, the computation year is the taxable year of the DISC which ends within the shareholder's preceding taxable year.

The rate of interest imposed on the shareholder's DISC-related deferred tax liability is determined by reference to a base period T-bill rate; this would mean the annual rate of interest that is equivalent to the average investment yield of U.S. T-bills with maturities of 52 weeks which were auctioned during the one-year period ending on September 30 of the calendar year ending with the close of the taxable year of the shareholder. The Secretary of the Treasury will be expected to publish this rate in October of each year. The interest a taxpayer is required to pay under this provision would be due at the same time the shareholder's regular tax is required to be paid.

Taxable income of the DISC attributable to qualified export receipts that exceed $10 million will be deemed distributed. Thus, if export receipts exceed $10 million, the DISC would not be disqualified; there would merely be no deferral of income attributable to the excess receipts. DISCs which are members of the same controlled group would be treated as a single corporation for purposes of the $10 million-rule.

Small FSC

A FSC that elects to be a small FSC need not meet the foreign management and foreign economic process requirements in order to have foreign trading gross receipts. However, in determining the exempt foreign trade income of a small FSC, any foreign trading gross receipts that exceed $5 million will not be taken into account. No exception to the requirements for use of the administrative pricing rules is provided for small FSCs. Because these activities may be performed by the FSC or by another person acting under a contract with the FSC and need not be performed outside the United States, the committee expects that this may not be as onerous a requirement to small exporters as the foreign management and economic process requirements might be.

Small FSCs which are members of the same controlled group will be treated as a single corporation. Regulations will prescribe how the $5 million gross receipts limitation will be allocated among members of a controlled group.

If the foreign trading gross receipts of a small FSC exceed the $5 million limitation, the corporation may select the gross receipts to which the limitation is allocated. This provision will allow a taxpayer to choose, for example, to allocate the limitation to gross receipts attributable to transactions where the profit margin is high; in this case, the amount of exempt income would be greater than if the limitation were allocated to low-margin transactions.

11. Taxable year of DISC and FSC

The taxable year of any DISC or FSC will be required to conform to the taxable year of the majority shareholder (or other group of shareholders with the same taxable year) as determined by voting power. Voting power will be determined on the basis of the total combined voting power of all classes of stock of the corporation entitled to vote. Special rules are provided where more than one shareholder or shareholder groups have the highest percentage of voting power. In cases where there are subsequent changes of ownership, the Secretary is directed to prescribe regulations under which these rules will apply only if there is a substantial change of ownership.

12. Transition rules

The taxable year of any DISC which begins before January 1, 1985 and which would otherwise include January 1, 1985, will close on December 31, 1984. To the extent that any underpayment of estimated tax is created or increased by this provision, no penalty will be imposed. The qualified assets test (under sec. 992(a)(1)(B)) will not apply to any taxable year ending on December 31, 1984.

Accumulated DISC income

Accumulated DISC income which is derived before January 1, 1985, will be exempt from tax. This result is achieved by treating such income as previously taxed income.

Export Trade Corporations

Export Trade Corporations (ETCs) may elect to discontinue operating as ETCs or elect to be a FSC. If an ETC so elects before January 1, 1985, the previously untaxed income attributable to earnings derived before January 1, 1985, will be treated as previously taxed income.

ETCs that do not elect to discontinue operating under the ETC rules may continue to operate as ETCs. However, in this case no portion of the untaxed income of the ETC will be treated as previously taxed income under the provisions of this bill.

Distributions

To alleviate the hardship that may result from deemed distributions to a shareholder of a DISC that would otherwise be recognized in income in a later year by the shareholder, a special rule provides for a spread of such income over four years. Deemed distributions from a DISC attributable to income derived by the DISC in the taxable year of the DISC which begins in 1984 after the date in 1984 on which the taxable year of the shareholder begins will be treated as received by the shareholder in four equal installments; the installments will be treated as received on the last day of each of the four taxable years of the shareholder which begins after the shareholder's taxable year beginning in 1984.

For example, a DISC's taxable year ends January 31 and the corporate shareholder of the DISC is a calendar year taxpayer. In 1984, the corporate shareholder will include in income the deemed distributions from the DISC for the DISC's year ending on January 31, 1984 and, under the bill (absent the four-year spread), the deemed distributions for the 11-month taxable year ending on December 31, 1985. Almost two years of deemed distributions will be includible in income in 1984. Under the bill, the deemed distributions for the 11-month period ending December 31, 1984, will be spread over a four-year period and includible in the income of the shareholder in 4 equal installments: on December 31 of 1984, 1985, 1986, and 1987.

Long-term contracts

The bill provides a transitional rule for taxpayers using the completed contract method of accounting. The transitional rule will apply if a taxpayer (1) has, on March 15, 1984, and at all times thereafter a firm plan, evidenced in writing, to enter into a contract, and (2) enters into a binding contract by December 31, 1984. The transitional rule provides that the taxpayer will be treated as having satisfied the foreign presence tests for periods before and the economic process tests with respect to costs incurred before December 31, 1984, with respect to such transactions. The income from the long-term contract will be treated as FSC income when recognized, provided the general FSC requirements are satisfied after December 31, 1984.

The bill also provides a transition rule for taxpayers with long-term contracts who do not use the completed contract method of accounting. The transitional rule will apply if a taxpayer enters into a binding contract before March 15, 1984. The rule provides with respect to such transactions that the taxpayer will be treated as having satisfied the foreign presence tests for periods before and the economic process tests with respect to costs incurred before December 31, 1984. This rule will apply only to income attributable to such contracts that is recognized before December 31, 1986.

Finally, a transition rule is provided for transactions undertaken pursuant to contracts entered into by a taxpayer on or before December 31, 1984, that are performed, or with respect to which all consideration is includible in income, before the end of the first taxable year of the FSC ending after January 1, 1985. Under this rule, a taxpayer will be treated as having satisfied the foreign presence tests for periods before and the economic process tests with respect to costs incurred before December 31, 1984, with respect to such transactions.

13. Transfers from DISC to FSC

Except to the extent provided in regulations to be prescribed, section 367 (which taxes some transfers of appreciated assets to foreign corporations) will not apply to transfers made generally before January 1, 1986 to a FSC of qualified export assets held on August 4, 1983, by a DISC in a transaction to which section 351 or 368(a)(1) apply.

D. Effective Date

These provisions will generally apply to transactions after December 31, 1984, in taxable years ending after such date.

E. Revenue Effect

This provision will decrease fiscal year budget receipts by $43 million in 1985, $33 million in 1986; increase receipts by $36 million in 1987, and $88 million in 1988; and decrease receipts by $98 million in 1989.

TITLE VI—HIGHWAY REVENUE PROVISIONS

A. Reduction in Heavy Vehicle Use Tax and Increase in Diesel Fuel Tax (secs. 601-603 and 611 of the bill and secs. 4041, 4481, 6427 and 9503 of the Code)

Present Law

Heavy vehicle use tax

In general

An annual excise tax is imposed on the use on the public highways of any highway motor vehicle whose taxable gross weight exceeds a prescribed minimum weight. The term "taxable gross weight" means the sum of (1) the unloaded weight of the vehicle when fully equipped for service; (2) the unloaded weight of semitrailers and trailers, when fully equipped for service, which are customarily used in connection with vehicles of the same type; and (3) the weight of the maximum load customarily carried on vehicles, semitrailers, and trailers of the same type.

Exemptions are provided for uses by State and local governments and the United States. In addition, the use of private transit buses for which certain fare requirements are met is exempt.

The taxable period for the highway use tax is generally the one-year period beginning on July 1. The amount of tax is prorated when the first use of the vehicle during the taxable period occurs later than the first month of the period. Payment in quarterly installments is permitted. The tax is paid by the person in whose name the vehicle is registered. Beginning in fiscal year 1985, up to 25 percent of Federal Interstate highway funds could be withheld from a State which fails to require proof of use tax filing before registering vehicles.

Rate of tax

For uses occurring before July 1, 1984, the annual rate of tax is $3 per 1,000 pounds of taxable gross weight or fraction thereof. However, the use of vehicles whose taxable gross weight is 26,000 pounds or less is exempt.

For uses occurring after June 30, 1984, the rate of tax is graduated according to taxable gross weight:

SCHEDULE OF HIGHWAY USE TAX, JULY 1, 1984 AND AFTER

Taxable gross weight		Rate of tax
At least:	But less than:	
33,000 pounds	55,000 pounds	$50 per year, plus $25 for each 1,000 pounds or fraction thereof in excess of 33,000 pounds.
55,000 pounds	80,000 pounds	$600 per year, plus the applicable rate for each 1,000 pounds or fraction thereof in excess of 55,000 pounds.
80,000 pounds or more.		The maximum amount.

The applicable rate and maximum amount are as follows:

Taxable period beginning on July 1, of	Applicable rate	Maximum amount
1984	$40	$1,600
1985	$40	$1,600
1986	$44	$1,700
1987	$48	$1,800
1988 or thereafter	$52	$1,900

This schedule applies with a one-year delay in the case of a person (a small owner-operator) who owns and operates no more than 5 taxable vehicles during a taxable period. The tax expires on October 1, 1988, and the amount of tax for the taxable period beginning on July 1, 1988, is prorated accordingly, as one-fourth of the annual tax.

Two additional rules are generally effective as of July 1, 1984. First, a vehicle that travels fewer than 5,000 miles on the public highways during a taxable period is exempt from the use tax, regardless of its taxable gross weight. Second, a credit or refund is allowed on a pro rata basis, if a vehicle on which the use tax has been paid is retired from service because of theft, accident or other casualty. Under present law, these additional rules are effective as of July 1, 1985, for small owner-operators.

Amounts equivalent to the taxes received in the Treasury from the heavy vehicle use tax are appropriated to the Highway Trust Fund.

Diesel fuel tax for highway vehicles

Present law imposes a 9-cents-per-gallon excise tax on the sale of diesel fuel for use in a highway vehicle. The tax terminates on October 1, 1988.

A number of exemptions are provided from the entire 9-cents-per-gallon tax. Other uses of diesel fuel are exempt from only a portion of the tax. The following table summarizes the exemptions and amount of each exemption.

EXEMPTIONS FROM TAX ON DIESEL FUEL

Exemption	Amount of exemption
Alcohol fuels mixture	5 cents/gal.
Intercity, school, and local buses	9 cents/gal.
Qualified taxicabs (through Sept. 30, 1984)	4 cents/gal.
State and local governments	9 cents/gal.
Nonprofit educational institutions	9 cents/gal.
Farming use	9 cents/gal.
Off-highway business use	9 cents/gal.
Certain aircraft museums	9 cents/gal.
Export	9 cents/gal.

Amounts equivalent to the taxes received in the Treasury from the diesel fuel tax are appropriated to the Highway Trust Fund. One-ninth of these amounts (currently, 1 cent per gallon of the 9-cents-per-gallon tax) is designated for the Mass Transit Account in the Highway Trust Fund.

Reasons for Change

The committee believes that highway excise taxes should be restructured to reduce the scope and magnitude of the heavy vehicle use tax. Taxpayers have objected that the higher rates scheduled to take effect this year will impose a large tax that is not necessarily related to the amount of business they may do, and that an alternative form of highway excise taxation should be devised which is more definitely correlated with use. The committee generally agrees with this position.

However, the committee does not believe that the heavy vehicle use tax should be eliminated. One objective of highway excise taxation is to impose taxes on highway users that are proportionate to the public highway costs which are allocable to their respective uses. These costs generally depend not only on mileage but also on vehicle weight. Reliance on taxes that correlate only with mileage cannot satisfy the objective of cost allocation. Thus. the committee decided to retain so much of a heavy vehicle use tax that increases with vehicle weight as is necessary (when taken in combination with modifications to the diesel fuel tax) to approximately maintain the present law relation between highway taxes and allocable costs for various types of highway vehicles.

Finally, the committee decided that the combined effects of modifications to the highway use and diesel fuel taxes should not result in any significant change in Highway Trust Fund receipts over the scheduled duration of these taxes.

Explanation of Provisions

1. Highway vehicle use tax

The bill modifies the heavy vehicle use tax in three major respects, for uses occurring after June 30, 1984.

First, the bill raises the threshold level at which vehicles become subject to the tax from 33,000 to 55,000 pounds of taxable gross weight.

Second, the bill restructures the rate of tax. In general, the rate of tax on vehicles whose taxable gross weight is at least 55,000 pounds is modified to $75 per year, plus $21 per 1,000 pounds of taxable gross weight (or fraction thereof) in excess of 55,000 pounds. The bill provides that the maximum rate of tax, applicable to vehicles with taxable gross weight over 80,000 pounds, is $600 per year. A special rule is provided for small owner-operators for the taxable period beginning July 1, 1984, according to which the rate of tax is $3 per 1,000 pounds of taxable gross weight for vehicles whose taxable gross weight is 55,000 pounds or more. However, if this special rule would produce a greater use tax on a small owner-operator's vehicle than does the general rate of use tax, then the general rate of tax applies to that vehicle for the taxable period beginning July 1, 1984. The general rate of tax provided by the bill, which applies to persons other than small owner-operators beginning July 1, 1984, applies to small owner-operators beginning July 1, 1985.

Third, the bill makes the 5,000-mile exemption and proration for theft or casualty available to small owner-operators beginning July 1, 1984, the same day on which these rules apply to persons other than small owner-operators under present law.

In addition, the bill provides that the rate of tax on vehicles used exclusively to haul harvested forested products from the forested site and registered under State law as used for that purpose will be one-half the rate otherwise imposed. The bill also requires the Secretary of Transportation (in consultation with the Secretary of the Treasury) to study the effects of the use tax on trans-border trucking operations, and to submit a report thereon within 1 year after the date of enactment to the tax-writing committees of Congress.

2. Diesel fuel tax for highway vehicles

The bill increases the excise tax on diesel fuel to 15 cents per gallon. Present law exemptions from the entire amount of tax will be increased from 9 cents a gallon to 15 cents a gallon. The exemption for alcohol fuels mixtures, as amended by section 614 of the bill, will be 6 cents a gallon. The exemption for certain taxicabs, as extended by section 612 of the bill, will continue at 4 cents a gallon.

The committee intends that the additional 6-cents-a-gallon tax (the diesel differential) will not ultimately be borne by purchasers of taxable diesel fuel used in vehicles of 10,000 pounds or less.

Therefore, the bill provides for a rebate of the diesel differential paid with respect to taxable fuel used in such vehicles. This rebate will generally be claimed annually on income tax forms. In the case of a person exempt from income tax, but subject to the diesel fuel tax, the rebate will be effected by a direct claim filed with the Internal Revenue Service. Rebates will not be available with respect to diesel fuel that is not subject to the diesel fuel tax. Rebates will be payable out of the Highway Trust Fund.

To maintain the currently effective designation of amounts to the Mass Transit Account, the bill provides that 1 cent per gallon of the 15-cents-per-gallon tax is designated to that account.

Effective Dates

The amendments to the heavy vehicle use tax and the diesel fuel tax are effective on July 1, 1984. The bill retains October 1, 1988, as the scheduled date of termination of those taxes.

The committee intends that any retail dealer who, on the effective date of the increased diesel fuel tax, holds diesel fuel on which tax has been paid at a rate of 9 cents a gallon shall pay an additional tax equal to 6 cents a gallon on such fuel.

Revenue Effect

The estimated effect of the provisions on net budget receipts is shown in the following table.

[In millions of dollars]

	Fiscal year					
	1984	1985	1986	1987	1988	1989
Highway use tax	−245	−562	−635	−696	−603	....
Diesel fuel tax	143	687	643	645	649	−66
Net effect	−102	125	8	−51	46	−66

B. One-year Extension of Refund of Taxes on Fuels Used in Qualified Taxicabs (sec. 612 of the bill and sec. 6427 of the Code)

Present Law

Present law imposes excise taxes on the sale of gasoline, diesel fuel, and special motor fuels used in highway motor vehicles. The rate of tax in each case is 9 cents a gallon.

A partial exemption from the motor fuels taxes is provided for fuel used in certain taxicabs. The amount of the exemption is 4 cents a gallon. Exemption is accomplished by a refund (without interest) paid by the Secretary to the ultimate purchaser of the fuel. To qualify for this refund, the taxicab must be operated by a licensed person who is not prohibited by company policy from furnishing shared transportation and generally must not be of a type that has below-average fuel economy. This partial exemption is scheduled to expire on October 1, 1984.

Reasons for Change

The committee believes that additional time is needed to assess the effectiveness of the exemption in promoting energy savings through shared transportation and to determine whether any adjustment of the exemption is needed.

Explanation of Provision

The bill extends for one year the present 4-cents-per-gallon exemption for fuels used in certain taxicabs. Thus, the exemption will expire on October 1, 1985.

The bill directs the Secretary of the Treasury to conduct a study of the effectiveness of this exemption, and to report with recommendations thereon to Congress before January 2, 1985.

Effective Date

The extension of the partial fuels tax exemption for qualified taxicabs will become effective on the date of enactment.

Revenue Effect

The provision will reduce fiscal year budget receipts by $2 million in 1985, and by a negligible amount in 1986.

C. Increase in Excise Tax Exemption for Alcohol Fuels Mixtures and Alcohol Fuels; Alcohol Fuels Credit; and Duty on Imported Alcohol Fuels (secs. 613 and 614 of the bill and secs. 44E, 4041, 4081, and 6427 of the Code, and Item 901.50 of the Tariff Schedules of the United States (19 U.S.C. 1202))

Present Law

Excise tax exemptions for alcohol fuels mixtures and alcohol fuels

Alcohol fuels mixtures

Present law provides a 5-cents-per-gallon exemption from the excise taxes on gasoline, diesel fuel, and special motor fuels for fuels consisting of mixtures of either of those fuels with at least 10 percent alcohol (secs. 4041, 4081, and 6427). The term alcohol is defined to include only alcohol derived from a source other than petroleum, natural gas, or coal. This "gasohol" exemption is computed by treating the alcohol fuels mixture as if it were gasoline or the other taxable fuel. The exemption does not apply to any sale or use after December 31, 1992.

Alcohol fuels

Present law provides a 9-cents-per-gallon exemption from the excise tax on special motor fuels for certain "neat" methanol and ethanol fuels (sec. 4041). The exemption applies to alcohol fuels, comprised of at least 85 percent methanol, ethanol, or other alcohol. The exemption does not apply to such alcohol fuel derived from petroleum or natural gas. This exemption expires on October 1, 1988.

Alcohol fuels credit

Present law allows an income tax credit for alcohol used in certain mixtures of alcohol and gasoline, diesel fuel, or any special motor fuel (e.g., gasohol) if the mixture is sold by the producer for use as a fuel or is so used by the producer (sec. 44E). The credit is equal to 50 cents for each gallon of alcohol used in a qualified mixture. The credit is available only if the sale or use is in a trade or business of the person claiming the credit.

The 50-cents-per-gallon credit is also permitted for alcohol, other than alcohol mixed with gasoline, diesel fuel, or any special motor fuel (e.g., methanol fuel), which is used by the taxpayer as fuel in a trade or business or is sold at retail by the taxpayer and placed in the fuel tank of the purchaser's vehicle.

The amount of any person's allowable alcohol fuels credit is reduced to take into account any benefit received with respect to the alcohol under the excise tax exemptions for alcohol fuels mixtures or alcohol fuels.

For purposes of the credit, the term alcohol includes methanol and ethanol, but does not include alcohol produced from petroleum, natural gas, or coal, or alcohol with a proof less than 150.

Duty on imported alcohol fuels

Present law imposes a duty equal to 50 cents per gallon on alcohol imported into the United States for use as a fuel (19 U.S.C. 1202).

Reasons for Change

The committee believes that tax incentives for alternative fuels are required at a higher level because recent declines in gasoline prices make it more difficult to develop a viable alcohol fuels industry in the United States. Providing an increased incentive for development of such an industry is consistent with the national policy of promoting energy self-sufficiency through encouragement of alternative fuels. The committee further anticipates that the increase in the Federal incentive will encourage States to repeal or reduce the varying levels of incentive for alcohol fuels presently provided by them.

Explanation of Provisions

1. Excise tax exemptions for alcohol fuels mixtures and alcohol fuels

Alcohol fuels mixtures

The bill increases the excise tax exemption for alcohol fuels mixtures (e.g., gasohol) to 6 cents per gallon. An additional amendment is made to clarify that alcohol derived from peat is to be treated as derived from coal in determining availability of this exemption for alcohol fuels mixtures.

Alcohol fuels

The bill retains the present 9-cents-per-gallon exemption for alcohol fuels (e.g., methanol fuels) derived other than from petroleum or natural gas. The bill also provides a new 4½-cents-per-gallon exemption for such fuels derived from natural gas. Otherwise qualified alcohol fuels that are derived from petroleum will continue to be subject to the full 9-cents-per-gallon excise tax on special motor fuels.

2. Alcohol fuels credit

The bill increases the alcohol fuels credit to 60 cents per gallon. The bill further clarifies that alcohol produced from peat is deemed to be produced from coal; therefore, such alcohol is not eligible for the credit when used in an alcohol fuels mixture or as an alcohol fuel.

3. Duty on imported alcohol fuels

The bill increases to 60 cents per gallon the duty on alcohol imported into the United States for use as a fuel.

Effective Date

These provisions of the bill are effective on July 1, 1984.

Revenue Effect

These provisions of the bill are estimated to reduce fiscal year budget receipts by $12 million in 1984, $63 million in 1985, $65 million in 1986, $69 million in 1987, $74 million in 1988, and $6 million in 1989.

D. Exemption from Sales Tax for Piggyback Trailers (sec. 621 of the bill and sec. 4063 of the Code)

Present Law

Present law imposes a 12-percent excise tax on the first retail sale of truck trailer and semitrailer chassis and bodies which are suitable for use with a trailer or semitrailer which has a gross vehicle weight over 26,000 pounds. The tax generally applies to retail sales made after March 31, 1983. Under prior law, a 10-percent manufacturers excise tax applied to the sale of these trailers before April 1, 1983. The changes to a retail tax and higher rate of tax were enacted in the Highway Revenue Act of 1982, which also exempted rail trailers sold after December 2, 1982, from the prior-law and present-law sales tax on heavy trailers.

Reasons for Change

The committee believes that piggyback trailers are sufficiently similar to rail trailers that they should be treated equally under the sales tax on heavy trailers.

Explanation of Provision

The bill exempts piggyback trailers and semitrailers (including parts or accessories) from the sales tax on heavy trailers. A piggyback trailer includes any trailer which is designed for use principally in connection with trailer-on-flatcar rail service and which the seller, according to regulations prescribed by the Secretary, certifies will be so used.

The conditions for exemption of a piggyback trailer continue to apply after the first retail sale. Thus, if the purchaser of an exempt piggyback trailer subsequently ceases to satisfy the conditions for exemption, the purchaser will be liable for the 12-percent excise tax (determined as if a taxable sale had occurred at that time). Similarly, if an exempt piggyback trailer is subsequently resold, the resale will be subject to the 12-percent tax and the reseller liable to pay the tax, unless the conditions for exemption apply to the resale.

Effective Date

The provision is effective as if included in that provision of the Highway Revenue Act of 1982 which exempted rail trailers. Thus, the exemption will apply to the 12-percent retail excise tax from its effective date of April 1, 1983, to the previous 10-percent manufacturers excise tax from January 7, 1983, until its replacement by the retail tax on April 1, 1983, and to the previous 10-percent manufacturers excise tax for piggyback trailers sold to ultimate purchasers after December 2, 1982. Refunds are provided for piggyback trailers sold to ultimate purchasers after December 2, 1982, and before the date of enactment.

Revenue Effect

The provision will reduce fiscal year net budget receipts by $14 million in 1984, $10 million in 1985, $12 million in 1986, $13 million in 1987, and $14 million in 1988.

E. Floor Stocks Refunds with Respect to Certain Tax-reduced Tires and for Retread Tires (sec. 622 of the bill, sec. 523(b) of the Surface Transportation Assistance Act of 1982 (P.L. 97-424), and sec. 4071 of the Code)

Present Law

Present law provides a floor stocks refund of the excise tax on tires in cases where the tax was repealed by the Surface Transportation Assistance Act of 1982 (STAA), but not in cases where the tire tax was reduced but not repealed.

Present law allows a refund of the prior law 5-cents-per-pound tread rubber tax if the tax was paid on tread rubber held in dealers' inventory on December 31, 1983, but not if the tax was paid on tread rubber which had been placed on retread tires held in dealers' inventory.

Reasons for Change

Congress enacted floor stocks refund provisions in the STAA to assure that dealers who had tax-paid articles in inventory when the rate of tax on those items was reduced or repealed would be able to recoup the amount of excess tax paid. The committee believes that technical amendments are needed to carry out this intent with respect to certain tires and tread rubber on retread tires.

Explanation of Provisions

The bill provides a refund with respect to tire floor stocks held on January 1, 1984, on which the excise tax was reduced, but not repealed. The amount of the refund will be equal to the difference in the tax imposed before January 1, 1984, and the tax that would have been imposed had the sale occurred after December 31, 1983. These refunds will be administered under rules similar to the rules governing other floor stocks refunds provided by section 522 of the Surface Transportation Assistance Act.

The bill provides that tread rubber which has been placed on retread tires prior to January 1, 1984, also qualifies for a floor stocks refund. Only one such refund per tire may be received.

Effective Date

This provision is effective as if it had been included in the Surface Transportation Assistance Act of 1982.

Revenue Effect

The revenue effect of the provision is negligible.

TITLE VII—TAX-EXEMPT BOND PROVISIONS

A. Mortgage Subsidy Bonds

(Secs. 701-704 of the bill and sec. 103A and sec. 103A and new secs. 44K and 6706 of the Code)

Present Law

Overview

The Mortgage Subsidy Bond Tax Act of 1980 (the "1980 Act")[1] imposed restrictions on the ability of State or local governments to issue bonds, the interest on which is tax-exempt, for the purpose of making mortgage loans on single-family, owner-occupied residences. The 1980 Act provides that interest on mortgage subsidy bonds is exempt from taxation only if the bonds are "qualified veterans' mortgage bonds" or "qualified mortgage bonds". The ability of State and local governments to issue tax-exempt qualified mortgage bonds expired on December 31, 1983.

Qualified veterans' mortgage bonds

Qualified veterans' mortgage bonds are general obligation bonds, the proceeds of which are used to finance mortgage loans to veterans. Unlike qualified mortgage bonds, the authority to issue tax-exempt veterans' bonds did not expire on December 31, 1983, and veterans' bonds are not subject to the volume, arbitrage, and most of the targeting rules applicable to qualified mortgage bonds.

Qualified mortgage bonds

Qualified mortgage bonds must satisfy numerous requirements discussed below. Also, interest on these bonds is tax-exempt only if the bonds were issued before January 1, 1984.

Volume limitations

The 1980 Act restricted the aggregate annual volume of qualified mortgage bonds that a State, and local governments within the State, can issue. The State ceiling is equal to the greater of (1) 9 percent of the average annual aggregate principal amount of mortgages executed during the 3 preceding years for single-family, owner-occupied residences located within the State or (2) $200 million. The State ceiling is generally allocated 50 percent to State, and 50 percent to local, issuers (on the basis of mortgage activity), unless the State provides a different allocation formula.

[1] Title XI of the Omnibus Reconciliation Act of 1980 (P.L. 96-499). The provisions adopted by the 1980 Act (Code sec. 103A) were subsequently amended by section 220 of the Tax Equity and Fiscal Responsibility Act of 1982 (P.L. 97-248) (TEFRA).

Limitation to single-family, owner-occupied residences

All lendable proceeds (i.e., total proceeds less issuance costs and reasonably required reserves) of qualified mortgage bonds must be used to finance the purchase of single-family residences located within the jurisdiction of the issuing authority. Additionally, it must be reasonably expected that each residence will become the principal residence of the mortgagor within a reasonable time after the financing is provided. Generally, the term single-family residence includes 2-, 3-, and 4-family residences if (1) the units in the residence were first occupied at least 5 years before the mortgage is executed and (2) one unit in the residence is occupied by the owner of the units.

General limitation to new mortgages

With certain exceptions, all lendable proceeds of qualified mortgage bonds must be used for acquisition of new mortgages rather than existing mortgages. The exceptions permit replacement of construction period loans and other temporary initial financing, and certain rehabilitation loans. Rehabilitation loans must be made for work begun at least 20 years after the residence is first used and the expenditures must equal 25 percent or more of the mortgagor's adjusted basis in the building. Additionally, at least 75 percent of the existing external walls of the building must be retained as such after the rehabilitation.

Certain mortgage assumptions permitted

Loans financed by qualified mortgage bond proceeds may be assumed if the residence satisfies the location and principal residence requirements, discussed above, and the assuming mortgagor satisfies the 3-year and purchase price requirements, discussed below.

Limitation on advance refunding

Mortgage subsidy bonds (including qualified mortgage bonds and qualified veterans' mortgage bonds) may not be advance refunded.

Targeting requirement

At least 20 percent of the lendable proceeds of each issue of qualified mortgage bonds (but not more than 40 percent of the average mortgage activity in the targeted area) must be made available for owner-financing in targeted areas for a period of at least one year. The term "targeted area" means a census tract in which 70 percent or more of the families have income which is 80 percent or less of the state-wide median family income, or an area designated as an area of chronic economic distress.

Three-year requirement

In order for an issue to be a qualified mortgage bond issue, at least 90 percent of the lendable proceeds must be used to finance residences for mortgagors who had no present ownership interest in a principal residence at any time during the 3-year period ending on the date the mortgage is granted.[2] The 3-year requirement does not apply with respect to mortgagors of residences in three situations: (1) mortgagors of residences that are located in targeted areas; (2) mortgagors who receive qualified home improvement loans;[3] and (3) mortgagors who receive qualified rehabilitation loans.

Purchase price restrictions

In order for an issue to be a qualified mortgage issue, all of the mortgages (or other financing) provided from the bond proceeds, except qualified home improvement loans, are required to be for the purchase of residences the acquisition cost of which does not exceed 110 percent (120 percent in targeted areas) of the average area purchase price applicable to the residence.[4] No limitation is imposed on the income level of homeowners qualifying for mortgage bond assistance.

Arbitrage requirements

In order for an issue to be a qualified mortgage issue, the issue is required to meet certain limitations regarding arbitrage as to both mortgage loans and nonmortgage investments.

Mortgage investments

The effective rate of interest on mortgages provided under an issue of qualified mortgage bonds may not exceed the yield on the issue by more than 1.125 percentage points.[5] This determination is made on a composite basis for all mortgages under the issue. Consequently, the effective interest rate on some mortgages may be greater than 1.125 percentage points above the yield of the issue if other mortgages have a lower effective interest rate.

Nonmortgage investments

The 1980 Act also imposed restrictions on the arbitrage permitted to be earned on nonmortgage investments with respect to a qualified mortgage bond issue. The amount of qualified mortgage bond proceeds that can be invested at unrestricted yield in nonmortgage investments is limited to 150 percent of the debt service on the issue for the year. Exceptions to the 150-percent of debt service rule are provided for proceeds invested for an initial temporary period until such proceeds are needed for mortgages and for temporary debt service funds. Arbitrage earned by the issuer or an intermediary on nonmortgage investments must be paid or credited to the mortgagors or paid to the Federal Government.

Reserves established to secure payment of the debt service on the bonds must be reduced as debt service is reduced. However, if the

[2] TEFRA reduced the percentage of bond proceeds that must be used in a manner satisfying the 3-year requirement from 100 percent to 90 percent, generally effective for bonds issued after September 3, 1982.

[3] Qualified home improvement loans are loans, not exceeding $15,000, that finance the alteration or repair of a residence in a manner that substantially protects "the basic livability or energy efficiency of the property" (sec. 103A(l)(6)).

[4] TEFRA increased the maximum purchase price restriction from 90 percent (110 percent in targeted areas) to its present level, effective for bonds issued after September 3, 1982.

[5] TEFRA increased the maximum permitted arbitrage from 1 percentage point to 1.125 percentage points, effective for bonds issued after September 3, 1982.

sale of any investment would result in a loss exceeding the amount otherwise required to be paid or credited to mortgagors, the investment may be retained until it can be sold without resulting in such a loss.[6]

Limited equity cooperatives

Present law provides that the owners of shares in housing cooperatives are to be treated as homeowners for purposes of the Code by allowing a deduction for the portion of the rents paid to the cooperative that are allocable to interest and taxes paid by the cooperative on the property (sec. 216). The Tax Equity and Fiscal Responsibility Act of 1983, P.L. 97-248 (TEFRA) included changes in the qualified mortgage bond provisions designed to enable tenant shareholders of cooperatives to be eligible for tax-exempt financing as owners of single family residences.

Reasons for Change

Extension of qualified mortgage bond program

The committee believes that mortgage subsidy bonds can perform a valuable function by enabling first-time homebuyers who might otherwise be unable to purchase a home, because of high interest rates, to do so. When Congress, in 1982, decided to relax certain of the restrictions applicable to qualified mortgage bonds, the interest rate on taxable mortgages approached 15 percent and the housing market was in a state of extreme crisis. Since that time, there has been a significant improvement in the housing market; however, the average mortgage interest rate is approximately 13 percent, and it remains difficult for average Americans (particularly first-time homebuyers) to purchase a single-family residence. In this situation, the committee believes that the qualified mortgage bond program can continue to make an important contribution by making housing more affordable to low- and middle-income Americans. Accordingly, the committee decided that the qualified mortgage bond program should be extended.

In order to provide an opportunity for reassessment of the qualified mortgage bond program under changing conditions, the committee decided that the program should be extended for a 4-year period only (i.e., for bonds issued prior to January 1, 1988). In the interim, in order to ensure an adequate basis for reevaluation, qualified mortgage bonds will be subject to reporting rules similar to the TEFRA information reporting requirements for private purpose tax-exempt bonds. Additionally, to ensure that the public and the Congress are aware of the policies to be pursued in distributing loans made under a mortgage bond program, State or local officials will be required to prepare annual reports on such policies, to file such reports with the Treasury Department, and to provide reasonable public notice and hearings before issuing the reports.

[6] The rule permitting retention of an investment where its disposition would result in a loss was added by TEFRA, effective for bonds issued after September 3, 1982.

Mortgage credit certificates

While approving the extension of the qualified mortgage bond program, the committee is aware of the relative inefficiency of tax-exempt bonds as a means of providing a subsidy to first-time homebuyers. Additionally, the committee is aware that, because of the nature of tax-exempt financing, it may be difficult to target the subsidy provided by mortgage bonds to those most in need of housing assistance. The committee therefore decided to offer States and localities the alternative of distributing mortgage credit certificates (MCCs) in place of qualified mortgage bonds. The rules for distributing MCCs have been designed to provide assistance to first-time homebuyers at a subsidy level that generally is the same as or greater than that provided by mortgage bonds. Further, under the MCC program, the entire amount of subsidy flows directly to the first-time homebuyer, rather than part of the subsidy flowing to the first-time homebuyer and part to the tax-exempt investor and middlemen as under a mortgage bond program. Thus, MCCs will provide the same or a larger subsidy at a reduced revenue cost. Additionally, by varying the amount of individual credits, State and local issuing authorities may achieve greater flexibility in targeting the subsidy to those individuals who are considered most in need.

To ensure that credits, in general, are targeted to those most needing assistance, the committee decided that MCCs should be subject to the pre-TEFRA purchase price limitations applicable to mortgage subsidy bonds (i.e., limited to residences not exceeding 90 percent of the applicable average area purchase price). Further, credits will be phased out under a formula for taxpayers having above average median income adjusted for family size. This rule is intended to reduce the amount of Federal subsidy provided as the borrower's income increases and he or she becomes able to afford to carry the mortgage without a subsidy.

Under the bill, States and localities have the choice of issuing qualified mortgage bonds, MCCs, or any mixture of bonds and credits, according to their particular needs. However, because of the relative ease of issuing credits, the committee believes that a transitional rule is necessary to provide equity between States and to mimimize the potential revenue loss associated with MCCs. The committee therefore decided to impose a phase-in of authority to issue MCCs for States which issued less than their statutory maximum of qualified mortgage bonds in 1983. In order to provide an opportunity to review the MCC program, the committee provided that authority to exchange mortgage bond authority for MCCs, together with authority to issue mortgage bonds, would sunset on December 31, 1987.

The committee intends that the procedures for distribution of MCCs will ensure that volume limitations are not exceeded, while providing maximum flexibility to State and local governments in deciding how to utilize and issue MCCs. The committee believes that these goals can be accomplished best by using a centralized recordkeeping system, maintained by the Treasury Department, which State and local governments will utilize in issuing MCCs. Such an approach will allow mortgage lenders and secondary market institutions to rely on the validity of an MCC without the necessity for an extensive system of penalties intended to discourage State and local governments from issuing unauthorized amounts of MCCs.

The committee understands that, despite changes included in TEFRA, housing cooperatives may have difficulties complying with the requirements for mortgage subsidy bond financing, in particular the first-time homebuyer limitation. Because of these problems, MCCs (as opposed to bonds) may provide a more attractive form of assistance for cooperative residents. Under the bill, MCCs may be used for that portion of interest on a cooperative mortgage which is deemed paid by a tenant-shareholder who otherwise qualifies for MCC assistance. To allow maximum flexibility in distributing credits, MCCs may also be used in connection with manufactured housing to the extent provided by regulations.

By providing a subsidy to lower-income homebuyers, mortgage subsidy bonds and MCCs complement the mortgage interest deduction, which provides greater benefits to higher income homeowners and no benefits at all to those lower-income taxpayers who do not itemize deductions. However, the committee is concerned that existing Federal eligibility requirements for mortgage subsidy bonds do not, by themselves, work effectively to target Federal subsidies to the lower-income taxpayers who need this additional assistance to afford homes.

The committee further is aware that the process of issuing mortgage subsidy bonds (as opposed to MCCs) may make income targeting particularly difficult. For example, an issuer concerned about the possibility of a bond call (e.g., because of declining interest rates) may be eager to lend bond proceeds as quickly as possible on a first-come, first-served basis, without taking the time to screen eligible borrowers and carefully selecting those borrowers who most need Federal assistance.

Despite these and related problems, the committee understands that many issuers are developing effective local standards and procedures to target mortgage bond loans to lower-income families. In addition, the committee believes that State and local governments may need flexibility to develop eligibility criteria suited to local conditions. Accordingly, the bill does not modify the existing Federal eligibility standards applicable to qualified mortgage bonds.

The bill includes a statement of Congressional intent that mortgage bond issuers are expected to use mortgage bond authority to the greatest extent feasible to make financing available to lower-income families who can use the loans to afford homes before making such financing available to higher-income families. The committee anticipates that this policy could be implemented in various ways. Issuers may elect to exchange bond authority for MCC authority; MCCs are limited by the bill to borrowers with incomes below local median income, with adjustments for family size.

Alternatively, issuers using qualified mortgage bonds may adopt lower income limitations, or revise existing income limitations to target loans to lower-incomer homebuyers. In addition, issuers may develop procedures to ensure that the availability of qualified mortgage bond loans is widely publicized, and that applications for such loans are reviewed with respect to family income and assets so that lower-income families can be given priority over higher-income families in receiving such loans.

Further rules

In extending the qualified mortgage bond program, the committee believed that it is no longer appropriate for issuers to issue bonds under the transition rules included in the Mortgage Subsidy Bond Tax Act of 1980 and therefore repealed these rules, effective December 31, 1984. The committee bill also allows limited advance refundings of certain veterans' mortgage bonds where such refundings are important to the continuing success of the program involved.

Explanation of Provisions

1. Qualified mortgage bonds

Extension of authority to issue qualified mortgage bonds

The bill extends the tax-exemption for interest on qualified mortgage bonds to bonds issued prior to January 1, 1988. These bonds are subject to the eligibility requirements and volume limitations applicable to bonds issued before expiration of the present law tax-exemption on December 31, 1983. The bill does not affect the existing tax-exemption for qualified veterans' mortgage bonds.

Information reporting and policy statement requirements

The bill requires all issuers of mortgage subsidy bonds (including qualifed mortgage bonds and qualified veterans' mortgage bonds) to submit to the Treasury Department, by the fifteenth day of the second calendar month after the close of the calendar quarter in which the bonds were issued, a statement providing certain information concerning the issue. This statement must contain (1) the name and address of the issuer, (2) the date of the issue, the amount of lendable proceeds of the issue, and the stated interest rate, term and face amount of each obligation which is part of the issue, and (3) such other information as the Treasury may require (including information required in order to determine whether the issue qualifies for tax-exemption and the extent to which proceeds of the issue have been made available to lower-income individuals). The bill allows the Treasury to grant extensions of time for providing any information where there is reasonable cause for delay.

The bill further requires an elected legislative body or public official of the governmental unit issuing qualified mortgage bonds, or on whose behalf such bonds are issued, to publish and submit to the Treasury Department an annual report which states the housing, development, and income distribution policies which the governmental unit is to follow in issuing mortgage subsidy bonds and mortgage credit certificates. This report also is to include an assessment of the compliance of the governmental unit during the preceding 1-year period with (1) the equivalent statement of policy that was set forth in the next previous report (if any) of such unit, and (2) the performance of the issuer's program relative to the stated intent of Congress, discussed below, that bonds and credits be made available, to the greatest extent possible, to lower income families before such assistance is made available to higher income families.

State allocation formulas

The bill provides that, if a State law which provides a formula for allocation of the State's qualified mortgage bond ceiling among State and local issuers expires as of the close of calendar year 1983, the law shall be treated as remaining in effect after 1983. If the expiring formula requires action by a State official in order to allocate the State ceiling, actions of such officials shall continue to be effective. The extension of the previously existing formula shall be effective until the effective date of any new State legislation with respect to allocation of the qualified mortgage bond ceiling.

Repeal of 1980 transition rules

The bill repeals certain transition rules for exempting certain bond issues from the restrictions of the Mortgage Subsidy Bond Tax Act of 1980, effective for bonds issued after December 31, 1984. Exceptions are provided for certain specified projects. State volume limitations for qualified mortgage bonds are reduced by the volume of bonds issued under the 1980 transition rules after April 21, 1984.

2. Mortgage credit certificates

Overview

The bill allows State and local governments to elect, for any calendar year beginning after 1983, to exchange all or part of their qualified mortgage bond authority for authority to issue mortgage credit certificates (MCCs). MCCs entitle taxpayers to nonrefundable Federal income tax credits for not more than 50 percent (but not less than 10 percent) of interest on indebtedness incurred to finance the acquisition (or qualified rehabilitation or improvement) of qualifying principal residences (as defined in sec. 103A). MCCs are subject to the purchase price requirements which applied to qualified mortgage bonds before TEFRA. Additionally, the credits are generally limited to first-time homebuyers having incomes below local area median income adjusted for family size.

Authority to trade in mortgage bond authority for authority to issue MCCs will expire after December 31, 1987. For States and localities which issued less than their statutory maximum of qualified mortgage bonds during calendar year 1983, authority to issue MCCs is subject to a phase-in rule.

Issuance of mortgage credit certificates (MCCs)

Mortgage credit certificates (MCCs) are to take the form of certificates issued to qualifying homebuyers. Each certificate is to specify (1) the principal amount of indebtedness which qualifies for the credit and (2) the applicable percentage rate of the credit. The applicable percentage may not exceed 50 percent, but may not be less than 10 percent, of interest on the qualifying indebtedness. The actual amount of the credit in any taxable year for which the MCC is effective depends upon the mortgage interest paid during that year. The certificate entitles the taxpayer to a credit against his Federal income taxes for the applicable percentage of mortgage interest paid during any taxable year during which it remains in effect. The certificate remains in effect until the taxpayer sells the residence or it ceases to be his or her principal residence.

MCCs are not refundable to the taxpayer (i.e., credit amounts in excess of any Federal income taxes will not be refunded to the taxpayer). When a taxpayer receives an MCC, the taxpayer's deduction for interest on the qualifying mortgage (sec. 163(a)) is reduced by the amount of the credit. For example, a taxpayer receiving a 50-percent credit, and making $5,000 of interest payments on qualified indebtedness in a given year, is to receive a $2,500 credit and a deduction for the remaining $2,500 of interest payments.

Issuers electing to exchange mortgage bond authority for authority to issue MCCs are not required to issue the credits in the year for which the bond authority was exchanged, but may issue such credits in any subsequent year. Therefore, MCCs may be used as a countercyclical subsidy (e.g., more credits may be issued in a time of higher interest rates) in a manner not possible with mortgage subsidy bonds.

Criteria for eligibility

MCCs generally are subject to eligibility requirements similar to the requirements applicable to qualified mortgage bonds prior to the enactment of TEFRA. Thus, MCCs are generally (1) limited to single-family owner-occupied residences as defined under the qualified mortgage bond provisions, (2) limited to residences located within the jurisdiction of the issuing authority, (3) available only for new mortgages (with allowances for qualified rehabilitation and improvement loans), and (4) available only to mortgagors who did not have a present ownership interest in a principal residence at any time during the 3-year period ending on the date the mortgage is granted with exceptions for qualified rehabilitation and home improvement loans (the so-called first-time homebuyer requirement). Additionally, MCCs are available only to finance the acquisition of residences the acquisition cost of which does not exceed 90 percent of the average area purchase price applicable to the residence. MCCs may be used for that portion of interest on a blanket mortgage of a housing cooperative which is allocable to payments made by a tenant-shareholder who otherwise qualifies for MCC assistance. Additionally, MCCs will be available, under Treasury regulations, for certain manufactured housing.

Under the bill, MCCs may be issued for debt incurred to refinance a principal residence if the refinancing takes the place of an existing construction period loan, bridge loan or temporary financing, or (in the case of qualified rehabilitation) an existing mortgage. Outstanding MCCs may be reissued to the original recipient under Treasury regulations, where the amount of the credit which will be allowable as a result of such reissuance is less than the credit which would be allowable under the original certificate.

Under the bill, MCCs are not available for residences financed with qualified mortgage bonds and qualified veterans mortgage bonds. Additionally, loans between certain related parties do not qualify for the credit. Finally, MCCs are not available if the homebuyer is required to obtain his mortgage from any particular lender. Only one MCC may be in effect with respect to any residence at any given time.

Limitation to lower-income homebuyers

The bill generally limits MCCs to first-time homebuyers having income below the average median family income for the area in which the residence is located. This is accomplished by limiting the amount of the credit in any year to one-fourth of the amount by which the greater of (1) the median income for a family of four in the area in which the taxpayer resides for the year the MCC is issued (as most recently determined by the Secretary of Housing and Urban Development), or (2) $20,000, exceeds the adjusted gross income of the taxpayer for the taxable year. Married taxpayers receiving credits are required to file a joint return. Where the taxpayer's adjusted gross income exceeds the average area median income for a family of four (or, if greater, $20,000), no credit will be allowed.

In the case of unmarried taxpayers with no dependents, a figure of 80 percent of median area income for a family of four will be substituted in the formula above. For a taxpayer with four or more personal exemptions (including the exemption of a spouse), a figure of 120 percent of average area median income for a family of four will be applied. (These adjustments are similar to those currently provided under Federal direct subsidy housing programs.) Additionally, the Treasury Department is authorized to prescribe regulations under which a higher figure may apply in the case of adjustable rate mortgages.

Volume limitations

General limits

Under the bill, the aggregate annual amount of MCCs distributable by a State or locality may not exceed 20 percent of the volume of qualified mortgage bond authority exchanged by the State or locality. For example, a State which is entitled to issue $200 million of qualified mortgage bonds, and which elects to exchange $100 million of bond authority, may distribute an aggregate amount of MCCs not exceeding $20 million.

The aggregate annual amount of MCCs issued by a State or locality is to be determined by multiplying (1) the principal amount of the indebtedness for each MCC issued by the State or locality by (2) the applicable percentage for each certificate, and adding the products. For example, a State with $20 million of MCC authority may distribute credits for 20 percent of the interest payments on mortgages having an aggregate principal amount of $100 million (thereby exceeding the benefits provided by $100 million of mortgage subsidy bonds). However, the State also may issue any other mix of higher or lower percentage credits in an aggregate amount not exceeding $20 million (subject to the 10- and 50-percent requirements and the targeting and applicable eligibility and income requirements).

Phase-in of and limitations on MCC authority

States in which total issues of qualified mortgage bonds in 1983 were less than the State volume ceiling are subject to a phase-in of authority to issue MCCs. For each year through 1987, the amount of qualified mortgage bond authority that such a State or locality may exchange for authority to issue MCCs is limited to the volume of qualified mortgage bonds it actually issued in 1983, increased for each year by 25 percent of the remaining difference between the 1983 volume and the statutory maximum amount. (These amounts are applicable regardless of the volume of bonds issued in any intervening year.) This phase-in rule is to be applied by means of an election by one or more of the issuing authorities within the State (including State and local issuers), in a manner to be prescribed by regulations, to forego the issuance of bonds or credits which exceed the applicable phase-in volume limit. If such election is not made, issuers in the State may not issue MCCs.

For example, if a State had authority to issue $200 million of qualified mortgage bonds in 1983, but actually issued only $100 million, and if the State desired to issue MCCs in 1984, issuers in the State would be required to relinquish $75 million of mortgage bond authority in 1984 before exchanging some or all of the remaining $125 million of bond authority for authority to issue MCCs. Under the same procedure, issuers in the State could exchange up to $144 million of authority in 1985 ($125 million plus 25 percent of authority remaining in 1984), $158 million in 1986 and $167 million in 1987. The phase-in rule will not limit the amount of mortgage bond authority except to the extent that issuers elect to relinquish a portion of such authority in order to qualify to exchange additional bond authority for authority to issue MCCs. Thus the rule does not result in any inadvertent reduction of bond authority.

Public notification requirement

Under the bill, State or local housing agencies may issue MCCs only after making generally available, at least 90 days before distribution, a proposed plan of distribution of the credits. The proposed plan must set forth the eligibility requirements for receipt of MCCs, the methods by which the certificates are to be issued, and such other information as the Treasury Department may require.

Administration of MCC program

The MCC program is to be administered as provided in Treasury regulations.

Certifications of MCC eligibility

The principal residence and first-time homebuyer requirements applicable to MCCs are to be enforced by requiring the taxpayer to provide verified written statements to the lender to the effect that these requirements have been satisfied. In the case of the principal residence requirement, this certification must include a statement that the taxpayer expects the residence to become his or her principal residence within a reasonable period of time. The statement with regard to first-time home ownership is to be accompanied by copies of the taxpayer's Federal income tax returns for the most recent 3 taxable years (to demonstrate that no deduction for mortgage interest has been taken in this period). The lender will then submit verified written statements to the administrator of the State or local MCC program indicating that, on the basis of information available to the lender, these requirements have been satisfied. The statement with regard to principal residence status will also be required to certify that the residence for which a credit is to be issued is a qualifying single-family residence. Additionally, the lender will be required to certify that the acquisition price of the residence does not exceed 90 percent of the average area purchase price.

If required certifications are properly made, tax credits will not be disallowed if the certification is erroneous. However, verified written statements required to be made in connection with the issuance of mortgage credit certificates are to be made under penalty of perjury and are to contain a declaration that the statement is so made. A penalty of $1,000 is provided for each MCC with respect to which a negligent misstatement is made. In the case of fraudulent misstatements, the penalty is $10,000 for each MCC (in addition to any applicable criminal penalties).

If a residence at any time ceases to be the taxpayer's principal residence, tax credits will be disallowed as of that time.

Administration of volume limitations

The committee anticipates that the Treasury Department will maintain a central recordkeeping system designed to monitor compliance with State volume limitations applicable to mortgage credit certificates. The administration of such a system will be determined as provided under Treasury regulations. Such a system might operate in the following manner. The Treasury Department would maintain current accounts of each State's unused mortgage bond authority (and each State's eligibility for MCCs under the applicable phase-in rules). Under regulations, issuers of mortgage bonds would be required to notify the Treasury Department in order to maintain current records. Issuers further would be required to notify the Treasury of elections to exchange bond authority for authority to issue MCCs.

Once a valid election was made, the election would be treated as if the amount of credits equivalent to the exchanged bond authority actually had been issued. Thus, subsequently issued bonds would not be tax-exempt if they exceeded the State's authority taking into account the bond authority exchanged for MCCs. Conversely, an election would be invalid to the extent it purported to exchange bond authority that had already been used to issue bonds.

The committee anticipates that the Secretary might require, as a matter of administration, that elections by all State and local issuers should be formally filed by a single official or agency within the State designated for this purpose. Any such procedure should restrict this official's or agency's role strictly to administration of State and local elections, and should not remove the discretion of particular State and local issuers to decide whether to issue mortgage bonds or MCCs (subject to volume limitations and applicable phase-in rules).

Once a valid election was made, the Treasury would establish an account in the name of the appropriate State or local housing finance agency (HFA). The HFA would be responsible for receiving applications and selecting potential MCC recipients. Recipients selected by the HFA would be given a formal Letter of Eligibility by the HFA, with a copy provided to the Treasury Department. The Letter of Eligibility would specify the maximum mortgage amount and credit percentage applicable to the recipient, who would then be entitled to "shop around" for an appropriate residence to purchase and an appropriate financing source. The committee believes that this market mechanism is preferable to allocating MCCs to specific lenders or sellers, since it will help ensure that the full Federal subsidy is provided to the homebuyer and is not reflected in artificially inflated home purchase prices or interest rates. Additionally, committee believes this mechanism will enable the homebuyer to purchase a residence and to secure financing on the most favorable terms available as well as receiving the benefits of an MCC.

The lender making or underwriting a loan in reliance on an MCC would verify the validity of the Letter of Eligibility with the records of the issuer's account at the Treasury Department. This procedure will allow the lender to ascertain that the MCC is valid and to ensure that MCCs are not used in excess of the HFA's authorized volume. In addition, this procedure will allow for adjustment in the issuer's account, so that the HFA may issue additional MCCs if the recipient of a Letter of Eligibility purchases a less expensive home than was anticipated or does not make use of the Letter of Eligibility.

The, committee anticipates that the Treasury Department may issue regulations requiring lenders to provide appropriate information returns to borrowers, and to the Internal Revenue Service, in order to ensure that tax credits are not claimed improperly.

The committee anticipates that the Treasury Department may establish a separate office to administer the MCC program, or may contract with a private firm or quasi-public agency to administer the program. In either case, the committee anticipates that any costs of administration would be defrayed by a moderate fee imposed on the borrower, not to exceed $200. In addition, the committee anticipates that issuers may incur costs in implementing the MCC program. Accordingly, the committee anticipates that an additional fee, not to exceed $100, might also be imposed on the borrower to defray the issuer's costs in administering the MCC program. These amounts should, in most cases, be less than one percent of the mortgage amount being financed, and in the committee's view, is consistent with the level of with other fees and costs associated with home purchases.

Illustration

Assume that a State or local housing finance agency (HFA) decides to issue MCCs to qualifying homebuyers in a locality for which the medium income for a family of four is $30,000. Under the income limitation, the maximum credit for a borrower with $24,000 of adjusted gross income could not exceed $1,500 (¼ of the excess of $30,000 over $24,000). Accordingly, the HFA might issue such a borrower an MCC allowing a credit for 20 percent of the interest on a certified mortgage indebtedness of $53,000.

The borrower might then contract to purchase a home costing $58,300 with a 10 percent down payment and a $53,000 mortgage bearing 14 percent interest. The borrower's gross mortgage interest payments in the first year would be approximately $7,500 and the borrower's tax credit for the year would be 20 percent of that amount or approximately $1,500. Since the $1,500 tax credit would be directly reflected in reduced wage withholding, or reduced estimated tax payments, the credit may be applied directly to monthly interest payments. The credit would thus enable a borrower with $7,500 of gross interest payments to qualify for a mortgage on the same basis as if the monthly payments were only $6,000 without any tax credits. Thus the borrower, with an income of $24,000, would be able to carry a mortgage ordinarily requiring an income of $30,000.

If, after one year, the borrower's adjusted gross income increased by $2,000, the borrower's maximum tax credit would be reduced from $1,500 to $1,000 under the income limitation rule. However, since the borrower's income has increased $2,000, and the credit has been reduced by only $500, the borrower's ability to carry the mortgage would not be adversely affected.

3. Statement of Congressional intent regarding mortgage bond and credit programs

The bill includes a statement of Congressional intent that issuers are expected to use mortgage bond authority (including such authority exchanged for MCC authority), to the greatest extent possible, to make loans available to lower-income families who can use the loans to afford home ownership before making such loans available to higher-income families, taking into account prevailing conditions in the housing market and prevailing interest rates. The Secretary of the Treasury, in consultation with the Secretary of Housing and Urban Development, is required to report annually to the Congress on the performance of mortgage bond issuers relative to this statement of program goals.

4. Limited authority for refunding of certain veterans' mortgage bonds

The bill provides limited authority for advance refundings of certain qualified veterans' mortgage bonds issued by the State of Oregon. The amount of bonds which may be issued under this provision may not exceed the excess of (1) the projected aggregate payments of principal on the bonds being refunded during the 15-year period beginning in fiscal 1984 over (2) the projected aggregate principal payments during this period on the mortgages being financed by the bonds. In addition, the amount of bonds which may be issued under this provision may in no case exceed $300 million.

Effective Dates

The extension of the tax-exemption for qualified mortgage bonds is effective for bonds issued after the date of enactment of the bill. The election for States and localities to issue mortgage credit certificates is effective for credits issued after December 31, 1984, with respect to elections to exchange qualified mortgage bond authority for years after 1983. Thus, issuers may elect to exchange 1984 bond authority after the date of enactment for authority to issue MCCs, but may not actually issue such credits until 1985. This rule does not affect the timing of issuance of credits for any subsequent year (e.g., credits issued in exchange for 1985 bond authority may be issued beginning in 1985).

The repeal of the 1980 mortgage subsidy bond transition rules is effective for bonds issued after December 31, 1984.

The limited authority to advance refund certain outstanding veterans' mortgage bonds is effective on the date of enactment.

B. Industrial Development Bonds

(Secs. 711-18 and 720-721 of the bill and secs. 103 and 168 of the Code)

Present Law

Tax-exemption for State and local obligations

Interest on State and local government obligations generally is exempt from Federal income tax. Under this rule, State and local governments generally may issue tax-exempt bonds to finance public projects or services (including schools, roads, water, sewer, and general improvement projects and the financing of public debt). Additionally, State and local governments may provide tax-exempt financing for certain private trades or businesses, for student loans and for use by tax-exempt religious, charitable, scientific, or educational organizations I described in Code section 501(c)(3)).

Industrial development bonds

Under present law, industrial development bonds (IDBs) are taxable except when issued for certain specified purposes. Industrial development bonds are obligations issued as part of an issue all or a major portion of the proceeds of which is to be used in any trade or business carried on by a nonexempt person and the payment of principal or interest on which is derived from, or secured by, money or property used in a trade or business. A non-exempt person is defined to mean all persons other than State or local governments or tax-exempt charitable, religious, educational, etc. organizations (described in sec. 501(c)(3)).

Exempt purpose IDBs

One of the exceptions under which interest on IDBs is tax-exempt is where the proceeds of the IDBs are used for certain exempt functions. Under this rule, interest on IDBs is tax-exempt if the bonds are used to finance the following activities: (1) certain projects for multifamily residential rental property; (2) sports facilities; (3) convention or trade show facilities; (4) airports, docks, wharves, mass commuting facilities, or parking facilities; (5) sewage and solid waste disposal facilities, or facilities for the local furnishing of electricity or gas; (6) air or water pollution control facilities; (7) certain facilities for the furnishing of water; (8) qualified hydroelectric generating facilities; (9) qualified mass commuting vehicles; or (10) local district heating or cooling facilities. In addition, interest on IDBs used to acquire or develop land as the site for an industrial park is exempt from tax.

Treasury regulations provide that whether the proceeds of an obligation are used for exempt facilities is to be determined by the ultimate use of the proceeds. Treas. Reg. sec. 1.103-8(a)(4). The regulations illustrate this principle by indicating that bond proceeds are used for an exempt purpose where the proceeds of the bonds are loaned to banks or other financial institutions who then relend those proceeds for exempt functions (referred to as a "loan to lenders" program).

Small issue IDBs

In general.—Present law provides tax-exemption for interest on limited amounts of IDBs used for the acquisition, construction, or improvement of land or depreciable property. This exemption is referred to as "the small-issue exception." [1] The exception applies to issues having an aggregate authorized face amount (including certain outstanding prior issues) of $1 million or less. Alternatively, the aggregate face amount of the issue, together with the aggregate amount of related capital expenditures during the 6-year period beginning 3 years before the date of issue and ending 3 years after that date, must not exceed $10 million.[2]

In determining whether an issue meets the requirements above, prior small issues (and in the case of the $10 million limitation, capital expenditures) are taken into account if (1) they are with respect to a facility located in the same incorporated municipality or the same county (but not in any incorporated municipality) as the facility being financed with small-issue IDBs, and (2) the principal users of both facilities are the same or two or more related persons. "Related persons" include family members, fiduciaries, and corporations (or partnerships) subject to common control. Capital expenditures are not taken into account if (1) they are made to replace property destroyed or damaged by fire, storm, or other casualty, (2) are required by a change in Federal, State or local law (or the application of such laws) made after the date of issue, (3) are required by circumstances which could not reasonably be foreseen on the date of issue, or (4) are qualifying in-house research expenses (excluding research in the social sciences or humanities and research funded by outside grants or contracts).

The Internal Revenue Service generally has ruled that, for purposes of the small issue volume limitations, where the facilities comprising a project are owned by unrelated parties, each party will be considered the principal user only of its own facility. Thus, under present law, a project in excess of $10 million (e.g., a multistory office building) may be divided into several nominally separate facilities, each costing $10 million or less, and each separate facility may be financed by corresponding separate small issues of IDBs.

Limitations on small issue IDBs.—The Tax Equity and Fiscal Responsibility Act of 1982 (TEFRA), Pub. L. 97-248, imposed certain new restrictions on small-issue IDBs. First, TEFRA provided that the small-issue exception will not apply to obligations issued after December 31, 1986. Second, TEFRA provided that the $1 million

[1] The small-issue exception does not apply to obligations a significant portion of the proceeds of which are used to provide residential real property for family units.

[2] In the case of facilities with respect to which an Urban Development Action Grant ("UDAG grant") is made under the Housing and Community Development Act of 1974, capital expenditures of up to $20 million are allowed.

"clean limit" exception is not available for any IDB issued as part of the same issue as other obligations, the interest on which is tax-exempt under a provision other than the small-issue exception. (The alternative $10 million limitation remains available for combined issues.) Third, TEFRA eliminated the small-issue exception for bonds issued after December 31, 1982, if (1) more than 25 percent of the proceeds of the issue are used to provide a facility the primary purpose of which is retail food and beverage services (including all eating and drinking establishments but not grocery stores), automobile sales or service, or the provision of recreation or entertainment, or (2) any portion of the proceeds is used to provide any private or commercial golf course, country club, massage parlor, tennis club, skating facility (including roller skating, skateboard, and ice skating), racquet sports facility (including any handball or racquetball court), hot tub or sun tan facility, or racetrack. These use limitations do not affect bonds issued pursuant to exemptions other than the small-issue exception.

In addition to the above limitations, TEFRA provided that multiple lots of small-issue IDBs are not to be treated as one issue unless the proceeds are used to finance two or more facilities which (1) are located in more than one State or (2) have the same or related principal users.[3] Under this rule, multiple lots of IDBs may qualify as tax-exempt as long as each separate lot qualifies as a small issue.

Cost recovery for property financed with tax-exempt bonds

Accelerated cost recovery (ACRS)

Present law provides for a reasonable depreciation allowance for property used in a taxpayer's trade or business or held for the production of income. Under the Economic Recovery Tax Act of 1981 (Pub. L. 97-34), cost recovery for tangible property placed in service on or after January 1, 1981, is determined according to the Accelerated Cost Recovery System (ACRS). ACRS provides for capital cost recovery over predetermined periods that are generally unrelated to, but shorter than, the useful lives of the property (as determined under prior law).

Recovery of costs under ACRS is determined by using a statutorily accelerated method. The schedules approximate the benefits of using a 150-percent declining balance method for the early recovery years and the straight-line method for later recovery years. For 15-year real property, the schedule reflects a 175 percent declining balance method (200 percent for low-income real property) switching to the straight-line method.

As an alternative to ACRS, a taxpayer may elect to depreciate real or personal property using the straight-line method over the applicable ACRS or extended recovery periods.

[3] For purposes of this rule, "principal users" include persons (other than governmental units) which (1) arrange or assist in the issuance or guarantee (directly or indirectly) the repayment of any obligation used to finance the facility, and (2) provide any property, franchise, or trademark to be used in connection with the facility.

Property financed with tax-exempt bonds

Property placed in service on or after January 1, 1983, generally is not eligible for full ACRS deductions or other accelerated cost recovery deductions, to the extent that the property is financed with tax-exempt IDBs. In lieu of the full ACRS deductions reflecting the accelerated recovery rates, the cost of personal property financed with IDBs must be recovered using the straight-line method (using a half-year convention and without regard to salvage value) over the applicable ACRS period. For 15-year real property, costs are to be recovered using the straight-line method (using a monthly convention and without regard to salvage value) over a 15-year period.

Present law contains several exceptions under which IDB-financed facilities may continue to be eligible for full ACRS deductions. The exceptions include: (1) projects for multifamily residential rental property; (2) public sewage or solid waste disposal facilities, where substantially all of the sewage or solid waste (other than recycled waste) processed by the facility is collected from the general public; (3) air or water pollution control facilities which are installed in connection with a facility in existence on July 1, 1982, or which are used in connection with conversion of oil- or gas-fired facilities to coal (but only if the oil- or gas-fired furnace which is converted to coal was in use at the facility before July 1, 1982); and (4) facilities with respect to which an Urban Development Action Grant ("UDAG grant") has been made.

The limitations on ACRS deductions, where applicable, apply to both the first owner of the property and to any subsequent owners who acquire the property while the tax-exempt IDBs (including any refunding issues) are outstanding.[4] The limitations do not apply if the taxpayer has elected a longer recovery period for the property than that provided by the limitations.

Arbitrage limitations

Present law denies tax-exemption for interest on obligations (including IDBs or other State or local obligations) which are treated as arbitrage bonds. An arbitrage bond is defined as an obligation which is part of an issue all or a major portion of the proceeds of which are to be used (directly or indirectly) to acquire taxable obligations which produce a materially higher yield than the yield on the tax-exempt obligations (or to replace funds that are so used). There are exceptions for materially higher yielding obligations held for a temporary period or in a reasonably required reserve or replacement fund.

Treasury regulations provide rules for purposes of determining when an obligation acquired with the proceeds of tax-exempt bonds has a yield materially higher than the bond yield. Treasury regulations apply different arbitrage restrictions to "acquired purpose obligations" and "acquired nonpurpose obligations" acquired with the proceeds of tax-exempt bonds. "Acquired purpose obligations" are obligations acquired to carry out the purpose of the bond issue. All

[4] If tax-exempt IDBs are first issued after the property is placed in service, the taxpayer is required to recompute any cost recovery deductions claimed for the property in prior years.

other obligations acquired with bond proceeds are "acquired nonpurpose obligations."

In the case of student loan bonds and other obligations issued in connection with certain governmental programs, permissible arbitrage on acquired purpose obligations that are acquired in connection with the program (acquired program obligations) generally is limited to a spread between the interest on the bonds and the interest on the acquired program obligations equal to the greater of (i) 1.5 percentage points plus reasonable administrative costs or (ii) all reasonable direct costs of the loan program (including issuance costs and bad debt losses). Additional rules apply to investments of sinking funds and other indirect and replacement proceeds of a bond issue.

Generally, permissible arbitrage is limited so that the issuer can earn a spread between the interest on the bonds and the yield on acquired purpose obligations not exceeding 0.125 percentage points plus reasonable administrative costs. Administrative costs basically are the costs of issuing, carrying, and repaying the bonds, the underwriter's discount, and the costs of acquiring, carrying, and redeeming the obligation of the bond user.

There are three principal exceptions to this rule. First, unlimited arbitrage is permitted on proceeds invested for a temporary period prior to use whether held by the issuer or the user of bond proceeds. An issuer may waive the temporary period and receive an arbitrage spread of 0.5 percentage points plus allowable costs with respect to obligations subject to yield restrictions. Second, unlimited arbitrage is permitted on investments held in a reasonably required reserve or replacement fund. Third, under certain circumstances, a minor portion of bond proceeds may be invested without yield restrictions.

Special arbitrage rules apply in the case of mortgage subsidy bonds, in addition to the regular arbitrage rules described above. Only 1.125 percentage points arbitrage may be earned on the mortgages (acquired purpose obligations) acquired with bond proceeds. For this purpose, costs related to the borrowing that are borne by the mortgagors generally are treated as yield on the mortgage loans. Yield on the bond issue is determined without regard to the underwriter's discount. The amount of bond proceeds that can be invested at a yield above the bond yield in acquired nonpurpose obligations in any bond year generally is limited to 150 percent of annual debt service for the bond year. The 150 percent of debt service limit does not apply to amounts invested for a temporary period after the date of issue or to amounts in a bona fide debt service fund. All arbitrage profits earned on acquired nonpurpose obligations (adjusted for gains and losses on such obligations and earnings on the gains and arbitrage profits) must be paid or credited to the mortgagors. Alternatively, the issuer may elect to make this payment to the United States. If the full 1.125 percentage points is not earned on the mortgage obligations, the amount to be paid to the mortgagors or the United States may be reduced by the amount by which the mortgage yield is less than 1.125 percentage points above the bond yield.

Federally guaranteed tax-exempt bonds

Tax-exempt IDBs guaranteed by FDIC or FSLIC

Federal deposit insurance laws

The Federal Deposit Insurance Corporation (FDIC) and the Federal Savings and Loan Insurance Corporation (FSLIC) insure deposits to a maximum of $100,000 per depositor.[5] Where assets of a trust are deposited in Federally insured institutions, the trust funds are insured up to $100,000 for each beneficial owner of the funds.[6] Additionally, where a public official deposits funds required to be paid to holders of bonds issued by a public unit, the interest of each bondholder is insured up to $100,000.[7]

The FDIC and FSLIC concluded in letter rulings issued in 1982 that, where the proceeds of a tax-exempt bond issue are used to purchase certificates of deposit of insured financial institutions, which may occur in a loan-to-lenders program, each bondholder's proportionate interest in the deposits would be separately recognized. Thus, if one or more depository banks failed, the interest of each bondholder would be insured up to $100,000 for each depository bank.

Typical structure of FDIC- and FSLIC-insured bonds

In certain issues of tax-exempt bonds, the issuing authority has deposited the bond proceeds in bank or savings and loan accounts insured by the FDIC or the FSLIC, to be loaned to the user by the depository institution. In the typical arrangement, the issuer transfers the proceeds to a trustee for the bondholders, which deposits the funds in FDIC- or FSLIC-insured certificates of deposit. The depository institution agrees to provide the deposited funds to private users for purposes eligible for tax-exempt IDB financing. Interest and principal on the bonds are repaid from payments on the certificates of deposit. The repayment of the bonds is secured by the certificates. Because the proceeds of the bonds are used ultimately for exempt purposes, the bonds qualify as tax-exempt under present law. Because the trustee for the bondholders holds a certificate of deposit in an insured institution, the amount of each bondholder's holdings is insured to the extent of $100,000.

Small Business Administration guarantees

The Small Business Administration (SBA) is authorized to guarantee 100 percent of the payments due from eligible small businesses under contracts for the planning, design or installation of governmentally mandated pollution control facilities.[8] Additionally, through its guaranteed debentures program, the SBA may provide an indirect guarantee for tax-exempt obligations. The current policy of the SBA is to avoid participation in projects financed with tax-exempt obligations. However, the Senate Committee on Small

[5] The FDIC provides insurance for deposits in commercial banks and State mutual savings banks. The FSLIC insures deposits in savings and loan associations, Federal mutual savings banks, and certain other thrift institutions.

[6] 12 U.S.C. sec. 1817(i) and 12 C.F.R. sec. 331(b) (FDIC); 12 U.S.C. sec. 1724(b) and 12 C.F.R. sec. 564.2(c) (FSLIC).

[7] 12 C.F.R. sec. 330.8(b) (FDIC); 12 C.F.R. sec. 564.8(b) (FSIC).

[8] Small Business Investment Act of 1958, 15 U.S.C. sec. 694-1.

Business has reported favorably[9] a bill (S. 499) which would prohibit SBA from declining to participate in projects because of the presence of tax-exempt financing.

Tax-exemptions outside the Internal Revenue Code

In addition to the tax-exemptions provided under the Internal Revenue Code, certain non-tax statutes provide an exemption for interest on specified obligations. Obligations to which these provisions apply generally are not subject to the restrictions on tax-exempt bonds contained in the Internal Revenue Code.

District of Columbia Bonds

Under the District of Columbia Self-Government and Governmental Reorganization Act, Pub. L. 93-198, the District of Columbia is authorized to issue (1) general obligation bonds and (2) revenue bonds and notes for use in the areas of housing, health, transit and utility facilities, recreational facilities, college and university facilities, pollution control facilities, and industrial and commercial development. Under the Act, the interest on these obligations is exempt from all Federal and District taxation (except estate and gift taxes).[10]

The Internal Revenue Service has held that interest on bonds and notes issued by the District of Columbia is exempt from Federal income taxes notwithstanding the industrial development bond provisions of the Internal Revenue Code.[11] Thus, the District of Columbia may issue bonds for industrial and commercial development without regard to the limitations on small-issue IDBs. However, the bonds remain subject to an arbitrage limitation.

Possessions bonds (Puerto Rico, Virgin Islands, and Guam)

Under the Puerto Rico Federal Relations Act,[12] interest on bonds issued by the Government of Puerto Rico, or by its authority, are exempt from Federal, State, and Puerto Rican taxation. Similarly, the government of the Virgin Islands may issue tax-exempt general obligations for public works, slum clearance, urban redevelopment or to provide low-rent housing. The government of Guam also has authority to issue obligations the interest on which is exempt from Federal, State or Guam taxation.[13]

TEFRA restrictions on private activity bonds

In addition to providing limitations on small issue IDBs (including the December 31, 1986 sunset for small issue IDBs) and on cost recovery for IDB-financed property, TEFRA made several changes in the rules concerning IDBs generally. First, TEFRA required that issuers of all private activity bonds (including IDBs, scholarship funding bonds, and bonds issued by charitable organizations exempt from tax under sec. 501(c)(3)) make quarterly information reports to the IRS concerning bonds issued by that issuer. TEFRA

[9] S. Rep. 98-22, 98th Cong., 1st Sess. (March 11, 1983). The House Committee on Small Business has reported a similar bill.

[10] D.C. Code sec. 47-332.

[11] Rev. Rul. 76-202, 1976-1 C.B. 26.

[12] Laws 1917, ch. 145, 39 Stat. 953 (48 U.S.C. sec. 745).

[13] Pub. L. 418, 81st Cong., 1st Sess. (1949) (48 U.S.C. sec. 1403).

also required that issuance of IDBs be approved by an elected official in the issuing jurisdiction, and in all jurisdications where the facilities financed with the bonds will be located, following a public hearing or that issuance be approved pursuant to a voter referendum. In addition, the average length of time to maturity of IDBs generally was limited by TEFRA to 120 percent of the economic life of the property being financed.

Reasons for Change

General considerations

The committee is extremely concerned with the growing volume of tax-exempt bonds used to finance private activities. At a time when the Congress is taking action to restrain the growth of expenditures for important Government programs, and in some cases reducing the level of Federal spending, the committee believes it would be inappropriate not to restrain the growth of subsidies provided for private businesses through industrial development bonds. The volume of these bonds has increased sharply over the past few years—private activity bonds increased from 21 percent of total State and local borrowings in 1975 to 68 percent in 1983. The TEFRA limitations on private activity bonds, including public notice and approval and information reporting requirements, limitations on cost recovery, and limitations on small issue IDBs, restricted the benefits associated with certain IDB-financed projects and eliminated some of the worst abuses associated with private activity bonds. However, the TEFRA rules appear unlikely to prevent substantial increases in the revenue loss associated with the growth in the volume of private activity bonds.

The rapid growth of private activity bonds is a source of concern for several reasons. First, the mounting volume of private activity tax-exempt bonds has resulted in an increasing revenue loss (a projected $8.5 billion for 1983 from identifiable private activity bonds). Because a substantial portion of the benefits of tax-exemption flows to the investor, tax-exempt bonds are a relatively inefficient means of providing a subsidy.

Second, the committee is concerned that the expanding volume of private activity bonds has inflated tax-exempt interest rates, thereby increasing the costs of State and local borrowing for traditional public purposes (schools, roads, public projects, etc). Competition from private activity bonds may thus force State and local governments to choose between raising taxes in order to meet increased borrowing costs or providing a lower level of services.

Finally, the availability of tax-exempt financing for certain types of projects tends to encourage investment in such projects independent of the economic value of the project. Such financing may therefore divert investment capital away from its most productive uses.

Restrictions on cost recovery deductions

The committee is also concerned with the combined subsidies provided by the interaction of the tax rules for cost recovery, investment tax credit and tax-exempt financing. In most cases, the committee believes that the combined subsidies are too generous.

Consequently, the committee believes that new restrictions on cost recovery deductions taken by private taxpayers for property financed by IDBs are necessary. Therefore, the bill requires taxpayers to choose between (1) ACRS and conventional financing and (2) tax-exempt financing and a slower rate of cost recovery than that usually provided in conjunction with the ACRS recovery periods. The committee does not believe such a requirement will reduce the use of IDBs in appropriate circumstances, but will simply eliminate an unnecessary portion of the total subsidy which is provided to the user of the bond proceeds.

The committee believes that extraordinary levels of subsidy are necessary in the case of certain types of property. In those cases, both tax-exempt financing and the full ACRS deductions will continue to be available. The committee believes that these additional levels of subsidy are appropriate for low-income rental housing, municipal solid waste disposal facilities, air and water pollution control facilities installed in existing plants, and projects financed in part with a UDAG grant.

Further restrictions

In addition to the restrictions on cost recovery deductions, the committee believes that a number of other modifications to the rules applicable to tax-exempt financing should be changed.

Federally guaranteed tax-exempt obligations

The committee is concerned by the combination of tax-exempt financing with Federal guarantees. This combination results in a double subsidy for certain activities. Since federally guaranteed tax-exempt bonds are more attractive than United States Treasury securities (which are taxable) and other State and local obligations (which do not have Federal guarantees), the proliferation of such bonds may make it difficult for both the Federal and State governments to raise needed funds. The bill therefore eliminates the tax-exemption for interest on bonds where a substantial portion of the issue is to be deposited in Federally insured deposits or accounts in financial institutions, thereby receiving an effective guarantee. Also the bill limits tax-exemption for SBA-guaranteed bonds to cases where the SBA charges a reasonable fee for this service.

Miscellaneous changes

The bill also imposes certain other restrictions on IDBs. These restrictions are designed, in part, to prevent the overuse of small issue IDBs by any one beneficiary and the aggregation of small issue bonds so as to provide extensive amounts of financing for one large-scale project. In addition, the bill tightens the arbitrage restrictions on certain IDBs by extending arbitrage rules similar to those applicable to mortgage subsidy bonds to IDBs, subjects bonds with respect to which the tax-exemption presently is outside the Internal Revenue Code to the Code provisions, and makes certain other changes in the law regarding IDBs.

Explanation of Provisions

1. Restriction of cost recovery deductions for certain property financed with tax-exempt bonds

General rule

The bill provides that property that is placed in service [14] after June 30, 1984, generally will receive cost recovery deductions using the straight-line method over extended recovery periods. This rule applies only to property of the type that presently is restricted to cost recovery deductions determined using the straight-line method over ACRS periods, and only to the extent that the facilities are financed by any tax-exempt bonds.[15] In lieu of using the straight-line method over ACRS periods, the cost of such property must be recovered using the straight-line method (with a half-year convention for personal property and a monthly convention for real property) over the following schedule of lives: 4 years for 3-year property, 7 years for 5-year property, 13 years for 10-year property, 20 years for 15-year public utility property, and 22 years for nonresidential 15-year real property (changed to 20-year property under other provisions of the bill). This limitation applies to both the first owner of the property and to any subsequent owners who acquire the property while the IDBs (including any refunding issues) are outstanding.

Exceptions for certain facilities

The bill retains the exceptions of present law permitting the cost of certain types of facilities financed in whole or in part with IDBs to continue to be recovered under ACRS. The facilities eligible for full ACRS deductions under the bill (and under present law) are low income rental housing, municipal solid waste disposal facilities, certain air or water pollution control facilities in existence on July 1, 1982, and certain facilities with respect to which a UDAG grant is made.

2. Denial of tax-exemption for certain obligations with a Federal guarantee

Federally insured deposits

The bill provides generally that interest on any obligation is not exempt from Federal income tax if the obligation is part of an issue, a significant portion of the proceeds of which are to be invested, directly or indirectly, in Federally insured deposits or accounts in a financial institution. These rules apply to all obligations which are issued by or on behalf of States and their political subdivisions or otherwise described in section 103.

For purposes of these rules, a "Federally insured financial institution" means any bank, credit union, mutual savings bank, cooperative bank, domestic building and loan association, or other sav-

[14] For this purpose, property is placed in service when it is eligible for investment credit and capital cost recovery deductions.

[15] If the tax-exempt IDBs are first issued after the property is placed in service, the taxpayer is required to recompute any cost recovery deductions claimed for that property in prior years.

ings institution whose deposits or accounts are insured under Federal law.

Federally insured deposits or accounts include any deposit or account in a financial institution to the extent the deposit or account is insured under Federal law by the Federal Deposit Insurance Corporation (FDIC), the Federal Savings and Loan Insurance Corporation (FSLIC), the National Credit Union Administration (NCUA), or any similar Federally chartered corporation. This rule on investment of bond proceeds in Federally insured deposits or accounts applies to all IDBs and to qualified mortgage bonds and veterans' mortgage bonds.

The prohibition on investing bond proceeds in Federally guaranteed deposits does not apply to the extent that bond proceeds are invested for an initial temporary period until the proceeds are needed for the purpose for which the bonds were issued, are part of a bona fide debt service fund, or are part of a reserve or replacement fund meeting the requirements of section 103(c)(4)(B).

Small Business Administration guarantees

The bill denies tax-exemption for bonds that are guaranteed under the Small Business Administration's pollution control or certified development loan program, unless the SBA charges a fair market loan guarantee fee equal to at least one percent of the guaranteed amount.

3. Additional arbitrage rules for IDBs

The bill extends arbitrage rules similar to those presently applied to qualified mortgage bonds to IDBs. Under these rules, certain arbitrage profits earned on acquired nonpurpose obligaticns acquired with the gross proceeds of the bonds must be rebated to the United States. This provision will apply to all IDBs except IDBs that are issued for housing and in connection with sewage and solid waste facilities described in section 168(f)(12)(C). For this purpose, gross proceeds are the original proceeds of the bonds, the investment return on obligations acquired with bond proceeds (including repayment of principal), and amounts to be used to pay debt service, such as sinking funds.

Ninety percent of the rebate will be due each 5 years, with the entire rebate due 30 days after the retirement of the bond issue. For purposes of determining the amount of rebate, no costs are taken into account, so that arbitrage is calculated by comparing the yield on nonpurpose obligations (determined without regard to costs of acquiring the obligations) with the yield on the bonds (determined without regard to issuance costs and underwriter's discount). The amount subject to rebate will not be taxable and the rebate will be nondeductible, for income tax purposes.

The rebate requirement does not apply when all gross proceeds of a bond issue are expended within 6 months of the issue date. Additionally, if less than $100,000 is earned on a bona fide debt service fund in a bond year, arbitrage earned on the fund in the year is not subject to the rebate requirement. As under the mortgage subsidy bond rules, hidden arbitrage is prohibited.

The bill further limits the amount of bond proceeds that can be invested at a yield above the bond yield in nonpurpose obligations in any bond year to 150 percent of the debt service on the issue for the bond year. These investments must be reduced as the obligations of the bond issue are repaid. The 150 percent of debt service limit does not apply to amounts invested for the temporary periods permitted under present law.

4. Other limitations on the use of IDBs

Restrictions on use of small issue IDBs where beneficiary has significant IDB use

The bill provides rules which restrict the amount of small issue IDBs that can be issued for a particular beneficiary of IDBs where that beneficiary has received the benefit of a significant amount of IDBs. Under the bill, tax-exempt small issue IDBs could not be issued if the total amount of all IDBs that would be outstanding after the issue for the beneficiary who would be the beneficiary of the small issue IDBs exceeds $40 million. In determining whether the $40 million limit has been reached, all types of IDBs (i.e., both exempt purpose and small issue IDBs) are counted. However, bonds which are to be redeemed with the proceeds of the small issue IDBs are not to be counted. A beneficiary is defined as any person who is a user of the bond-financed facilities. Additionally, all related parties are treated as one user.

The bill includes allocation rules for applying the $40 million limitation. Under these rules, the entire face amount of the issue is allocated to any person (other than the issuer) who is a lessor of the facility or sublessor of the entire facility. A sublessor of a part of a facility also will be allocated a proportionate part of the bond amount equal to the percentage of the facility with respect to which he or she is a sublessor. In addition, a portion of the issue equal to the percentage of the facility used by any person other than a lessor is allocated to each such other person. No portion of the face amount of an issue is allocated, however, to any beneficiary who uses less than 5 percent of the facilities financed with the issue.

Denial of tax-exempt IDB financing for certain facilities

The bill provides that interest on IDBs is not exempt if any portion of the proceeds of the IDB are to be used to provide any airplane, skybox or other private luxury box, any facility primarily used for gambling, or any store the principal business of which is the sale of alcoholic beverages for consumption off-premises. The prohibition applies both to exempt-purpose IDBs and to small-issue IDBs.

Extension of Internal Revenue Code rules to certain obligations

The bill extends certain Internal Revenue Code rules relating to tax-exempt obligations to bonds which are described in provisions of Federal law outside of the Internal Revenue Code. The rules extended to these obligations include (1) the rules relating to industrial develpment bonds, arbitrage bonds, and mortgage subsidy bonds; (2) the public approval requirements and information reporting requirements of present law; (3) the requirement that obligations be in registered form; and (4) the disallowance of tax-exemption for obligations which are invested in Federally insured deposits or guaranteed by the SBA (except as provided above). Under this amendment, interest on the obligations described in those non-Code provisions will not be exempt from Federal income tax unless the obligations complies with the rules described above. In addition, the bill authorizes the Virgin Islands and American Samoa to issue IDBs, subject to the restrictions of the Code.

Application of small issue IDB limits to entire project

The bill provides a special rule which prevents avoidance of the limitations on small issue IDBs through division of the ownership of a project. Under the rule, where two or more issues of IDBs are used to finance a single building, an enclosed shopping mall, or a strip of offices, stores, or warehouses which use substantial common facilities, the two or more issues are treated as a single issue for purposes of determining qualification under the small issue exception, and all principal users of any of the facilities financed with the issue are treated as principal users of a single facility. Thus, under the rule, where ownership of a project is divided among several different unrelated users, qualification under the small-issue exception is to be determined by measuring the capital expenditures and outstanding obligations of all the principal users of that project.

Examples of common facilities include situations where there are (1) common heating, cooling and other facilities or (2) common entrances, plazas, malls, lobbies, parking, elevators, and stairways for use by employees or patrons of the facilities. In order for there to be common facilities, the two facilities used by the different users generally must be contiguous. For example, all units in a strip shopping center which use a common parking lot would be treated as a single facility (regardless of whether the strip shopping center is physically divided into more than one structure) because the structures are essentially contiguous to each other. However, two or more stores located in a downtown redevelopment project which are not contiguous to each other generally would not be treated as a single project. Structures which are separated by inconsequential barriers, such as rights of way, would be treated as contiguous for this purpose.

The committee anticipates that the Treasury Department will issue regulations defining circumstances where, because use of common facilities is *de minimis*, otherwise separate facilities will not be treated as a single project. For example, ordinarily separate department stores that each lease less than 25 percent of an independently owned parking garage adjoining them should not be treated as a single facility. Likewise, use of utility facilities, such as the same local district heating and cooling system, by otherwise separate businesses is not in itself sufficient to treat the buildings used by the businesses as a single project.

Extension of substantial user rule to all partners and shareholders in an S corporation

The bill amends the rules of present law under which interest on IDBs is not exempt to the extent that the bonds are owned by a substantial user of the facilities financed with the IDB or the holder is a related person to that substantial user. Under the bill, all partners (including both general and limited partners) of a partnership and spouses and dependent children of partners are treated as related persons to the partnership. Also, all shareholders of an S Corporation and spouses and dependent children of shareholders are treated as related persons to the corporation. Thus, interest on IDBs held by any partner of a partnership or shareholder of an S Corporation that is a substantial user of the facilities financed with the IDBs would not be exempt from Federal income tax.

Exemption from IDB restrictions for bonds issued by the Power Authority of the State of New York

The bill provides that bonds issued by the Power Authority of the State of New York will not be subject to the restrictions applicable to IDBs. This provision applies only to bonds used to finance generating plants and transmission facilities for power that is sold to investor-owned utilities who in turn sell the power to consumers at no mark-up in price.

Effective Dates

Restrictions on cost recovery deductions for property financed with IDBs

The provision that restricts the cost recovery deductions of property financed with IDBs generally applies to property placed in service after June 30, 1984, to the extent that such property is financed by the proceeds of IDBs (including a refunding obligation) issued after March 15, 1984. For purposes of this rule, a refunding issue issued after March 15, 1984, generally is treated as a new issue and the taxpayer must use the slower recovery methods for costs that are unrecovered on the date of the refunding issue.

However, the restrictions on cost recovery deductions do not apply to facilities placed in service after June 30, 1984 if—

(1) the original use of the facilities commences with the taxpayers and the construction of the facilities had commenced before March 16, 1984,

(2) a binding contract existed on March 15, 1984, and at all times thereafter which committed the purchaser to incur significant expenditures for construction or acquisition of the facilities.

In cases where a change of recovery method is required because of a refunding issue, only the remaining unrecovered cost of the property is required to be recovered using the slower method and period. Therefore, no retroactive adjustments to cost recovery deductions previously claimed are required upon a refinancing of a pre-March 16, 1984 issue where no significant expenditures are made with respect to the facility after June 30, 1984.

Whether or not an arrangement between a purchaser and contractor or seller constitutes a contract is to be determined under the applicable local law. A binding contract is not considered to have existed on March 15, 1984, however, unless the property to be acquired or service to be rendered was specifically identified or described before that date.

A binding contract for purposes of this provision exists only with respect to property or services for which the taxpayer is obligated to pay under the contract. In addition, where a contract obligates a taxpayer to purchase a specified number of items and also grants an option to purchase additional items, the contract is binding on the taxpayer only to the extent of the items that must be purchased.

A contract may be considered binding on the taxpayer even though (1) the price of the item is to be acquired or services rendered under the contract is to be determined at a later date, (2) the contract contains conditions the occurrences of which are under the control of a person not a party to the contract, or (3) the taxpayer has the right under the contract to make minor modifications as to the details of the subject matter of the contract.

A contract which was binding on the taxpayer on March 15, 1984, will not be considered binding at all times thereafter if it is substantially modified after that date. Additionally, a contract under which the taxpayer has an option to acquire property is not a contract that is binding on the taxpayer for purposes of this exception unless the amount paid for the option is forfeitable and is more than a nominal amount.

Other rules

The provision denying tax-exemption to interest on obligations the proceeds of which are invested in Federally insured accounts in financial institutions is efffective with respect to obligations issued after April 15, 1983, except for obligations issued pursuant to a written commitment binding on March 4, 1983, and at all times thereafter.

The provision affecting tax-exemption of interest on bonds repayment of which is guaranteed by the Small Business Administration is effective for bonds issued after the date of the bill's enactment.

The provisions affecting the allowable arbitrage on industrial development bonds apply to bonds issued after December 31, 1984.

The other provisions of the bill, which are similar to provisions contained in H.R. 4170, as reported by the House Committee on Ways and Means on March 5, 1984, apply generally to bonds issued after December 31, 1983. These provisions do not apply, however, to bonds the proceeds of which are used to finance facilities (1) the original use of which commences with the taxpayer and the construction of which began before October 19, 1983, or (2) with respect to which a binding contract to incur significant expenditures was entered into before October 19, 1983. The rules for determining when a binding contract exists for purposes of the restrictions on cost recovery deductions apply as well for that purpose under this transitional rule.

Special rules

The special exemption for bonds issued by the Power Authority of the State of New York applies to bonds issued after the date of enactment and to bonds issued after December 31, 1969, the interest on which was tax-exempt when the bonds were issued.

The bill also provides special transitional rules under which certain projects are exempt from some or all of the restrictions provided by the bill.

C. Student Loan Bonds

(Sec. 719 of the bill and sec. 103 of the Code)

Present Law

Tax-exempt student loan and other consumer loan bonds

Presently, tax-exempt bonds may be issued to finance personal loans to individuals for non-business purposes, including the financing of student loans. Because the proceeds of such loans generally are not used in the conduct of a trade or business, these bonds are not subject to the restrictions applicable to industrial development bonds. However, present law does contain a number of restrictions on the use of tax-exempt bonds to provide financing for owner-occupied residences (sec. 103A).

Department of Education subsidies

The Department of Education subsidizes student loans under the Guaranteed Student Loan (GSL) and PLUS programs. These Federally subsidized loans, in turn, can be financed with tax-exempt bonds. The subsidy takes three forms. First, the Department of Education guarantees repayment of qualified student loans. Second, the Department pays these special allowance payments ("SAPs") as an interest subsidy on qualifying student loans so that the student borrowers are required to pay less interest on the loans. If student loans are financed with tax-exempt bonds, the amount of these SAPs is reduced. Third, the Department pays an additional interest subsidy on qualified loans while the student is attending school.

Section 7 of the Student Loan Consolidation and Technical Amendments Act of 1983 requires issuers of tax-exempt bonds, as a condition to receiving SAP payments, to issue no more tax-exempt bonds than are required to finance the reasonable needs for student loan credit within the area served by the authority, after taking into account existing sources of student loan credit in the area. The Department of Education issued proposed regulations under this provision on February 10, 1984 (49 *Fed. Reg.* 5330), which generally require that an authority conduct a survey of available credit (including taxable loans) in the area and conclude that such credit is insufficient to meet reasonable needs before issuing tax-exempt student loan bonds. Additionally, the proposed regulations restrict the maturity of tax-exempt student loan bond issues to 10 years. Refinancing are limited to the outstanding balance of the loans being financed.

The proposed regulations also require that proceeds of tax-exempt issues be expended within two years (in the case of issues used to acquire existing student loans) or one year (in the case of proceeds used to make direct loans). Proceeds not so used in excess of five percent of the original issue (other than proceeds included in a reasonably required reserve or replacement fund) must be used promptly to repay obligations comprising the issue. An authority further is prohibited from issuing bonds more than 3 months before the bond-use period commences.

Restrictions on arbitrage

Present law denies tax-exemption for interest on obligations, including qualified scholarship funding bonds, that are treated as arbitrage bonds. An arbitrage bond is defined as an obligation that is part of an issue all or a major portion of the proceeds of which are to be used (directly or indirectly) to acquire taxable obligations which produce a materially higher yield than the yield on the tax-exempt obligations (or to replace funds which are so used). There are exceptions for materially higher yielding obligations held for a temporary period or in a reasonably required reserve or replacement fund.

Treasury regulations generally limit permissible arbitrage on student loan notes to a spread between the interest on the bonds and the interest paid equal to the greater of (i) 1.5 percentage points plus reasonable administrative costs, or (ii) all reasonable direct costs of the loan program (including issuance costs and bad debt losses). For this purpose, the SAP payments made by the Department of Education as an interest subsidy on student loan notes are not treated as interest on notes. As a result, issuers may receive the regular arbitrage plus the direct interest subsidy. Additional arbitrage rules apply to investments other than student loan notes that are acquired with the proceeds of a student loan bond issue.

Reasons for Change

The committee is concerned about the growing use of tax-exempt bonds to finance loans for personal expenses of higher education (including tuition, fees, books, and personal living expenses) and the possible use of tax-exempt bonds to finance other personal loans.

Currently, the average charges for tuition, fees, and room and board are in excess of $7,000 at private colleges and universities and exceed $3,000 at public institutions. With over 12 million students enrolled in institutions of higher education, the committee is concerned that the volume of tax-exempt bonds may increase substantially if such bonds can be issued without limitation to finance the costs of tuition, room, and board at colleges and universities. If tax-exempt bonds were used to finance an average loan of $4,000 for 12 million students, the annual volume of private purpose bonds would increase by $48 billion, an amount that exceeds the total volume of private purpose bonds issued in 1982. If tax-exempt bonds were used only to finance an average loan of $6,000 for the approximately 2.5 million students enrolled at private institutions, the increased volume of bonds would be $15 billion, more than the total amount of small-issue IDBs issued in 1982. Currently, there are no Federal limitations or standards imposed on student loan bonds other than bonds issued in connection with the Guaranteed

Student Loan and PLUS programs under the Higher Education Act of 1965.

In the area of higher education loans, the committee believes that a moratorium should be imposed on the creation or substantial expansion of existing tax-exempt student loan bond programs (other than the GSL and PLUS programs) so that Congress can evaluate the costs and benefits of such programs and consider whether Federal standards or limitations should be imposed for such programs. With respect to bonds for other types of personal loans, the committee believes it is appropriate to adopt a general rule denying tax-exemption.

The committee is also concerned that the existing arbitrage rules for student loan bonds may not be appropriate. In particular, the committee is concerned that changes in the Higher Education Act of 1965, and the Internal Revenue Code, affecting student loan bonds, may be made in the future, without consideration of the interaction between the two statutes.

Finally, the committee believes that issuers of student loan bonds under the GSL and PLUS programs should be encouraged to issue taxable bonds where taxable financing, together with the higher SAP authorized by Higher Education Act of 1965, can serve the reasonable needs for student loan credit within the area served by the issuer.

Explanation of Provisions

Limitations on Consumer Loan Bonds

The bill generally denies tax-exemption for interest on consumer loan bonds, which are defined as obligations five percent or more of the proceeds of which are to be used directly or indirectly to make loans to persons other than exempt persons. (For this purpose, investments of bond proceeds unrelated to the purpose of the bond issue are not taken into account.) Loans to enable a borrower to finance any tax or governmental assessment of general application for an essential government function are not taken into account. In addition, consumer loan bonds do not include IDBs, qualified mortgage bonds and qualified student loan bonds.

Student loan bonds

Limitation on nonqualified student loan bonds

The bill continues the tax-exemption for interest on student loan bonds issued in connection with the Guaranteed Student Loan and PLUS programs of the Department of Education. These qualified student loan bonds are defined as bonds all or a major portion of the proceeds of which are to be used to make or finance loans for which a SAP payment under the GSL or PLUS programs is authorized to be paid to the bond issuer (or other holder of the loan for the benefit of the issuer).

The bill denies tax-exemption for student loan bonds other than qualified student loan bonds. This rule applies to bonds issued after the date of enactment and before October 1, 1986. Transition rules are provided allowing continued issuance of a limited amount of nonqualified student loan bonds by issuers with existing programs.

Arbitrage restrictions on student loan bonds

The bill continues the present-law arbitrage rules for student loan bonds and requires the Congressional Budget Office and General Accounting Office to study and report to the Congress, within 9 months of the date of enactment, on the proper role to be served by tax-exempt financing in the Guaranteed Student Loan and PLUS programs, and the appropriate arbitrage provisions that should be made applicable to such bonds. The committee anticipates that, following receipt of this report, Congress will study the issue of student loan bond arbitrage profits and adopt statutory provisions that will eliminate abuses, but ensure that such bonds can be issued where such bonds are needed to serve reasonable needs for student loan credit.

In the event Congress does not adopt statutory arbitrage provisions for student loan bonds, the Treasury Department is authorized to issue regulations replacing the current statutory and regulatory rules that determine whether a student loan bond is an arbitrage bond as defined in section 103(c)(2). Under the bill, these arbitrage regulations will not become effective until the later of (1) six month's after their adoption or (2) the earlier of the reauthorization or expiration of the Guaranteed Student Loan program authorized by the Higher Education Act of 1965.

Exceptions from the new arbitrage regulations are provided for bonds issued exclusively to refund student loan bonds issued before the effective date of the regulations, and for bonds which are needed to fulfill certain binding written commitments of the issuer to acquire student loan notes. This exception is intended to apply only to commitments made before the effective date of the regulations to acquire student loan notes originated after June 30, 1984, and before such date. In addition, the exception applies only to commitments made consistent with the issuer's practices in establishing a secondary market as of March 15, 1984. The committee believes that this rule will ensure that an increased level of purchase commitments in excess of reasonable needs for student loan credit is not made solely to enable the issuer to issue additional tax-exempt bonds under current arbitrage rules.

Election to issue taxable student loan bonds

The bill clarifies present law by allowing issuers of tax-exempt student loan bonds to make an election to treat any bond issue as a taxable bond, without prejudice to the status of the issuer's outstanding or future tax-exempt bonds, or the issuer's tax-exempt status. The comittee intends that the Treasury Department will establish a procedure for making this election.

Requirement that student loan bond proceeds be devoted to loan program

Present law (sec. 103(e)) defines a qualified scholarship funding bond as an obligation issued by a non-profit corporation established at the request of a State or local government exclusively for the purpose of acquiring student loan notes incurred under the Higher Education Act of 1965, and required to devote any income (after payment of expenses, debt service, and the creation of reserves for the same) to the purchase of additional student loan notes or to pay over any income to the State or a political subdivision thereof. The bill requires that bond indentures for student loan bonds issued after the date of enactment provide that income (as defined in sec. 103(e)) from the bond, and from prior student loan bonds of the issuer be devoted to the purchase of additional student loan notes or paid over to the United States. Similarly, the indenture must provide for payment to the United States of an amount equal to any prohibited payments. Prohibited payments are payments to a State or political subdivision for non-student loan purposes and the total amount of any lavish or extravagant expenditures. The bond indenture requirement would not be applicable with respect to payments that are required to be made by a binding contract or provision of State law in effect on March 15, 1984. In addition, for bonds issued after December 31, 1984, section 103(e) would be amended to require that income from qualified scholarship funding bonds be devoted to the purchase of student loan notes or paid over to the United States (rather than a State of political subdivision thereof).

Effective Date

Except as otherwise noted in the "Explanation of Provisions," the student loan bond provisions are effective upon enactment.

D. Revenue Effect of Tax-Exempt Bond Provisions

Mortgage Bonds

The mortgage bond provisions are estimated to reduce fiscal year receipts by $52 million in 1984, $238 million in 1985, $551 million in 1986, $910 million in 1987, $1,180 million in 1988, and $1,245 million in 1989.

Industrial Development Bonds and Student Loan Bonds

The IDB and student loan bond provisions are estimated to increase fiscal year receipts by $26 million in 1984, $124 million in 1985, $304 million in 1986, $509 million in 1987, $657 million in 1988, and $742 million in 1989.

Total Tax-exempt Bond Provisions

The total tax-exempt bond provisions are estimated to reduce fiscal year receipts by $26 million in 1984, $114 million in 1985, $247 million in 1986, $401 million in 1987, $523 million in 1988, and $503 million in 1989.

TITLE VIII—MISCELLANEOUS REVENUE PROVISIONS

A. Estate and Gift Tax Provisions

1. Qualification of Certain Holding Company Stock for Installment Payment of Estate Tax (sec. 801 of the bill and sec. 6166 of the Code)

Present Law

Qualification for installment payments

Estate tax attributable to certain interests in closely held businesses may be paid in installments over up to 14 years (interest only for 4 years followed by up to 10 annual installments of principal and interest) (Code sec. 6166). A special 4-percent interest rate is provided for the first $345,800 of tax (less the decedent's unified credit) (sec. 6601).

An estate is eligible for the installment payment provision if the value of the business interest equals at least 35 percent of the value of the adjusted gross estate. An interest in a corporation qualifies for the installment payment provision if (1) the corporation has 15 or fewer shareholders or (2) the decedent owned 20 percent or more of the voting stock of the corporation.

Generally, only directly owned stock in a corporation actively engaged in a business operation is considered for purposes of the 35-percent and 20-percent tests. A special rule permits attribution to a decedent of stock in an otherwise qualified corporation that is owned by certain family members; however, if this attribution provision is elected, the 5-year deferral of principal and the special 4-percent interest rate are not available.

Present Treasury regulations take the position that the value of a trade or business carried on as a proprietorship includes only the value of those assets of the decedent which were actually used in the trade or business. On the other hand, if the business is carried on as a partnership or a corporation, the value of the trade or business is determined based upon the value of all partnership or corporate assets, even though a portion of the partnership or corporate assets may be used for a purpose other than carrying on a trade or business. Treas. reg. sec. 20.6166A-2(c)(2).

Acceleration of unpaid installments

Unpaid installments of tax are accelerated in certain circumstances. First, if cumulative dispositions and withdrawals from the business equal 50 percent or more of the decedent's interest, all unpaid installments are accelerated. Redemptions of stock under section 303 (relating to income tax treatment of certain redemptions for payment of estate taxes) are not considered withdrawals for purposes of the acceleration rules if an amount equal to the redemption proceeds is used to pay Federal estate taxes on or before the due date of the first installment that becomes due after the date of the redemption.

Second, all unpaid installments are accelerated if an estate has undistributed net income (UNI) in any year after the first installment is due unless the executor pays an amount equal to the UNI to reduce the amount of unpaid installments. Third, all unpaid installments are accelerated if payment of any installment is not made within 6 months after the due date of that installment.

Reasons for Change

The estate tax installment payment provision is intended to prevent the necessity of disposing of interests in active businesses solely to enable payment of Federal estate tax by estates which are illiquid because a substantial amount of the estate's value is comprised of an interest in a closely held business operation. Because liquidity problems may arise whether the closely held business interest is owned directly or indirectly through a holding company, the committee believes it is appropriate to permit certain holding companies to be "looked through" to determine whether an individual owned a qualifying interest in a closely held business.

The committee believes that this look through rule should be limited, however, to cases where the indirectly owned interest in an active business would qualify for the installment payment provision were it directly owned by the decedent. Additionally, the committee determined that this look through should be limited to cases where the decedent owned at least 20 percent of the value of each successive corporation which is looked through. These limitations are consistent with the general rule defining an interest in a closely held corporation. The committee also determined that the special restrictions that apply to cases where stock owned by family members is attributed to a decedent should apply in the case of active business interests owned indirectly through holding companies.

The committee further determined that similar rules should be applied in valuing a decedent's closely held business interest whether that business is operated as a proprietorship, a partnership, or a corporation. Therefore, the committee bill provides that investment assets owned by partnerships and corporations should be disregarded when determining whether the business qualifies under section 6166. This is the same rule as now applies to businesses conducted as proprietorships.

Explanation of Provisions

Qualification of certain holding company stock for installment payments

The bill permits an executor to elect to treat stock in certain holding companies as stock in an active business for certain purposes under the estate tax installment payment provision. Under the bill, any stock in a corporation carrying on an active business, which could be considered in determining qualification for estate tax installment payments were it owned directly, generally can be so considered. Indirectly owned stock need not, by itself, qualify the estate for the installment payment provision, however. Rather, the indirectly owned stock can be combined with other stock that the decedent owned directly to qualify the estate. Likewise, stock the ownership of which is attributed to the decedent because family members actually own it may be considered in conjunction with directly owned stock and stock owned indirectly through a holding company.

The provision permits multiple holding companies to be looked through in determining whether the decedent owned an interest in an active corporation. Because of the complexity associated with looking through multiple corporations, the bill provides that a corporation will be looked through only if at least 20 percent of the total value of the corporation is included in the decedent's gross estate, either directly, or indirectly through a qualifying interest in another, higher tier, corporation. For example, if the corporation carrying on an active trade or business were a fourth-tier subsidiary, the value of that active corporation could be considered for purposes of the installment payment provision only if the decedent directly owned at least 20 percent of the value of the first-tier holding company, and indirectly owned at least 20 percent of each of the second-tier and third-tier holding companies. The look through provision is applied successively to the stock of each corporation in a chain, stopping at the earlier of the corporation of which the decedent owns less than the required 20-percent interest or the active business corporation which the executor elects not to look through.

Under the bill, the value of voting stock in a corporation carrying on an active business may only be reflected through the value of voting stock in higher-tier holding companies to determine whether the decedent owned 20 percent or more of the voting stock in a corporation carrying on a trade or business (sec. 6166(b)(1)(C)(i)). The value of lower-tier voting stock may not be reflected through the value of nonvoting stock in any higher-tier corporation for purposes of the 20-percent test since that test requires ownership of voting stock.

For purposes of the 35-percent test, the value of both voting and nonvoting stock in an indirectly owned active business corporation may be reflected through the value of stock in higher-tier holding companies since, unlike the 20-percent test, the 35-percent test does not require ownership of voting stock.

For purposes of the installment payment provision, the value of the holding company stock that is treated as if it were stock of an active business corporation is the value of such stock for Federal estate tax purposes, unaffected by the treatment of such stock as stock of a lower-tier active business corporation.

If an executor elects to include the value of qualified holding company stock under section 6166, the special 4-percent interest rate and the 5-year deferral of principal payments are not available.

Acceleration of unpaid installments if holding company election is made

Special rules apply under the acceleration provisions of section 6166(g) if the executor makes an election under this provision of the bill. First, any disposition of holding company stock or withdrawal of money or other property from the holding company is treated as a disposition of or withdrawal from the closely held business qualifying for installment payments. In addition, if the qualified holding company disposes of any of its active business stock or withdraws money or other property from the business, the dispcsition or withdrawal is included in determining whether unpaid installments are accelerated. The committee intends that the Treasury Department will issue regulations to ensure that dispositions or withdrawals from the corporation carrying on an active business are considered only once in determining whether tax is accelerated.

Another special rule provides that, under the provision providing for acceleration of unpaid installments, if an estate has undistributed net income in any year, dividends paid to any qualified holding company by the corporation carrying on the active business are treated as if the dividends were paid to the decedent's estate to the extent of the decedent's ownership (direct or indirect) of the company receiving the dividend.

Investment assets disregarded in the case of partnerships and corporations

The bill provides that, in the case of an interest in a partnership or corporation, assets other than property directly related to the reasonable needs of the conduct of the active trade or business with respect to which the estate qualifies for installment payments are to be disregarded for all purposes under the installment payment provision. This rule applies to all estates electing the installment payment provision; property contributed to the business must be used directly in the active conduct of the trade or business. In general, assets will be disregarded under the rule unless they form part of a partnership's or corporation's working capital or constitute reasonable reserves for financing of a specifically identified project. For example, a reserve for expansion of a factory building that is reasonably expected to be completed within two years of the time the contributions to the reserve fund are made would be a reasonable reserve.

The committee is aware that corporations may often own stock in other corporations for purposes other than as passive investments. For example, a group of corporations may be functionally related (e.g., a manufacturing corporation may own all or a part of the stock in one or more of its supplier corporations). Similarly, corporations that are engaged in unrelated lines of business may be subject to varying degrees of common ownership and managerial control and direction. The committee intends that stock owned by a corporation, an interest in which qualifies for the installment payment provision, be considered as an active business asset (rather than a passive investment) if the corporations, viewed together, form a controlled group of corporations as defined in section 1563. Additionally, even though the requirements for a controlled group (under sec. 1563) are not satisfied, stock owned by one corporation in another corporation may be viewed as an active business asset, provided that based on all facts and circumstances, the businesses are either functionally related or subject to common managerial control and direction.

The committee intends that the Treasury Department issue regulations defining the circumstances under which partnership and corporate assets are to be treated as passive investments, and therefore, disregarded for purposes of the installment payment provision. In general, these regulations should provide rules similar to the rules governing the accumulated earnings tax (sec. 531). However, the committee does not intend that the accumulated earnings tax rules be followed in any case where those rules differ from the present rules under the installment payment provision pursuant to which business and personal assets are segregated in the case of proprietorships unless the difference is necessary because of the partnership or corporate form of business operation.

The committee further intends that where only a portion of a partnership interest or of stock in a corporation is treated as an interest in a closely held business, and a part of such partnership interest or stock is disposed of (or property withdrawn from the partnership or corporation), only a portion of the proceeds or property withdrawn from the business will be the 50-percent amount specified in section 6166(g)(1)(A). In most cases, the appropriate portion will be a pro rata amount. Thus, for example, if 75 percent of the stock in a corporation was treated as an interest in a closely held business and the stock was sold, only 75 percent of the proceeds would be treated as received from disposition of section 6166 stock for purposes of the acceleration rules. In some cases, however, it may be appropriate to trace proceeds, as in the case where specific assets are withdrawn from the business.

Effective Date

This provision of the bill applies to estates of individuals dying after the date of enactment.

Revenue Effect

This provision is estimated to reduce fiscal year budget receipts by less than $5 million in 1984, $13 million in 1985, $19 million in 1986, $24 million in 1987, $29 million in 1988, and $36 million in 1989.

2. Repeal of the Generation-Skipping Transfer Tax (sec. 802 of the bill and Chapter 13 of the Code)

Present Law

Under present law, a tax is imposed on generation-skipping transfers under a trust or similar arrangement upon the distribution of the trust assets to a generation-skipping heir (for example, a great-grandchild of the grantor of the trust) or upon termination of an intervening interest in the trust (for example, termination of a life income interest in the trust held by the grantor's grandchild).

Basically, a generation-skipping trust is one which provides for a splitting of benefits between two or more generations that are younger than the generation of the grantor of the trust. The generation-skipping transfer tax is not imposed in the case of outright transfers to younger generation heirs or to a trust if the benefits are not split between two or more younger generations. Thus, no generation-skipping transfer tax is imposed upon a "generation-jumping" or "layering" transfer directly to the grantor's grandchildren or other lower generation heirs. In addition, the tax is not imposed if the younger generation heir has (1) nothing more than a right of management over the trust assets or (2) a limited power to appoint the trust assets among the lineal decendants of the grantor. Present law also provides a grandchild exclusion for the first $250,000 of generation-skipping transfers per deemed transferor that vest in the grandchildren of the grantor.

The tax is substantially equivalent to the tax which would have been imposed if the property had been actually transferred outright to each successive generation (in which case, the gift or estate tax would have applied). For example, assume that a trust is created for the benefit of the grantor's grandchild during the grandchild's life, with remainder to the great-grandchild. Upon the death of the grandchild, the tax is determined by adding the grandchild's portion of the trust assets to the grandchild's estate and computing the additional tax at the grandchild's marginal estate tax rate. In other words, for purposes of determining the amount of the tax, the grandchild would be treated under present law as the "deemed transferor" of the trust property.

The grandchild's marginal estate tax rate is used for purposes of determining the tax imposed on the generation-skipping transfer, but the grandchild's estate is not liable for the payment of the tax. Instead, the tax is generally paid out of the proceeds of the trust property. In determining the amount of the generation-skipping transfer tax arising after the death of the deemed transferor, the trust is entitled to any unused portion of the grandchild's unified transfer tax credit, the credit for tax on prior transfers, the credit for State death taxes, and is allowed a deduction for certain administrative expenses.

A transitional rule was included in the law for generation-skipping transfers occurring pursuant to revocable trusts or wills in existence on June 11, 1976, if the instrument was not amended after that date to create or increase the amount of a generation-skipping transfer, and if the grantor or testator died before January 1, 1983. Generation-skipping trusts that were irrevocable on June 11, 1976, are not subject to the tax.

Reasons for Change

The present generation-skipping transfer tax is part of an integrated system of transfer taxation—gift, estate, and generation-skipping—designed to ensure that transfers for less than adequate consideration will be taxed comparably regardless of the form of the transfer. The committee has received testimony from many affected groups in favor of repeal of the present tax on generation-skipping transfers. Many of these groups have further testified to their willingness to work with the committee in the future to develop an alternative to the present tax that would not entail the administrative problems associated with the present law. Therefore, because of the complexity associated with administration of the present tax, the committee determined that it should be repealed at this time.

Explanation of Provision

The bill repeals the tax on generation-skipping transfers (Chapter 13 of the Code).

Effective Date

This provision is effective with respect to otherwise taxable generation-skipping transfers occurring after June 11, 1976. Refunds of tax will be permitted to the extent the period of limitations has not expired at the time the claim is made.

Revenue Effect

This provision will reduce fiscal year budget receipts by $5 million in 1984, and by $10 million annually in fiscal years 1985 through 1989.

3. Tax Treatment of Certain Disclaimers of Interests Transferred Before November 15, 1958 (sec. 803 of the bill and sec. 2518 of the Code)

Present Law

In general, a disclaimer is a refusal to accept the ownership of property or rights with respect to property. If a qualified disclaimer is made, the Federal gift, estate, and generation-skipping transfer tax provisions apply with respect to the property interest disclaimed as if the interest had never been transferred to the person making the disclaimer. Thus, the transfer of property pursuant to the disclaimer will not be treated as a taxable gift.

Prior tc the enactment of Code section 2518 in 1976, there were no uniform Federal disclaimer rules. Before the promulgation of Treasury regulations in 1958, the administrative practice of the Internal Revenue Service was to allow the Federal consequences of a disclaimer to depend upon its treatment under local law.

On November 14, 1958, the Treasury Department issued regulations (T.D. 6334) which required that a disclaimer (1) be effective under local law and (2) notwithstanding the timeliness of the disclaimer under local law, be made "within a reasonable time after knowledge of the existence of the transfer." In litigating this issue, the Treasury interpreted these regulations to require that a disclaimer be made within a reasonable time after the creation of the interest, rather than the time at which the interest vested, or became possessory. Thus, for example, where property was transferred to X for life, remainder to Y, both X and Y were required to disclaim within a reasonable time of the original transfer, although Y could not take possession of the property until X's death.

These regulations also applied to interests created in transfers before November 15, 1958. Thus, under the regulations, a disclaimer of an interest created in a transfer before November 15, 1958, would be qualified for Federal tax purposes only if it were made within a reasonable time after the original transfer creating the interest.

This dispute as to the timing of a qualified disclaimer generated considerable litigation, with conflicting results. The Tax Court upheld the Treasury position in a series of cases including *Jewett* v. *Commissioner,* 70 T.C. 430 (1978), *Estate of Halbach v. Commissioner,* 71 T.C. 141 (1978), and *Cottrell* v. *Commissioner,* 72 T.C. 489 (1979). However, the Circuit Courts were divided on the issue. The Eighth Circuit rejected Treasury's position, concluding that State law determines the validity of a disclaimer in *Keinath* v. *Commissioner* 480 F.2d 57 (1973) and *Cottrell* v. *Commissioner,* 628 F.2d 1127 (1980). However, the Ninth Circuit upheld the decision in *Jewett* v. *Commissioner* in 1980 (638 F.2d 93 (1980)) and the Supreme Court granted *certiorari.*

On February 23, 1982, the Supreme Court resolved the controversy in *Jewett* v. *Commissioner* (455 U.S. 305 (1982)) by upholding the Treasury position. Noting that the Treasury interpretation is entitled to respect because it has been consistently applied over the years, the Court concluded that the relevant "transfer" occurs when the interest is created and not at such later time as the interest vests or becomes possessory.

In the Tax Reform Act of 1976, Congress adopted a set of uniform rules to govern disclaimers of property interests transferred after December 31, 1976 (sec. 2518). Under these rules, a disclaimer generally is effective for Federal gift and estate tax purposes if it is an irrevocable and unqualified refusal to accept an interest in property and meets four other conditions. First, the refusal must be in writing. Second, the written refusal generally must be received by the person transferring the interest, or the transferor's legal representative, no later than nine months after the transfer creating the interest.[1] Third, the disclaiming person must not have accepted the interest or any of its benefits before making the disclaimer. Fourth, the interest must pass to a person other than the person making the disclaimer or to the decedent's surviving spouse as a result of the refusal to accept the interest.[2]

Reasons for Change

The committee determined that a limited exception to the requirements for making a qualified disclaimer is appropriate in the case of property transferred before November 15, 1958, but only if the person disclaiming the property has not accepted any of the benefits of the property and if the other requirements of present law (except for time requirements) are satisfied.

Explanation of Provisions

The bill permits disclaimers of property interests created by transfers made before November 15, 1958, to be made within 90 days after the date of the bill's enactment in certain cases. To be effective, these disclaimers must satisfy all requirements of present Code section 2518, except for the requirement that the disclaimer be made within nine months of the transfer creating the interest. Under these rules, for example, the party making the disclaimer cannot have accepted the property interest or any of its benefits, and as a result of the disclaimer, the interest must pass without any direction on the part of the person making the disclaimer in a manner satisfying the requirements of section 2518.

[1] However, the period for making the disclaimer is not to expire until nine months after the date on which the person making the disclaimer has attained age 21.

[2] In addition, with respect to interests created after December 31, 1981, certain transfers to the person or persons who would have otherwise received the property if an effective disclaimer had been made under local law, may be treated as qualified disclaimers, provided the transfers are made timely and the transferor has not accepted the transferred interests or any of their benefits.

Effective Date

This provision of the bill is effective for disclaimers made within 90 days after the date of enactment with respect to property interests transferred before November 15, 1958.

Revenue Effect

This provision will have a negligible effect on Federal budget receipts; however Government outlays in the form of tax refunds are estimated to be increased by $10 million in fiscal year 1984, $30 million in 1985, and by less than $5 million annually for subsequent years.

4. Clarification That Certain Usufruct Interests Qualify for Estate Tax Marital Deduction (sec. 804 of the bill and secs. 2053 and 2056 of the Code)

Present Law

Present law generally permits an unlimited estate tax deduction for the value of interests in property passing from a decedent to his or her surviving spouse (Code sec. 2056). In general, the deduction is available only if the property interest is not a "terminable interest." A terminable interest is an interest that terminates upon the lapse of time or the occurrence or failure of an event or other contingency.

Executors of estates may elect to claim a deduction for certain qualified terminable interest property ("QTIP" property). If this election is made, the full value of the QTIP property is includible in the estate of the surviving spouse, or is treated as a gift by the surviving spouse if the spouse makes an inter vivos transfer of any part of his or her interest in the property.

QTIP property is property passing from the decedent with respect to which the surviving spouse has a right to all income, payable annually or at more frequent intervals. Additionally, no person may have a power to appoint any part of the property to any person other than the surviving spouse unless the power is exercisable only at or after the death of the surviving spouse.

Under the Louisiana Civil Code, if a surviving spouse receives a usufruct interest created by will, the interest generally is comparable to a common law life estate. A usufruct interest may be in consumable or nonconsumable property. If the usufruct is in consumable property, State law does not trace the usufruct property to find if that property is actually included in the surviving spouse's estate.

Reasons for Change

The committee believes that it is unclear under present law whether a QTIP election is available with respect to a usufruct interest for life under the Louisiana Civil Code. The committee determined that this ambiguity should be clarified to ensure that estates of Louisiana decedents receive comparable benefits from this provision to the benefits received by estates of residents of the common law States.

Explanation of Provisions

The bill redefines the term "qualified income interest for life" to include interests under which (1) the surviving spouse is entitled to all of the income from the property, payable annually or at more frequent intervals, or has a usufruct for life in the property, and (2) no person has a power to appoint any part of the property to any person other than the surviving spouse (except for a power exercisable only at or after the spouse's death).

The bill further provides that the QTIP election is to be available without regard to whether the interest is in consumable property. In the case of such consumable property, however, the value of the usufruct will be treated as included in the surviving spouse's estate under section 2044 (and not under section 2033). Additionally, no deduction is to be allowed under section 2053 for any claim against a surviving spouse's estate by a remainderman with respect to an interest (including a usufruct interest) for which a QTIP election was made by the estate of the first spouse to die.

Effective Date

This provision applies as if included in section 403 of the Economic Recovery Tax Act of 1981 (P. L. 97-34).

Revenue Effect

This provision of the bill is estimated to reduce fiscal year budget receipts by less than $5 million annually.

5. Special Estate Tax Credits (sec. 805 of the bill)

a. Estate tax credit for Estate of Nell J. Redfield (sec. 805 of the bill)

Present Law

A deduction generally is allowed for estate tax purposes for certain amounts transferred for charitable purposes (Code sec. 2055). The United States is a qualified donee of such deductible transfers. Credits against estate tax are not provided for transfers for charitable purposes.

If an estate has an estate tax liability after taking into account all allowable deductions and credits, that liability generally must be paid in cash or a cash equivalent (i.e., check or money order) (sec. 6311). Certain series of Treasury bonds (often called "flower bonds") may also be used to pay estate tax. To be eligible, these bonds must have been issued as part of certain pre-March 4, 1971, series of bonds, have been owned by the decedent at the time of his or her death, and have been included in the decedent's gross estate (sec. 6312).

Except in a case where the Internal Revenue Service must levy to secure payment of tax, real property and personal property other than cash or flower bonds cannot be used to pay estate tax.

Reasons for Change

The committee believes that the Secretary of the Treasury should be authorized to accept payment of estate tax in kind in the case of the Estate of Nell J. Redfield. In this way, a forced sale of certain land within or adjacent to the Toiyabe National Forest can be avoided, and the property can be transferred to the Secretary of Agriculture for administration by the National Forest Service.

Explanation of Provision

The bill provides a special credit against Federal estate tax imposed on the Estate of Nell J. Redfield. The credit will apply to the transfer, without reimbursement or payment, to the Secretary of Agriculture for addition to the Toiyabe National Forest of real property located within or adjacent to the boundaries of that national forest. The credit is available only if the transfer occurs within 90 days of the date of the bill's enactment.

The amount of the credit will be equal to the lesser of (1) the fair market value of the transferred property as determined for Federal estate tax purposes or (2) the estate's Federal estate tax liability (plus interest thereon).

Effective Date

This provision is effective on the date of the bill's enactment.

b. Estate tax credit for Estate of Elizabeth Schultz Rabe (sec. 805 of the bill)

Present Law

A deduction generally is allowed for estate tax purposes for certain amounts transferred for charitable purposes (Code sec. 2055). The United States is a qualified donee of such deductible transfers. Credits against estate tax are not provided for transfers for charitable purposes.

If an estate has an estate tax liability after taking into account all allowable deductions and credits, that liability generally must be paid in cash or a cash equivalent (i.e., check or money order) (sec. 6311). Certain series of Treasury bonds (often called "flower bonds") may also be used to pay estate tax. To be eligible, these bonds must have been issued as part of certain pre-March 4, 1971, series of bonds, have been owned by the decedent at the time of his or her death, and have been included in the decedent's gross estate (sec. 6312).

Except in a case where the Internal Revenue Service must levy to secure payment of tax, real property and personal property other than cash or flower bonds cannot be used to pay estate tax.

Reasons for Change

The committee believes that the Secretary of the Treasury should be authorized to accept payment of estate tax in kind in the case of the Estate of Elizabeth Schultz Rabe. In this way, a forced sale of certain land within or adjacent to the Toiyabe National Forest can be avoided, and the property can be transferred to the Secretary of Agriculture for administration by the National Forest Service.

Explanation of Provision

The bill provides a special credit against Federal estate tax imposed on the Estate of Elizabeth Schultz Rabe. The credit will apply to the transfer, without reimbursement or payment, of approximately 97.6 acres of property located in Douglas County, Nevada, to the Secretary of Agriculture for addition to the Toiyabe National Forest. The credit is available only if the transfer occurs within 90 days after the date of the bill's enactment.

The amount of the credit will be equal to the lesser of (1) the fair market value of the transferred property as determined for Federal estate tax purposes or (2) the estate's Federal estate tax liability (plus interest thereon).

Effective Date

This provision is effective on the date of the bill's enactment.

c. Revenue effect of special estate tax credits

It is estimated that these provisions will produce a one-time revenue loss of $22 million in fiscal year 1984.

B. Charitable Provisions

1. Expansion of Circumstances in Which a Deduction May be Claimed for Qualified Conservation Contributions (sec. 806 of the bill and secs. 170, 2055, and 2522 of the Code)

Present Law

Charitable contributions generally

Subject to certain limitations, present law provides a deduction for contributions of property to charitable organizations, to the United States, or to a State or local government. The deduction generally is equal to the fair market value of the property on the date of the contribution. Charitable deductions are provided for income, estate, and gift tax pruposes (Code secs. 170, 2055, and 2522).

Gifts of certain types of property interests are subject to special restrictions, either as to the amount deductible or as to the types of property interests for which a deduction is permitted. For example, a contribution of less than the donor's entire interest in property generally does not give rise to a charitable deduction (for income, estate, or gift tax purposes) unless the gift takes the form of an interest in a unitrust, annuity trust, or a pooled income fund. Exceptions to the partial interest rule are provided for gifts of remainder interests in farms or personal residences, gifts of undivided portions of the donor's entire interest in the property, and for gifts of qualified conservation interests.

Qualified conservation interests

Under present law, qualified conservation interests are real property interests donated in perpetuity for any of the following conservation purposes—

a. The preservation of land areas for outdoor recreation by, or for the education of, the general public;

b. The protection of a natural habitat of fish, wildlife, plants, or a similar ecosystem;

c. The preservation of open space (including farmland and forest land) but only if such preservation (1) either is for the scenic enjoyment of the general public, or is pursuant to a clearly delineated Federal, State, or local governmental conservation policy, and (2) will yield a significant public benefit; or

d. The preservation of an historically important land area or a certified historic structure (sec. 170(h)).

Deductible conservation interests may take any of three forms. First, the value of a remainder interest is deductible. Second, the value of a restriction (e.g., an easement) granted in perpetuity on the use of the property is deductible. Finally, the contribution of the donee's entire interest is deductible, except that the donor may retain his or her interest in subsurface oil, gas, or other minerals and the right of access to such minerals. If a donor retains mineral interests, surface mining must be precluded on the property at all times.

Reasons for Change

The committee believes that the general restrictions governing the deductibility of qualified conservation contributions, as enacted in 1980, remain appropriate today. However, it has come to the committee's attention that certain historical patterns of land ownership in some areas preclude realization of this incentive to the preservation of America's natural habitats in those areas. Therefore, the committee determined that a narrow exception to the prohibition on surface mining is justified in certain cases.

Explanation of Provisions

The bill creates a narrow exception to the general rule precluding any deduction for a conservation contribution if there is any possibility of surface mining occurring at any time on the land with respect to which the contribution relates. Under this exception, deductions for contributions of conservation interests satisfying all requirements of present law other than the complete prohibition on surface mining will be permitted if two conditions are satisfied.

First, the surface and mineral estates in the property with respect to which the contribution is made must have been separated before June 13, 1976. This separate ownership must have been continuous at all times after June 12, 1976. If the ownership of the surface and mineral estate in property first become separated after June 12, 1976, and surface mining is not completely precluded, a contribution of a restriction on the property will not qualify as a conservation contribution. In addition, under this exception, no deduction will be permitted if the owner of the surface interest at any time transferred (directly, or indirectly through a person related to the original transferor) the mineral interests to the person who owns those interests at the time the qualified conservation contribution is made, and the present owner is related to the owner of the surface estate. The committee anticipates that the Treasury Department will define the term related party in a manner similar to the definition contained under section 267.

The second condition that must be satisfied if a deduction is to be allowed under the exception is that the probability of surface mining on the property with respect to which a contribution is made must be so remote as to be negligible. The committee intends that the Treasury Department will issue regulations defining the circumstances under which the probability of surface mining occurring is so remote as to be negligible.

Effective Date

This provision is effective on the date of enactment.

Revenue Effect

This provision will reduce fiscal year budget receipts by $25 million annually during the period 1985 through 1989.

2. Collection of Amounts for U.S. Olympic Committee (sec. 807 of the bill and new secs. 6097 and 9504 of the Code)

Present Law

Present law does not provide a procedure under which the Treasury Department, through the Federal income tax return process, collects amounts to be transferred to a charitable organization. However, an individual may designate on the income tax return that $1 ($2 on a joint return) of his or her tax liability be paid over to the Presidential Election Campaign Fund to finance certain candidate campaign expenses.

Reasons for Change

The committee believes it is desirable to facilitate support by large numbers of individuals to the United States Olympic Committee as a means of encouraging financial support for this program.

Explanation of Provision

Payment of support

Under the bill, individuals entitled to an income tax refund may instruct, on the face of the return, that $1 of the refund ($2 on a joint return) be transferred to the United States Olympic Committee. Individuals not entitled to a refund who wish to support the United States Olympic Committee may pay an additional $1 with their return ($2 on a joint return) and designate this amount for the Committee. No charitable deduction is allowed in either situation. The committee intends that this be accomplished through a single line item on the income tax return.

Olympic Trust Fund

The bill also establishes a trust fund (the "United States Olympic Trust Fund") in the trust fund Code (chapter 98), for deposit of amounts designated for the U.S. Olympic Committee on individual income tax returns and to administer the provisions. The Treasury Department will pay over amounts collected from taxpayers in this manner, less the costs of collection and disbursement, to the U.S. Olympic Committee at least quarterly for use by the Committee in its exempt-function activities.

Effective Date

The provision will be effective for returns filed for taxable years beginning after December 31, 1983, and ending before January 1, 1989.

Revenue Effect

This provision will have no direct revenue effect.

3. Charitable Expense Deduction for Use of Passenger Automobile (sec. 808 of the bill and sec. 170 of the Code)

Present Law

Unreimbursed out-of-pocket expenses incurred by a taxpayer incident to the rendition of services provided to a charitable organization, such as fuel costs for a vehicle, are treated as charitable contributions (Treas. Reg. sec. 1.170A-1(g)). In determining the amount of the contribution deduction attributable to the operation of a vehicle, the taxpayer may deduct actual expenses, or may use a standard rate. At present, this rate is nine cents a mile (Rev. Proc. 82-61, 1982-2 C.B. 849). Under either computation method, the taxpayer may also deduct parking fees and tolls, but may not deduct general repair or maintenance expenses, depreciation, insurance, etc.

Reasons for Change

The committee recognizes that in recent years, increasing numbers of individuals are volunteering their services to help carry out the activities of charitable organizations, such as scouting and other youth activities, providing meals to the homeless or elderly, etc. To support the efforts of these volunteers, many of whom themselves have limited resources, and who do not receive any charitable deduction for the value of their contributed time, the committee believes that the mileage deduction allowed for use of a car in providing services to a charity should be increased to take into account additional out-of-pocket costs of operation.

Explanation of Provision

Under the bill, the standard mileage rate used in determining the amount of a taxpayer's charitable contribution deduction for the use of a passenger automobile (if the actual expense method is not used) is increased to 12 cents a mile. As with the present mileage rate, the taxpayer may also deduct parking fees and tolls, but may not also deduct general repair or maintenance expenses, depreciation, insurance, etc.

Effective Date

This provision applies to taxable years beginning after 1984.

Revenue Effect

The provision will reduce fiscal year budget receipts by $5 million in 1985, $37 million in 1986, $43 million in 1987, $51 million in 1988, and $60 million in 1989.

4. Permanent Rules for Reforming Governing Instruments Creating Charitable Remainder Trusts and Other Charitable Interests (sec. 809 of the bill and sec. 2055 of the Code)

Present Law

The Reform Act of 1969 imposed new requirements that must be met in order for a charitable deduction to be allowed for income, gift, and estate tax purposes for the transfer of a split interest to charity (i.e., part charitable and part non-charitable). In the case of a remainder interest in trust, the interest passing to charity must be in either a charitable remainder annuity trust, a charitable remainder unitrust, or a pooled income fund. In addition, a deduction is allowed for a remainder interest in a farm or personal residence. In the case of an "income" interest passing to charity (i.e., a charitable lead trust), the "income" interest must be either a guaranteed annuity or a fixed percentage of the fair market value of the trust (determined at least annually).

Present law also allows the governing instruments of charitable split-interest trusts which were executed before December 31, 1979, to be amended to conform the governing instruments to the new requirements if the amendment is completed, or judicial proceedings necessary to amend the governing instrument are begun, by December 31, 1981.

Reasons for Change

Congress first permitted reformation of charitable remainder trusts in 1974 and since that time, the Congress has extended the period for reformations several times and extended the procedure to other types of split-interest charitable contributions. Even so, it has come to the attention of the committee that there are still many instruments providing for split-interest charitable contributions which do not meet the requirements for qualification under the rules of the Tax Reform Act of 1969. In many of these cases, disqualification results in reduced amounts passing to charity. In light of the repeated need to extend the period to reform such governing instruments and the fact that failure to meet the 1969 Act rules often results in reduced amounts passing to charity, the committee believes that a permanent rule permitting reformation of split-interest charitable contributions should be permitted as long as there are adequate safeguards to avoid abuse.

Specifically, the committee is concerned that governing instruments of charitable split-interest trusts which evidenced no attempt to comply with the 1969 Act rules would be reformed only if the defects are found upon audit by the Internal Revenue Service. In order to prevent this from occurring, the committee believes that, in order for a governing instrument of a charitable split-interest contribution to be reformable, either (1) the creator had to make a bona fide attempt to comply with the 1969 Act rules or (2) the taxpayer must initiate reformation proceedings before the Internal Revenue Service could reasonably be expected to begin an audit. The committee believes that these rules will permit the correction of major, obvious defects (such as where the "income" interest is not expressed as an annuity interest or a unitrust interest) as long as the taxpayer initiates reformation proceedings before audit, while allowing the correction of minor defects (such as defects in determining the correct payout in short taxable years, in years of additional contributions, etc.) upon audit as long as there was a good faith attempt to comply with the 1969 Act rules (i.e., the payout is basically expressed as an annuity interest or a unitrust interest).

Second. The committee further believes that any reformation proceedings necessary to cure defective governing instruments should not be an opportunity to significantly revise the substance of the split-interest transfer, especially where the change reduces charity's share of the trust. Accordingly, the committee believes that the relative actuarial values of the interests of each beneficiary before and after the reformation should not differ by more than that 5 percent and that the durations of the interests before and after the reformation should be the same. In addition, to insure that the reformation not be used to increase the amount of any charitable contribution deduction allowed with respect to the original transfer, the committee believes that the deduction under the reformed governing instrument should not exceed the actuarial value of the charitable interest before the reformation.

Explanation of Provision

In general

The bill provides a permanent rule permitting reformation of governing instruments of charitable split-interest trusts which do not meet the requirements of the 1969 Act rules. In general, such reformations will be allowed where either the instrument evidences an intent to comply with the 1969 Act rules or the reformation proceedings are begun before there is an opportunity by the Internal Revenue Service to audit the matter. In addition, the bill requires that the actuarial values and durations of the charitable and noncharitable interests in the trust generally must remain the same before and after the reformation. These results are achieved under the bill by allowing an income, gift, or estate tax charitable deduction for property passing to charity in respect of any qualified reformation of a reformable interest into a qualified interest.

Qualified reformation

A qualified reformation is a change in the governing instrument of a trust which changes a reformable interest into a qualified interest if two requirements are met. As under present law, the reformation must be retroactive to the date of death in the case of testamentary trusts or the date of creation in the case of inter vivos trusts and should provide for correction of any overpayments or underpayments prior to reformation. In order to insure the proper taxation of the trust and its beneficiaries, the bill provides that the period for assessing any deficiency of any tax shall not expire before the date which is one year after the Secretary of the Treasury is notified that the reformation has occurred.

Under the first requirement, the difference between the actuarial value of the charitable interests of the reformed trust and the unreformed trust cannot exceed 5 percent of the actuarial value of the charitable interest before the reformation.[1]

The second requirment limits changes in the length of the charitable and noncharitable interests in the trust. In the case of a charitable remainder trust, the noncharitable interests must terminate at the same time both before and after the reformation.[2] An exception is made to this rule to permit a noncharitable interest which is for a term of years in excess of 20 years to be reduced to 20 years.[3] In the case of other interests (e.g., charitable lead trusts), the charitable interest must be the same duration under both the reformed and unreformed trusts.

Reformable interest

In order for an interest to be a reformable interest, it must meet two requirements. First, the charitable interest prior to the reformation must have been in a form for which a deduction would have been allowable for that interest under the rules applicable to split-interest transfers prior to the Tax Reform Act of 1969.

Second, either the reformation must be commenced[4] within a specified period or, in the case of wills executed after December 31, 1978, the will creating the trust must have evidenced an intent to comply with the 1969 Act. The specified period generally is the period that ends 90 days after the filing date (including extensions) of the estate tax return on which a charitable deduction for the transfer to the trust is claimed. If no estate tax return is required to be filed for such a transfer, the period terminates 90 days after the due date (with extensions) for the first required income tax return for the trust. The committee intends that, in order for the commencement of a judicial proceeding to be timely, the pleading must describe the nature of the defect that must be cured. The filing of a general protective pleading is not sufficient.

The governing instrument evidences an intent to comply with the 1969 act rules if all current payouts from the trust are expressed solely as a fixed dollar amount or a fixed percentage of the value of the trust's assets. Thus, a trust does not meet this requirement if the governing instrument provides for powers of invasion for a noncharitable beneficiary of any sort. However, the failure to

[1] Under the bill, a reformation that changes the relative interests of noncharitable beneficiaries may be a qualified reformation. However, such changes may be gifts from one noncharitable beneficiary to another noncharitable beneficiary.

[2] Where an unreformed trust contains a contingency which accelerates the charitable remainder interest, the actuarial value of the charitable and noncharitable interests before the reformation is to be determined, for this purpose, without regard to the contingency.

[3] In such a case, the amount of the annual noncharitable distributions must be increased to insure that the actuarial value of the charitable and noncharitable interests are the same before and after the reformation.

[4] Where a judicial proceeding is begun in one court, but it is later determined that the proceeding should have been commenced in a different court (for example, where it is determined that jurisdiction over the trust lies in a different State), then the proceeding will be treated as timely filed if the first proceeding was timely filed.

have detailed rules relating to the computation of the fixed dollar amount or the fixed percentage of the value of the trust's assets in special circumstances (e.g., short taxable years, years where there are additional contributions, year when interests terminate, etc.) will not preclude the interest from being a reformable interest. In addition, an interest will be treated as expressed as a fixed percentage of the value of the trust's assets if the current payout is expressed as the lesser of trust income or a fixed percentage of the value of the trust's assets or the current payout is expressed in any other formulation which indicates an intent to create a trust described in section 664(d)(3).

Method of reformation

The bill provides that a qualified reformation can be achieved in any method permitted under applicable local law as long as that change is binding on all relevant parties under applicable local law. Thus, changes can be accomplished by reformation, amendment, construction, or otherwise, as long as those changes are binding on all parties under applicable local law.

In addition, the bill provides that the death of all of the noncharitable "income" beneficiaries of a charitable remainder trust before the filing of the estate tax return (including any extensions) on which the charitable deduction for the transfer to the trust is claimed is to be treated as a reformation of the governing instrument of the trust. In such a case, the charitable deduction is the actuarial value of the remainder interest before the reformation, adjusted for any payments made to those "income" beneficiaries.

The bill also provides that a reformation occurs where, pursuant to the governing instrument of a trust, all or a specific portion of the trust passes directly to charity before the filing of the estate tax return (including any extensions).

Amount of allowable deduction

If there is a qualified reformation, a deduction is allowed for the lesser of (1) the actuarial value of the charitable interest after the reformation or (2) the amount of the actuarial value of the charitable interests prior to the reformation for which a deduction would have been allowable but for the disallowance rules of section 2055(e)(2).[5]

Effect of reformation for other purposes

The bill provides that the Secretary of the Treasury shall prescribe regulations concerning the taxation of trusts, and the application of the rule relating to exempt organizations and private foundations to trusts, which are reformed pursuant to the provisions of the bill. The committee intends that those regulations continue the present-law rule that, in the case of a reformation of a charitable remainder trust, the exemption from tax and the income characterization of payments provided by section 664 are retroactive to the creation of the trust.

[5] In determining the actuarial value of the charitable interest of the unreformed trust, the committee intends that trusts to which Rev. Proc. 73-9, 1973-1 C.B. 758, apply be treated as if they had complied with that revenue procedure.

Pooled income funds, farms, and personal residences

The bill provides that the Secretary of the Treasury is to prescribe rules permitting the reformation of charitable transfers involving remainder interests in pooled income funds, farms, and personal residences. The rules to be prescribed are to be consistent with the rules provided by the bill for reformations of charitable remainder annuity trusts and charitable remainder unitrusts.

Special rule for contingencies in charitable remainder trusts

The bill provides a special exception to the present law rule that the noncharitable interests in a charitable remainder annuity trust or a charitable remainder unitrust must terminate at the end of lives in being or a term of years (not to exceed 20 years). Under the special exception, contingencies in the time that annuity trust interest or unitrust interest payments are to be made are permitted where a trust provides for such interests which terminate at times permitted by present law, but provides additionally that those interests may terminate at some earlier time such that the charitable remainder interest is accelerated. For example under the bill, the annuity trust interest or unitrust interest may terminate at the earlier of death or remarriage of a named individual. In such a case, the value of the charitable remainder is determined without regard to the contingency (i.e., the value of the charitable remainder is determined as if the payments of the annuity trust interest or unitrust interest did not terminate until the periods permitted by present law). For example, where the annuity trust interest or unitrust interest lasts until the earlier of the death or remarriage of a named individual, the value of the remainder interest is determined as if the annuity trust interest or unitrust interests terminated at the death of the named individual.

Effective Date

The amendments made by this section apply to reformations made after December 31, 1978, other than reformations to which present law (as in effect prior to this bill) applies. The bill also provides a special rule which opens the period of limitations for one year after the date of enactment. Thus, in the case of a reformation in 1979 of a trust created pursuant to a will executed in 1979, the period of limitations for the estate tax deduction with respect to transfers to the trust or with respect to the income taxation of the trust will not expire earlier than one year after the date of enactment. However, where a credit or refund is made which is allowed by reason of the extension of the statute of limitations, no interest is allowable on such claim or refund for the period before 180 days after the Secretary of the Treasury is notified of the reformation.

Revenue Effect

This provision will decrease revenues by less than $5 million per year.

5. Charitable Deduction Limitations Rules (sec. 812 of the bill and sec. 170 of the Code)

Present Law

Under present law, contributions of cash and ordinary-income property by an individual to public charities or private operating foundations are deductible up to 50 percent of the donor's contribution base for the year (adjusted gross income, with certain modifications). Contributions in excess of this limitation, or of the 30-percent limitation applicable to gifts by individuals of capital-gain property to such charities, may be carried forward and deducted over the following five years, subject to applicable percentage limitations in those years (Code sec. 170).

Reasons for Change

The committee believes that it is desirable to provide greater tax incentives for charitable contributions of cash, and to extend the carryover period for excess contributions to 15 years.

Explanation of Provision

The bill increases to 60 percent the present-law 50-percent limitation on the deductibility by individuals of certain charitable contributions, and extends to 15 years the present-law five-year carryover period for excess contributions.

Effective Date

The provision applies to contributions made after December 31, 1984. Carryovers of excess pre-1985 contributions to post-1984 years will remain subject to the present-law carryover period and deduction limitations.

Revenue Effect

The provision will reduce fiscal year budget receipts by $8 million in 1985, $26 million in 1986, $29 million in 1987, $29 million in 1988, and $28 million in 1989.

C. Excise Tax Provisions

1. Excise Tax on Sport Fishing Equipment and Financing of Sport Fish Restoration and Boating Safety Programs; Excise Tax on Certain Arrows (secs. 813-821 of the bill and sec. 4041, 4081, 4161, and new sec. 4499 of the Code)[1]

a. Revenue Provisions

Present Law

Excise tax on fishing equipment

An excise tax equal to 10 percent of the sales price is imposed on the first sale of fishing rods, creels and reels, and on artificial lures, baits, and flies (including parts and accessories) by the manufacturer, producer, or importer of the taxable item (Code sec. 4161(a)).

Amounts equivalent to the revenues from the 10-percent excise tax on fishing equipment are appropriated (based on the prior fiscal year's tax receipts) to the States in partial reimbursement of the costs they incur in approved fish restoration and management projects, discussed below under the explanation of the sport fish restoration program (presently referred to as the Dingell-Johnson fund program).

Time for payment of tax

Treasury regulations require returns of manufacturers excise taxes, including the tax on the sale of fishing equipment, to be filed quarterly, unless the Internal Revenue Service requires more frequent filing by an individual taxpayer (Treas. Reg. sec. 48.6011(a)-1). Quarterly returns are due on the last day of the first month after the end of the quarter (Treas. Reg. sec. 48.6071(a)-1).

Although most Federal excise tax returns are filed on a quarterly basis, Treasury regulations generally require monthly, or semimonthly, payment of the tax (Treas. Reg. sec. 48.6302(c)-1). If a taxpayer is liable in any month for more than $100 of manufacturers excise tax, the taxpayer must deposit the amount on or before the last day of the next month at an authorized depository or at the Federal Reserve Bank serving the area in which the taxpayer is located. If a taxpayer had more than $2,000 in manufacturers excise tax liability for any month of a preceding calendar quarter, these taxes must be deposited for the following quarter (regardless of amount) on a semimonthly basis. These taxes must be deposited by the ninth day following the semimonthly period for which they are deposited.

[1] These provisions are contained in S. 2062, reported by the Senate Committee on the Budget, on November 4, 1983.

Taxes on motorboat fuels

Taxes at a rate of 9 cents per gallon are imposed on gasoline and special motor fuels used in motorboats. For fiscal years 1983 through 1988, up to $45 million per year (but not to exceed a total balance of $45 million in the fund at any time) of the revenue from these taxes is to be transferred into the National Recreational Boating Safety and Facilities Improvement Fund (the "Boating Safety Fund"). The balance, if any, is to be transferred to the Land and Water Conservation Fund.

Import duties on fishing equipment and yachts and pleasure craft

Duties at varying rates are imposed on the importation of specified articles of fishing equipment (19 U.S.C. 1202). Duties are also imposed on the importation of certain yachts and pleasure craft (19 U.S.C. 1202). Revenues from these import duties are deposited in the general fund of the Treasury.

Reasons for Change

Excise tax on sport fishing equipment

In expanding the list of items subject to the excise tax on sport fishing equipment, the committee is concerned that domestic producers of fishing equipment have been disadvantaged by the present law method of imposing tax at the manufacturer or importer level. Specifically, the committee understands that some importers of fishing equipment have been able to reduce the sales price on the first sale after import (and hence the amount of tax) to an artificially low level, resulting in their receiving an unfair advantage over domestic producers. To provide equity among all taxpayers, the bill imposes the tax on the last sale before retail for both domestic and imported equipment. Special rules apply in the case of importer-retailers and certain mass merchandising firms.

The committee believes that the 10-percent excise tax on fishing equipment should be expanded to cover other sport fishing equipment so that all purchasers of such equipment will contribute to the financing of the Federal-State sport fish restoration program. In the case of fishing tackle boxes, which may be used for both fishing and other purposes, the committee decided to impose the tax at a special 3-percent rate. The committee further decided to impose the tax at a special 3-percent rate on electric outboard boat motors, which are used primarily in sport fishing. Further, the committee decided to impose the tax at a special 3-percent rate (rather than 10-percent rate) on certain fishfinders and to limit the maximum tax on any fishfinder to $30 because these devices may be used both as depth finders (navigational aids) and as devices for locating fish.

The committee is concerned that, because of the seasonal nature of sport fishing equipment sales, expansion of this tax may cause difficulties for small manufacturers who sell directly to retailers. Accordingly, the committee decided to provide an extension of time for payment of the tax by small manufacturers (i.e., those having gross receipts of $100,000 or less for the preceding calendar year).

This extended payment time, however, is not to be viewed as a precedent for other payors of Federal excise taxes.

Additional revenue sources for sport fish restoration program

The committee recognizes the need for additional revenues for the Federal-State sport fish restoration program. In addition to the revenues from the expanded excise tax on sport fishing equipment, the committee determined that it is appropriate to transfer revenues from the existing import duties on fishing equipment and on yachts and pleasure craft to the new Sport Fish Restoration Account of the Aquatic Resources Trust Fund (discussed below). Further, the committee believes that the revenues from the existing excise taxes on motorboat fuels should be reallocated so that the excess of such revenues over the $45 million per year allocated to the boating safety programs (with the exception of the first $1 million of such excess) should be allocated to the new Sport Fish Restoration Account.

Explanation of Revenue Provisions

Imposition of tax on last sale before retail

The bill replaces the present manufacturers excise tax on fishing equipment with a new, expanded tax imposed on the last sale before retail of sport fishing equipment. Therefore, sales of sport fishing equipment by manufacturers, producers, and importers generally will not be taxable unless they are direct sales to retailers. Sales by wholesale distributors, on the other hand, generally will be taxable.

The tax will be imposed at a 10-percent or 3-percent rate on the sales price of the taxable equipment. The bill provides that rules similar to the constructive sales price rules of Code section 4216 will apply in determining sales price in cases involving sales between related parties. The committee intends, for example, that these rules apply to sales for less than the article's fair market value between a wholesale distribution subsidiary of a mass merchandising company and a retail store under common ownership.

A special rule is provided where the last sale before retail occurs before importation of the taxable equipment. In such cases, the tax will be imposed on the importer at the point of entry into the United States. A further special rule is provided under which certain leases are treated as sales.

Expansion of articles subject to 10-percent tax

The bill expands the articles of sport fishing equipment subject to excise tax at a 10-percent rate, and classifies the articles into five main categories:

Fishing rods and poles (and component parts)

The term fishing rods and poles means any tube or shaft-like device made of natural, synthetic, or other material which is designed or used to cast, troll, or otherwise present a bait or lure to fish. It is not the intention of the committee to tax bamboo poles that are not designed or intended for use in fishing; however, any pole intended for attaching a fishing line, to or through, is to be considered to be a fishing rod or pole. "Component parts" means rod handles, guides, reel seats, blank rods, tip-tops, ferrules, or any other devices which are designed to be attached to such poles or rods for use in fishing.

The term fishing reels means any mechanical device which can be attached to rods or poles and is used or designed for dispensing and retrieving fishing line. The term includes reels used in fly fishing and also reels or spools which are employed for dispensing and retrieving the line attached to arrows and spears used in fishing.

The term fly fishing lines and other fishing lines not greater than 130-pounds test means all lines, either monofilament, multifilament, synthetic, organic, or inorganic, including metal lines, which are used or designed for the purpose of attaching lures, hooks, flies, bobbers, sinkers, and any other item of terminal tackle, including lines to attach items of terminal tackle to one another, such as leaders. Fishing lines over 130-pounds test (i.e., lines able to suspend a 130-pound weight without breaking or stretching more than 5 percent of line length while suspending that weight) are not taxable under the committee bill. This limitation is made because the committee understands that commercial fishermen primarily use fishing line greater than 130-pounds test, while sport fishermen generally use lines equal or less than 130-pounds test.

The term fishing spear means any tube or shaft-like device ending in a sharp tip and designed for the purpose of spearing fish. A taxable spear gun is any device designed for propelling a shaft or tube-like item through the water for the purposes of spearing fish. A fishing spear tip is any device designed to be attached to a shaft or tube-like device which ends in one or several sharp tips.

Items of terminal tackle

Items of terminal tackle subject to the 10-percent tax include, but are not limited to:

(1) Leaders, i.e., items used for attaching the end of a fishing line to a hook or lure or any other device of terminal tackle (a leader may include, but is not limited to, fishing lines, swivels, and snaps);

(2) Artificial lures, i.e., all artifacts (whatever materials made) that simulate an article considered edible to fish or that are otherwise intended to induce a fish to attempt to confront, swallow, bite, or consume said device, and that are designed to be attached to a line (a lure usually includes one or more attached books);

(3) Artificial baits, i.e., any baits that simulate an article considered edible to fish and that are designed to be attached to a hook or lure (but not including preserved packaged natural baits);

(4) Artificial flies, i.e., hooks less than size 6/0 (i.e., less than 2-⅛ inches in length as measured from the top of the shank to the bottom of the bend in the hook) to which feathers, beads, lead, or other items are attached to make said items resemble insects or other organisms which are considered edible to fish and that are designed to be attached to a fishing line, leader, swivel, or snap;

(5) Fishing hooks smaller than size 6/0, i.e., any curved or bent metallic device which terminates in a sharp point for the purpose of catching, holding, or pulling fish or fishing bait, and which is smaller than size 6/0 (less than 2-⅛ inches as measured from the top of the shank to the bottom of the bend in the hook);

(6) Bobbers, i.e., any device used as a means to suspend a fishing line or lure in the water column, or which can be used to track visually the location and status of fishing line and associated hooks and bait, and which can be attached to a fishing line (the term bobbers includes articles made of plastic, cork, or other material);

(7) Sinkers, i.e., devices wholly or in part made of lead or other metallic substances which are designed to attach to fishing lines or items of terminal tackle with the intention of or causing the terminal tackle to descend into the water column;

(8) Snaps, i.e., a catch, clip, or fastening device which is designed at one end to tie onto the end of a fishing line and to attach, by means of a clasp at the other end, items of terminal tackle;

(9) Drayles, i.e., any article made, wholly or in part, of lead or other metallic substances which can be tied or otherwise attached to the end of a fishing line to which is attached leaders or other items of terminal tackle and which is designed to be trolled behind a boat, such that the line or terminal tackle descends into the water column; and

(10) Swivels, i.e., devices of terminal tackle which are designed such that fishing line can be attached to either end and so that the ends of the fishing line can pivot freely.

Certain items of fishing supplies and accessories

The following items of fishing supplies and accessories are subject to the 10-percent excise tax:

(1) Fish stringers, i.e., articles designed for or sold as devices for attaching fish through the opercular opening and mouth, including devices consisting of a series of metal or plastic clips as well as cords consisting of a ring and threader connected by a cord;

(2) Creels, i.e., all portable containers of whatever material made that are designed for storing and carrying fish from the time they are caught until such time as they are removed from the container for consumption or preservation;

(3) Bags, baskets, and other containers designed to hold fish, including such items as collapsible baskets or similar devices made of any material and which are designed to be hung over the side of the boat to keep fish captive and alive in the water;

(4) Portable bait containers, i.e., any device specifically designed or sold as an article to hold or transport bait such as minnow buckets and grasshopper cages, or any other device designed specifically to hold worms, insects, frogs, etc., in connection with fishing activities;

(5) Fishing vests, i.e., garments designed for storing various lures, flies, hooks, and other fishing paraphernalia and which may also have the capacity to store fish (the term fishing vest includes vests with flotation capacity but not those vests that are solely intended as flotation devices);

(6) Landing nets, i.e., items consisting of a handle connected to a hoop, which hoop is covered by a bag-type net, and which items are designed primarily for scooping a hooked fish out of the water and into a vessel or onto shore;

(7) Gaff hooks, i.e., devices consisting of a handle and hook for holding or lifting fish into a vessel once they are brought to the boat on the end of a fishing line;

(8) Fishing hook disgorgers, i.e., any implement designed solely for use in removing fishing hook(s) from the mouth, gill, arches, or stomach of fish; and

(9) Dressing for fishing lines and artificial flies, i.e., any substance applied onto fishing lines or artificial flies designed to enhance the flotation of the line or fly or otherwise designed to attract fish to the artificial fly.

Fishing tip-ups and tilts

The term fishing tip-ups and tilts means devices consisting of such parts as a spool on a spindle and a spring-mounted flag on opposite ends of a vertical pole with cross members to support the pole over a hole in the ice, or any other such device designed to alert a fisherman when a fish is either hooked or in the process of attempting to eat the bait on a hook or bite a bait or lure.

Other fishing equipment

Certain other types of fishing equipment are also subject to the 10-percent tax, including—

(1) Fishing rod belts, i.e., articles which fasten around or near the waist and which are designed for placing the butt end of a rod or pole in a cup-like depression to aid in holding or handling of a rod or reel.

(2) Fishing rod-holders, i.e., devices which are portable and can either be inserted into beaches or clamped onto boats and which hold a rod or pole in a stationary position relative to the boat or beach.

(3) Fishing harnesses, i.e., articles worn by an angler to transmit muscular power to the rod or to absorb strain. Fishing harnesses usually are made of canvas, leather, and/or similar materials, and have straps with devices that can be fastened to the reel and/or sockets into which the rod butt may be seated.

(4) Fish fighting chairs, i.e., a heavily built chair designed to have a footrest, rod holders, and a swivel base attached and which is usually permanently installed in a suitable fishing boat for the purpose of fighting deep sea fish with rod and reel.

(5) Fishing outriggers, i.e., a device, or pair of devices, attached to a boat consisting of a braced rod or tube with a means for attaching the fishing line out and away from the boat for trolling purposes in such a way that when the fish strikes the rolled bait, the line is released from the outrigger so that the fish may be fought directly with rod and reel.

(6) Fishing downriggers, i.e., devices used for submerging and lowering the fishing line and bait down and away from a boat while trolling. A downrigger usually consists of a boom and reel attached to the boat supporting a cable and weight with a means for attaching the fishing line in such a way that when a fish strikes the trolled bait, the line is released from the weight so that the fish may be fought directly with rod and reel.

Three-percent rate on tackle boxes, fishfinders, and electric outboard boat motors

Tackle boxes

The committee bill imposes the excise tax on sport fishing equipment at a special 3-percent rate on tackle boxes, i.e., all portable containers of whatever material made that are primarily designed or intended to be used as items in which to store or organize fishing paraphernalia such as hooks, lures, flies, sinkers, bobbers, etc., until such time as these items are placed on the fishing line, rod, or reel.

Fishfinders

The bill imposes the new tax at a special 3-percent rate on certain fishfinders. The amount of tax imposed under this provision may not exceed $30 per item.

Fishfinders subject to tax generally include all sonar devices suitable for finding fish. An exemption is provided, however, for sonar devices which are graph recorders, digital type devices, or meter readout devices. In addition, any combination sonar device which includes a meter readout or graph recorder is not subject to tax. Other combination devices (e.g. a combination flasher and digital device) will be taxable.

Electric outboard motors

The bill also imposes the tax at a special 3-percent rate on electric outboard boat motors.

Treasury regulations

The committee recognizes that certain sonar devices and utility boxes (tackle boxes) are primarily designed or intended to be used for purposes other than sport fishing. For instance, sonar devices may determine the depth of water under a boat and the type of water bed as an aid to navigation and safe boating. Utility boxes (tackle boxes) may be used to store a wide range of items, such as including tools, which are unrelated to catching fish. The committee intends that the tax be imposed only upon those items which are primarily designed or intended to be used for sport fishing, and not upon those items primarily designed and used for other purposes. Accordingly, the bill provides that, pursuant to Treasury regulations, articles similar to tackle boxes and fishfinders which are not primarily designed or intended to be used for sport fishing shall be delineated to insure that, to the extent practicable they are not subject to tax. The committee anticipates that these regulations will provide that articles advertised as fishfinders or tackle boxes will be taxable as such.

Time for payment of excise tax on sport fishing equipment

The bill extends the time for paying the excise tax on sport fishing equipment for manufacturers (but not other taxpayers) having gross sales receipts of $100,000 or less for the preceding calendar year. Under the bill, these manufacturers are excused from the deposit requirements otherwise applicable under Code section 6302. These manufacturers generally will be allowed to make tax payments on a quarterly basis. For manufacturers having gross sales receipts of more than $100,000 for the preceding calendar year, the bill retains the present law excise tax payment schedule.

The committee bill does not amend the time prescribed under present law for filing of sport fishing equipment excise tax returns by any taxpayers or the time for payment of excise taxes on articles other than sport fishing equipment.

Transfer of revenues from import duties on fishing tackle and on yachts and pleasure craft

An amount equivalent to the revenues received from the import duties on fishing equipment and on yachts and pleasure craft is to be dedicated to the sport fish restoration program, rather than being retained in general revenues.

Reallocation of motorboat fuels tax receipts

Revenues from the existing excise taxes on gasoline and special motor fuels used in motorboats are to be reallocated between the sport fish restoration program, the Federal boating safety program, and the Land and Water Conservation Fund. This reallocation is explained more fully in item b., "Trust Fund Provisions," following.

Effective Dates

The sport fishing equipment excise tax provisions of the bill, including the changes in the point of imposition of that tax, generally apply with respect to articles sold after September 30, 1984. However, the imposition of the tax on tackle boxes and fishfinders is effective on October 1, 1985.

Revenue Effect

These provisions will increase gross fiscal year budget receipts (for the Sport Fish Restoration Program) by $16 million in 1985, $17 million in 1986, and $19 million in each of 1987 and 1988. Net fiscal year budget receipts (after income tax offsets) are estimated to increase by $12 million in 1985, $13 million in 1986, and $14 million in each of 1987 and 1988, and $15 million in 1989.

b. Trust Fund Provisions

Present Law

Present law does not provide an established trust fund for the sport fish restoration and Federal boating safety programs. Instead, these programs are funded by an appropriation from general Treasury funds of amounts equivalent to specific tax revenues (in the case of the sport fish restoration program) or by appropriation to a special "fund" not having the status of an established trust fund (in the case of the Federal boating safety program).

Sport fish restoration program

The Act of August 9, 1950 (presently referred to as the Dingell-Johnson Act) provides for cooperation between the Federal Government and State fish and game departments. Although the Act did not establish a separate fund for sport fish restoration purposes, appropriations for this purpose are linked to specific tax revenues. Limits are placed on State expenditures of Federally appropriated funds until the State has passed laws governing the conservation of fish and the State meets other requirements.

Under present law, an amount equivalent to revenues from the 10-percent excise tax on fishing equipment is authorized to be appropriated (under 16 U.S.C. sec. 777b) to carry out fish restoration and management projects. The appropriation is based on the prior year's tax receipts. The appropriation for any fiscal year continues to be available for the succeeding fiscal year. If the amount apportioned to any State is unexpended or unobligated at the end of the period for which it is available, this amount is then authorized to be made available for expenditure by the Secretary of the Interior on the research program of the Fish and Wildlife Service.

Any State that wishes to receive any of these appropriations must submit to the Secretary of the Interior a program or project for fish restoration. Amounts are appropriated to reimburse States for up to 75 percent of the cost of approved projects. Approved projects include research into problems of fish management and culture, surveys and inventories of fish populations, restocking waters with game fishes according to natural areas, and acquisition and improvement of fish habitats that provide access for public use. The amount of assistance for these programs is determined by a statutory formula.

A portion of each annual appropriation is available to the Secretary of the Interior to defray expenses of administering the program and of aiding in the formulation, adoption, or administration of any compact between two or more States for the conservation and management of migratory fishes in marine or fresh waters. The remainder of the appropriation is required to be apportioned to the States as follows:

(1) 40 percent in the ratio which the area of each State, including coastal and Great Lakes waters, bears to the total area of all the States; and

(2) 60 percent in the ratio which the number of persons holding licenses to fish for sport or recreation in the State in the second fiscal year preceding the fiscal year for which the apportionment is made bears to the number of such persons in all the States.

No State is permitted to receive less than one percent or more than five percent of the total amount apportioned. Puerto Rico, Guam, American Samoa, the Commonwealth of the Northern Marianc Islands, and the Virgin Islands may also receive limited amounts of these revenues.

National Recreational Boating Safety and Facilities Improvement Fund ("Boating Safety Fund")

The National Recreational Boating Safety and Facilities Improvement Fund ("Boating Safety Fund") was enacted on October 14, 1980 (P.L. 96-451) (the "1980 Act") to provide a source of funding for Federal recreational boat safety and facilities improvement projects. Before this time, all funds attributable to the excise taxes on gasoline and special motor fuels used in motorboats were transferred periodically into the Land and Water Conservation Fund.

The 1980 Act provided financing for the Boating Safety Fund for fiscal years 1981 through 1983. The Highway Revenue Act of 1982 (Title V of the Surface Transportation Assistance Act of 1982, P.L. 97-424) extended the Boating Safety Fund through fiscal year 1988, and increased the amounts to be transferred into the Fund (as indicated below).

Under present law, the Secretary of the Treasury is authorized to pay into the Boating Safety Fund certain amounts equivalent to the motorboat fuels taxes received on or after October 1, 1980, and before October 1, 1988. The aggregate amount transferred cannot exceed $45 million for each of fiscal years 1983 through 1988. Additionally, the maximum amount permitted to be held by the Fund at any time cannot exceed $45 million. Any excess motorboat fuels tax receipts are transferred into the Land and Water Conservation Fund, discussed below.

Amounts in the Boating Safety Fund are available, as provided in appropriation acts, for carrying out the purposes of the Federal Boat Safety Act of 1971 (46 U.S.C. 1476). Under that Act, as amended in 1982 by the Highway Revenue Act, the Secretary of Transportation is provided with authority to contract with the States to implement and administer boating safety programs. Approval of specific elements of a State program by the Secretary of Transportation is deemed to be a contractual obligation of the United States.

Under section 26 of the Federal Boat Safety Act, the Secretary of Transportation may allocate and distribute amounts from the Boating Safety Fund to any State that has a State recreational boating safety and facilities improvement program if that program meets certain standards and the State provides matching funds. Currently, one-third of the revenue available for allocation and distribution is to be allocated for recreational boating safety programs and two-thirds is to be allocated for recreational boating facilities improvement programs.

Available Boating Safety Fund amounts are allocated and distributed to the States for recreational boating safety programs and facilities improvement programs as follows: one-third allocated equally among eligible States; one-third allocated among eligible States who maintain an approved State vessel numbering system according to number of vessels; and one-third allocated to eligible States according to the amount of State funds expended for obligated for State boating safety programs or boating facility improvement programs.

Land and Water Conservation Fund

On September 3, 1964 (P.L. 88-578), Congress established the Land and Water Conservation Fund as a separate account in the Treasury, effective January 1, 1965. Present law (16 U.S.C. 460*l*-5) provides for deposit of the following amounts in the Land and Water Conservation Fund:

(1) All proceeds, except those committed under other statutes, received from any disposal of surplus property and related personal property under the Federal Property and Administrative Services Act of 1949, as amended;

(2) Amounts equivalent to the 9-cents-per-gallon taxes on gasoline and special motor fuels used in motorboats (to the extent these revenues exceed the amount transferred to the Boating Safety Fund);

(3) Revenues from Federal recreation fee collections (since January 1, 1981);

(4) If appropriated, amounts necessary to make the income of the Fund not less than $900 million for fiscal year 1978 and for each fiscal year thereafter through September 30, 1989; and

(5) To the extent that the appropriated sums are not sufficient to make the total annual income of the Fund equivalent to the amounts stated above, an amount sufficient to cover the remainder from miscellaneous receipts under the Outer Continental Shelf Lands Act (43 U.S.C. 1331 et seq.).

The general purposes of the Land and Water Conservation Fund are (1) to provide funds for and authorize Federal assistance to the States in planning, acquisition, and development of needed land and water areas and facilities, and (2) to provide funds for the Federal acquisition and development of certain lands and other areas. Monies in the Fund are available for expenditures as provided in appropriation Acts. Not less than 40 percent of annual appropriations are to be used for Federal purposes; these include activities and programs of the Bureau of Land Management, the Forest Service, the Fish and Wildlife Service, and the National Park Service. The remainder of funds appropriated are apportioned among the States on the basis of statutory formulae and criteria.

Reasons for Change

The committee believes that additional revenues should be dedicated to support the Federal-State sport fish restoration program and that this support should be accomplished through a special fund established for that purpose. The committee further believes that such a fund should be a regular trust fund and placed in the Trust Fund Code of the Internal Revenue Code for ease of administration and oversight and to conform to the prior congressional policy of incorporating trust funds (e.g., Airport and Airway, Highway, and Black Lung Trust Funds) into the Internal Revenue Code. The committee believes that amounts appropriated for boating safety purposes should also derive from an established trust fund.

To provide funds for the sport fish restoration and boating safety programs, the committee determined that a new Aquatic Resources Trust Fund should be established having two separate accounts, the Sport Fish Restoration Account and the Boating Safety Account, each with its own earmarked revenue sources. In funding these accounts, the committee determined that up to $45 million per year (for fisal years 1983-1988) of revenues from the taxes on motorboat fuels should continue to be dedicated to Federal-State boating safety programs. However, to provide additional revenues for sport fish restoration programs, the committee determined that motorboat fuels tax revenues in excess of the amounts transferred to the Boating Safety Account (with the exception of the first $1 million per year of such excess) should be allocated to the Sport Fish Restoration Account rather than to the Land and Water Conservation Fund as under present law.

Explanation of Trust Fund Provisions

Establishment of Aquatic Resources Trust Fund

In general

The bill establishes a new trust fund, The Aquatic Resources Trust Fund (to be known as the Wallop-Breaux Fund), in the Trust Fund Code of the Internal Revenue Code, to be administered by the Secretary of the Treasury. The new Wallop-Breaux Fund expands and combines funding for the present sport fish restoration and boating safety programs into a single Trust Fund. The Trust Fund will consist of two accounts, the Sport Fish Restoration Account and the Boating Safety Account, described below. The bill also makes conforming amendments necessitated by the establishment of the Aquatic Resources Trust Fund.

Under the bill, amounts equivalent to the following revenues are appropriated to the Aquatic Resources Trust Fund:

(1) Revenues from the new expanded excise tax on sport fishing equipment (both the 10-percent and the 3-percent portions);

(2) Revenues from the 9-cents-per-gallon excise taxes on gasoline and special fuels used in motorboats (other than $1 million of those revenues which will be transferred to the Land and Water Conservation Fund); and

(3) Import duties imposed on fishing equipment and on yachts and pleasure craft.

Sport Fish Restoration Account

The present sport fish restoration program is replaced by the expanded program provided by the new Sport Fish Restoration Account. This expanded program is financed by trust fund revenues attributable to (1) the excise tax on sport fishing equipment, (2) motorboat fuels taxes (to the extent these revenues exceed the amount transferred to the Boating Safety Account and the Land and Water Conservation Fund),[2] and (3) import duties on fishing equipment and on yachts and pleasure craft.

The expenditure purposes established for the Sport Fish Restoration Account are those purposes established for the sport fish restoration program as amended by the bill. Expenditure purposes are limited to those provided by law as of October 1, 1984.

Specifically, monies in the account may be expended, subject to appropriation acts, for the purpose of restoring and managing all species of fish which have material value in connection with sport or recreation in the marine and/or fresh waters of the United States, including—

(1) Such research into problems of fish management and culture as may be necessary for efficient administration affecting fish resources;

(2) Acquisition of such facts as are necessary to guide and direct the regulation of fishing by law, including the extent of the fish population, the drain on the fish supply from fishing and/or natural causes, the necessity of legal regulation of fishing, and the effects of any measures of regulation that are applied;

(3) Formulation and adoption of plans for restocking waters with food and game fishes according to natural areas or districts to which such plans are applicable, together with the acquisition of such facts as are necessary to the formulation, execution, and testing the efficacy of such plans;

(4) Selection, restoration, rehabilitation, and improvement of areas of water or land adaptable as hatching, feeding, resting, or breeding places for fish, including acquisition by purchase, condemnation, lease, or gift of such areas or estates or interests therein as are suitable or capable of being made suitable therefor, and the construction thereon or therein of such works as may be necessary to make them available for such purposes, and such preliminary or incidental costs and expenses as may be incurred in and about such works;

(5) Acquisition, development, renovation, or improvement of facilities (and auxiliary facilities necessary to insure safe use of such facilities) that create, or add to, public access to the waters of the United States for boating purposes;

(6) Aquatic resource education programs for increasing public understanding of the Nation's water resources and associated aquatic life form; and

(7) Subject to a percentage limitation contained in the Act, for administration of the sport fish restoration program by the Secretary of the Interior.

[2] Under the bill, amounts equivalent to the revenues derived from the excise taxes on motorboat fuels are allocated first to the Land and Water Conservation Fund (in an amount not exceeding $1 million), and second, to the Boating Safety Account (in an amount not exceeding $45 million), with the excess being allocated to the Sport Fish Restoration Account. By contrast, under present law, these amounts are allocated first to the Boating Safety Fund (in an amount not exceeding $45 million), with the entire excess being allocated to the Land and Water Conservation Fund.

Monies in the Account will be available for expenditure by the Secretary of the Interior as provided in the Act of August 9, 1950, establishing the sport fish restoration program, and will remain available until spent.

Boating Safety Account

The National Recreational Boating Safety and Facilities Improvement Fund is replaced by a new Boating Safety Account in the Aquatic Resources Trust Fund. The Boating Safety Account is to be funded by an amount equivalent to a portion of the revenues from the excise taxes on motorboat fuels. The amount of revenues allocated to the Account cannot exceed $45 million in any fiscal year through fiscal year 1988. Additionally, no amount may be allocated to the Account if such allocation would cause the uncommitted balance of the Account to exceed $45 million.

The expenditure purposes established for the Boating Safety Account are the same as those established for the present Boating Safety Fund, as amended by the bill. Expenditure purposes are limited to those provided by section 30 of the Federal Boat Safety Act of 1971, as of October 1, 1984.

Specifically, monies in the Account may be expended, subject to appropriation acts, as follows—

(1) Two-thirds of the amount allocated to the Account in any fiscal year (i.e., up to $30 million) for State boating safety programs; and

(2) One-third of the amount allocated to the Account (i.e., up to $15 million) to the operating expenses account of the Coast Guard (including the Coast Guard Auxiliary) to defray the cost of services provided by it for recreational boating safety.

The State boating safety program purposes eligible for funding from the account are—

(1) Providing facilities, equipment, and supplies for boating safety education and law enforcement, including purchase, operation, maintenance, and repair;

(2) Training personnel in skills related to boating safety and to the enforcement of boating safety laws and regulations;

(3) Providing public boating safety education, including education programs and lectures, to the boating community and the public school system;

(4) Acquiring, constructing, or repairing public access sites used primarily by recreational boaters;

(5) Conducting boating safety inspections and accident investigations;

(6) Establishing and maintaining facilities for, and providing, emergency or search-and-rescue assistance; and

(7) Establishing and maintaining waterway markers and other appropriate aids to navigation.

Monies in the Account will be available, subject to appropriations acts, for expenditure by the Secretary of Transportation pursuant to that Secretary's contract authority, and will remain available until spent.

Land and Water Conservation Fund

An amount not exceeding $1 million per fiscal year of the revenues attributable to the excise taxes on gasoline and special fuels used in motorboats will be transferred to the Land and Water Conservation Fund. No other amendments are made by the bill to that Fund.

Effective Date

The trust fund provisions of the bill are effective on October 1, 1984.

Revenue Effect

The overall revenue effect of these provisions is indicated in the following table.

ESTIMATED REVENUES AVAILABLE FOR SPORT FISH RESTORATION PROGRAM UNDER PRESENT LAW AND UNDER THE COMMITTEE BILL, FISCAL YEARS 1984-1988

[In millions of dollars]

Revenue source	1984	1985	1986	1987	1988
Existing revenue source:					
Present law 10-percent excise tax on fishing equipment	38	41	44	49	53
Additional revenues:					
Expanded tax on sport fishing equipment		16	17	19	19
Transfer of import duties on fishing equipment and yachts and pleasure craft [1]		20	20	20	20
Excess motorboat fuels taxes (over that estimated going to the Boating Safety Account) [2]		[3] 20	[3] 20	[3] 20	[3] 22
Total available [4]	[3] 38	[3] 97	[3] 101	[3] 108	[3] 114

[1] Amounts now go into the general fund.

[2] Excess over the $45 million limit going to the Boating Safety Account plus the $1 million to the Land and Water Conservation Fund. Such excess amounts now go into the Land and Water Conservation Fund.

[3] This assumes that the full $45 million per year would be transferred to the Boating Safety Account. However, if as the Treasury Department assumes only $15 million is appropriated and transferred each year, there would be an additional $30 million per year available for the sport fish restoration program.

[4] Amounts are available for appropriation for the sport fish restoration program in the year following receipt.

c. Amendments to the Federal Aid to Sport Fish Restoration Act

The bill provides that all funds accruing to the sport fish restoration program are to be allocated equitably between projects that benefit marine sport fisheries and projects that benefit freshwater sport fisheries, since the funds used are being collected from both marine and freshwater boaters and fishermen.

The committee recognizes that, since all coastal States do not require marine fishing licenses, the exact calculation of the proper allocation would be virtually impossible. The procedures should be based on the most reliable and uniformly derived estimates of salt water anglers, such as the National Survey of Fishing, Hunting and Wildlife Associated Recreation published by the U.S. Fish and Wildlife Service. The committee also recognizes that it would be impracticable for States to design projects that would meet the allocation requirements exactly and intends that the guidelines allow for variance from the allocation formulae on a yearly basis as long as the States make a good faith effort to allocate the funds properly over a reasonable multi-year period, such as three years.

The bill amends Section 3 of the original Sport Fish Restoration Act to incorporate the authorization of appropriations of sums equal to the motorboat fuels taxes (less appropriations to the Boating Safety Fund Account and the Land and Water Conservation Fund), as well as the import duties imposed on fishing tackle, yachts and pleasure craft pursuant to the tariff schedules and the revenues from the new tax on sport fishing equipment.

The committee believes that the incorporation of these additional funds into the sport fish restoration program is consistent with the basic user tax concept of the program. The tax on motorboat fuels, a portion of the 9 cents a gallon tax on gasoline and other fuels, is generally viewed as a user tax, a fixed rate tax designed to benefit the users of the product taxed. The thrust of the bill is to make the expenditure of motorboat fuels tax revenues responsive to the needs of recreational boaters and fishermen. The committee also believes that diversion of import duties collected on fishing tackle, yachts and pleasure craft to the sport fish restoration program is appropriate as a partial Federal matching of the contributions of fishermen paying the tax on fishing tackle items.

The bill amends Section 4 of the Sport Fish Restoration Act by reducing the amount available to the Department of the Interior for administration of the program from 8 percent to 6 percent. The committee believes that the administrative costs of the program reflect responsibilities that are more or less fixed and that a smaller percentage of a larger fund should, therefore, provide for adequate administration and oversight.

The bill amends Section 6 of the Act to allow the Secretary of the Interior to agree to assume 75 percent of the cost of qualified projects over a period of years, subject to the availability of funds.

This provision is designed to allow the States to schedule the payments for large scale projects over a period of years.

The bill also contains two amendments to Section 8 of the Sport Fish Restoration Act. The first would require each State to allocate a minimum of 10 percent of its annual allocation to projects that improve public access to the waters of the U.S. or improve the suitability of those waters for recreational boating. The intent of this provision is to ensure that a portion of the funds being derived from the motorboat fuels tax is used for projects that directly benefit the people who pay the tax. Thus, it is the intent of the committee that these projects be designed to accommodate motorboats. While it is obvious that not every such project can be designed for the most powerful of boats, it is the intent of the committee that these projects accommodate boats with common horsepower ratings.

The committee specifically intends that a broad range of access facilities and associated amenities qualify for construction under this set-aside. Examples of projects would include, but not be limited to: launching facilities, such as ramps and boat lifts; docking facilities; breakwaters; and fishing and boating lakes and ponds (provided power boats are permitted). The committee also intends that these funds be available for such additional amenities as fish cleaning stations, restrooms, trash receptacles and parking areas. Engineering costs, as well as the costs of environmental assessment and permit applications, could also be included in the project costs. The committee does not intend that these set-aside funds be the only source of public access, acquisition, construction, repair, or maintenance. Access and safety related facilities will also be constructed with boating safety funds and sport fish restoration expenditures. If any State does not utilize the set-aside for access, those funds will be available for the subsequent fiscal year. Any funds not used after two years will be made available to the Fish and Wildlife Service for sport fishery research projects.

The second amendment to Section 8 of the Act authorizes the use of up to 10 percent of a State's allocation under the Act for aquatic resource education programs. The purpose of this provision is to encourage programs that increase public understanding of the nation's water resources and aquatic lifeforms. The committee intends that these funds be available for a broad range of education programs, including programs designed for presentation to civic groups and volunteer organizations as well as programs designed for educational institutions.

d. Amendments to the Federal Boat Safety Act

The bill amends and restates the policies and purposes of the Federal Boat Safety Act of 1971 (P.L. 92-75, the "1971 Act"), as amended, recognizing the important role of the States in boating safety. Additional emphasis is given to the need for continued coordination and cooperation between the Federal Government and the States in administering and enforcing Federal and State boating laws. Recognition is also given to the need to use revenues generated by motorboat fuels taxes equitably and in a manner which enhances boating safety.

The bill amends the 1971 Act by eliminating the definition and the description of State recreational boating facilities programs. All references made to facilities programs are eliminated through conforming amendments.

The bill retains the authorization in present law for the Secretary of Transportation to enter into contracts to implement boating safety programs, but eliminates the authority for facilities programs. Two-thirds of the money in the Boating Safety Account is to be made available for State boating safety programs.

The Secretary of Transportation is required to establish guidelines prescribing purposes for which funds available for the boating safety programs may be used. These purposes include the provision of facilities, equipment and supplies for boating safety education and law enforcement; training and education in boating safety and the enforcement of boating safety laws; the acquisition, construction and repair of public access sites used primarily by recreational boaters; providing boat numbering or titling programs; conducting boating safety inspects and accident investigations; establishing and maintaining state capabilities to provide emergency or research and rescue assistance; and establishing and maintaining aids to navigation.

It is the intent of the committee that the types of navigation aids covered by the State programs are those that mark State waters, marinas, and other areas of concern to each local interest and do not necessarily replace the general aids to navigation function performed by the Coast Guard along our coasts and on the rivers. Further search and rescue assistance might include State expenditures not only for the usual small boat search and rescue services but also authority for States to use helicopter services and other contract or in-house services appropriate for search and rescue programs.

In addition, one-third of the money in the Account is to be available to the Secretary for expenditure each year out of the operating expenses account of the Coast Guard for services provided by the Coast Guard for recreational boating safety, including services provided by the Coast Guard Auxiliary. Funds collected will become available to the Secretary immediately upon transfer and shall remain available until expended.

Further, the bill amends Section 202 of the Recreational Boating Fund Act of 1980 (46 U.S.C. 1479a) to eliminate references to boating facilities programs, to re-designate the Fund as the Boating Safety Account (in the Aquatic Resources Trust Fund) and to extend the deadline on making expenditures out of the renamed Account from March 31, 1984 to March 31, 1989.

e. Expansion of Excise Tax on Certain Arrows

Present Law

Under present law, an 11-percent manufacturers excise tax is imposed on the sale by a manufacturer or importer of any bow which has a draw weight of 10 pounds or more and of any arrow which measures 18 inches overall or more in length (sec. 4161(b)). Revenues from this tax are appropriated to the Federal Aid to Wildlife Program (Pittman-Robertson fund) for support of State wildlife programs.

Reasons for Change

This provision expands the present excise tax on arrows to include arrows used by crossbow hunters. The committee believes that arrows used by crossbow hunters should be subject to tax because these hunters benefit from the Federal Aid to Wildlife Program as do other hunters using other types of bows.

Explanation of Provision

Under the bill, the excise tax on arrows is expanded to include arrows less than 18 inches in overall length which are suitable for use with a taxable bow (i.e., for crossbows).

Effective Date

This provision of the bill is effective with respect to arrows sold after September 30, 1984.

Revenue Effect

This provision will increase budget receipts by a negligible amount each year.

2. Increase in the Distilled Spirits Excise Tax Rate (sec. 822 of the bill and secs. 5001, 5010, and 5013 of the Code)

Present Law

An excise tax is imposed on distilled spirits produced in or imported into the United States (sec. 5001). The tax is determined when the distilled spirits are removed from a bonded distillery or released from customs custody.

The present rate of tax on distilled spirits is $10.50 per proof gallon. A proof gallon of distilled spirits is defined as a U.S. gallon of liquid one-half of the volume of which consists of ethyl alcohol of a specified gravity (sec. 5002). The present distilled spirits tax rate produces a tax of $2.10 on a fifth of 100-proof spirits and a tax of $1.68 on a fifth of 86-proof spirits.

Reasons for Change

The present tax on distilled spirits has not been increased since 1951. Since the tax is imposed at a set amount, rather than as a percentge of sales price, the effective level of the tax has declined by more than 70 percent in constant dollars since it was last increased. The committee believes, therefore, that a modest adjustment of $2.00 per proof gallon is appropriate at this time. Increasing the tax rate by this amount does not increase the per-proof-gallon rate, in real terms, above the 1951 level.

Explanation of Provisions

Tax rate

The bill increases the excise tax rate on distilled spirits from $10.50 per proof gallon to $12.50 per proof gallon, effective on January 1, 1985.

Floor stocks tax

The bill also imposes a special tax extending the increased rate of tax on distilled spirits to certain floor stocks. Under the bill, a special tax of $2.00 per proof gallon generally is imposed on distilled spirits held for sale on January 1, 1985, which distilled spirits were removed from bonded premises before that date, and a tax at the pre-January 1, 1985, rate imposed at the time of such removal. The term held for sale does not include merchandise withdrawn from, or in the process of withdrawal from, the market. The special tax is treated as if it were a tax imposed under Code section 5001 (or sec. 7652). The tax will be due on a date, not later than July 1, 1985, to be established under Treasury regulations.

The bill also authorizes the Treasury Department, by regulation, to exempt from the floor stocks tax, limited quantities of distilled spirits held by any person exclusively for sale and on-premises consumption on January 1, 1985. The committee intends that this exemption not apply in the case of any person holding distilled spirits for sale and on-premises consumption in the same facility where other distilled spirits are held for sale and off-premises consumption. The committee further intends that this exemption not apply in the case of any person holding more than 400 liters of such spirits on January 1, 1985.

Effective Date

These provisions are effective on January 1, 1985.

Revenue Effect

These provisions of the bill will increase fiscal year budget receipts by $371 million in 1985, $479 million in 1986, $510 million in 1987, $520 million in 1988, and $535 million in 1989.

3. Certain Helicopter Uses Exempt from Aviation Excise Taxes (sec. 823 of the bill and secs. 4041(l) and 4261(e) of the Code)

Present Law

Helicopters are exempt from the aircraft fuels and transportation taxes when employed in qualified activities involving hard mineral resources or forestry and when not using federally aided airports or Federal airway facilities. Qualified uses for hard mineral activities include transporting individuals, equipment or supplies in the exploration for, or the development or removal of, hard mineral resources. Qualified uses for forestry activities include planting, cultivation, cutting, transportation of, or caring for, trees. These activities cover tree farming, timber harvesting, and fire or insect control of trees.

The fuels and transportation tax exemptions do not apply to nonqualified hard mineral resources or forestry activities.

Reasons for Change

The committee believes that the fuels and transportation tax exemptions available to helicopters used in natural resource operations should be the same regardless of the type of resource to be developed. The committee in the past has approved such uniform fuels and transportation tax exemptions—most recently in the version of the Tax Equity and Fiscal Responsibility Act initially passed by the Senate and sent to the House—and is reaffirming its initial position by approving this amendment to the fuels and transportation tax exemptions for helicopters.

Explanation of Provision

The bill expands the present exemption from the excise taxes on aviation fuels to include helicopters engaged in the exploration and development of oil and gas. As under present law, the exemption does not apply to helicopters that depart from or arrive at heliports or airports that receive funds from the FAA airport development assistance programs or helicopters that follow FAA air navigation signals in their flight patterns.

The bill also makes a parallel change in the tax on transportation by air. In section 4261(e), the exemption from the air passenger tax which applies to qualified hard mineral resource activities is extended to include transporting individuals, equipment or supplies in the exploration for oil or gas.

Effective Date

The extension of the exemption from the aviation fuels and passenger excise taxes to include oil and gas exploration is effective as of April 1, 1984.

Revenue Effect

The provision will decrease fiscal year budget receipts by $3 million in 1984, by $4 million each in years 1985 and 1986, by $5 million in 1987, and $2 million in 1988.

4. Technical Amendments to the Hazardous Substance Response Revenue Act of 1980 (sec. 824 of the bill and secs. 4661 and 4662 of the Code)

Present Law

The Hazardous Substance Response Revenue Act of 1980 (Superfund) imposes excise taxes on petroleum and certain chemicals. The proceeds of these taxes are deposited in the Hazardous Substance Response Trust Fund for use in responding to releases of hazardous substance into the environment. The taxes imposed under present law are scheduled to terminate on September 30, 1985, or, if earlier, when the aggregate taxes collected exceeds $1.38 billion.

The excise tax on chemicals applies to the following 42 specifically enumerated substances:

Acetylene, Benzene, Butane, Butylene, Butadiene, Ethylene, Methane, Napthalene, Propylene, Toluene, Xylene, Ammonia, Antimony, Antimony trioxide, Arsenic, Arsenic trioxide, Barium sulfide, Bromine, Cadmium, Chlorine, Chromium, Chromite, Potassium dichromate, Sodium dichromate, Cobalt, Cupric sulfate, Cupric oxide, Cuprous oxide, Hydrochloric acid, Hydrogen fluoride, Lead oxide, Mercury, Nickel, Phosphorous, Stannous chloride, Stannic chloride, Zinc chloride, Zinc sulfate, Potassium hydroxide, Sodium hydroxide, Sulfuric acid, Nitric acid.

In the case of butane and methane, the tax is imposed only if those substances are used other than as a fuel in which case the person so using them is treated as the manufacturer. Another exemption is provided for certain chemicals that are used to produce fertilizer or that are directly applied to crops or cropland as fertilizer. These chemicals are nitric acid, sulfuric acid, ammonia, and methane used to produce ammonia. The exemption applies if the manufacturer, producer, or importer of the chemicals either uses them for fertilizer or sells them to a purchaser who either uses them for fertilizer or sells them to a second purchaser who uses them for fertilizer. In the case of a sale for use, the regulations require the manufacturer, producer, or importer to obtain a certificate in which the purchaser agrees to use the chemicals for fertilizer and to notify the manufacturer, etc., if the chemicals are sold or are not used for fertilizer. In the case of a sale for resale, the regulations require the manufacturer, producer, or importer to obtain a certificate in which the purchaser agrees to resell the chemicals to a second purchaser only for use by the second purchaser as fertilizer, and to obtain proof from the purchaser that the chemicals have been resold for fertilizer. In both cases, the manufacturer, producer, or importer remains liable for tax if the use for which the chemicals were sold is not made. If a substance on which the chemical tax has been paid, is subsequently used in a fertilizer use, the user is entitled to a refund of the tax previously paid.

Under the proposed regulations published by the Treasury on October 20, 1983, the addition of substances (such as toluene) to gasoline or the use of a light hydrocarbon stream contain taxable chemicals (such as benzene, toluene, or xylene) to make gasoline is subject to tax as a use. Similarly, the creation of a metal compound (such as cupric sulfate) in a metal refining process would give rise to a tax on use when that substance is consumed in the refining process.

Reasons for Change

The committee believes that some of the rules in the proposed regulations are inconsistent with the intent of Congress in enacting the chemical excise tax. If these rules are not modified, the intended balance of the superfund taxes between chemicals and petroleum will be significantly altered. Similarly, the committee believes that the treatment in the regulations of metal compounds existing temporarily during a refining processes could frustrate the intent of the original bill to exempt zinc, lead, and copper metals from tax. Also, the exemption process provided in 1980 for fertilizer has proven to be too cumbersome and should be simplified.

Explanation of Provision

The bill makes three amendments to the Hazardous Substance Response Revenue Act of 1980. First, to prevent a shifting of the intended burden of the superfund taxes away from the chemical industry to the petroleum industry, the bill provides that when any of the 11 listed petrochemicals (i.e., the first 11 substances in the above list) subject to the chemical tax is used for the manufacture or production of motor fuel, diesel fuel, aviation fuel, or jet fuel, the chemical tax will not apply. Of course, the excise tax on crude oil and imported petroleum products will continue to apply even if the oil or products are used for motor fuels, etc. Under this exception, an otherwise taxable substance will not be subject to the chemical tax if it is (1) added to a qualified fuel, (2) used to produce another substance that is added to a qualified fuel, or (3) sold for either of the uses described in (1) or (2), above. For example, if a refiner or chemical plant operator produces butylenes in a cracking process and then converts those butylenes to methyl tertiary butyl ether or alkylate which is used as a motor fuel additive, no chemical tax will be imposed. If, however, a portion of the alkylate is used or sold to produce, for example, solvents, then tax will be imposed on a corresponding portion of the butylenes. Similarly, if isobutanes are used to produce tertiary butyl alcohol for use in a motor fuel, no chemical tax will be imposed.

In the case of cupric sulfate, cupric oxide, cuprous oxide, zinc chloride, zinc sulfate and lead oxide, the bill provides that the transitory existence of those substances during a metal refining process will not give rise to a liability for the chemical tax if the compound exists in the process of converting or refining non-taxable metal ores or compounds into other (or more pure) non-taxable compounds. If a substance is removed from use in the refining process tax will be imposed. This would be true even if the substance is later reintroduced to the refining process.

The third amendment made by the bill relates to the manner in which the exemption for nitric acid, sulfuric acid, and ammonia used for fertilizer uses may be claimed. The bill permits manufacturers or producers of those substances to sell them free of tax, if the purchaser certifies that the material will ultimately be used for fertilizer purposes. This certification may be made upon the purchaser's reasonable expectation that the material will be used in a fertilizer use. This expectation could be based, for example, on the fact that the material is to be sold to a farm cooperative. If the material is subsequently used for nonfertilizer purposes, the user will be taxed as if it were the manufacturer. If the manufacturer sells one of these substances to a person who does not intend to use or resell them for fertilizer purposes, then the chemical tax will be imposed on that sale by the manufacturer.

Effective Date

These provisions will be effective as if enacted as part of the Hazardous Substance Response Revenue Act of 1980.

Revenue Effect

These provisions are not anticipated to affect revenue receipts that were projected originally when Congress enacted the chemical and crude oil environmental excise taxes.

D. Employee Benefits

1. Effective Date for 1978 Revenue Act Rules on Taxation of Unemployment Compensation Benefits (sec. 825 of the bill)

Present Law

Prior to the Revenue Act of 1978, unemployment compensation paid under most government programs was excludable from gross income under a series of Internal Revenue Service rulings dating from 1938.[1] Section 112 of the Revenue Act of 1978 made includible a portion of unemployment compensation benefits paid pursuant to government programs to taxpayers who have substantial income during the year (Code sec. 85).

Under the 1978 legislation, gross income included the lesser of the amount of unemployment compensation or one-half of the excess of (1) the sum of the taxpayer's adjusted gross income, all unemployment compensation paid pursuant to government programs, and all disability income of the type eligible for exclusion from income under Code section 105(d) (now repealed), over (2) the taxpayer's base amount. The Economic Recovery Tax Act of 1981 (sec. 103(c)(1)) modified the includible amount by adding to the items in (1) above the amount allowed under the deduction for two-earner married couples. (Any social security benefits otherwise included in adjusted gross income under the Social Security Amendments of 1983 are not included in adjusted gross income for purposes of determining taxable unemployment compensation.) [2]

The Revenue Act of 1978 provides that the unemployment compensation taxation provisions apply to payments of unemployment compensation made after 1978, in taxable years ending after 1978. Thus, benefits paid in 1979 and later years may be subject to income tax even if attributable to periods of unemployment before 1979.

Reasons for Change

The committee believes that it is inappropriate to include in income any unemployment compensation benefits attributable to

[1] See I.T. 3230, 1938-2 C.B. 136 (payments by a State agency out of funds received from the Federal Unemployment Trust Fund); Rev. Rul. 55-652, 1955-2 C.B. 21 (unemployment compensation payments to Federal employees by State or Federal agencies); Rev. Rul. 70-280, 1970-1 C.B. 13 (payments by a State agency out of funds received from the Federal Unemployment Trust Fund); Rev. Rul. 73-154, 1973-1 C.B. 40 (unemployment compensation payments made under the Unemployment Compensation Act of 1971); Rev. Rul. 76-63, 1976-1 C.B. 14 (unemployment compensation benefits paid under the Emergency Jobs and Unemployment Assistance Act of 1974 and the Emergency Unemployment Compensation Act of 1974); Rev. Rul. 76-144, 1976-1 C.B. 17 (payments made under the Disaster Relief Act of 1974); and Rev. Rul. 76-229, 1976-1 C.B. 19 (trade readjustment allowances paid under the Trade Act of 1974).

[2] Social Security Amendments of 1983 (the Amendments), sec. 121(f)(1). The Amendments also repeal former Code sec. 105(d) and delete the reference to Code sec. 105(d) disability income in Code sec. 85 (Amendments, secs. 122(b) and 122(c)(2)).

weeks of unemployment beginning before December 1, 1978, since such benefits may be for periods of unemployment occurring well before the unemployment compensation taxation provisions were enacted. Accordingly, the provision amends the Revenue Act of 1978 so that the unemployment compensation taxation provisions apply to payments of unemployment compensation benefits made after 1978, except payments for weeks of unemployment ending before December 1, 1978.

Explanation of Provision

The provision amends the Revenue Act of 1978 to provide that the provisions of that Act making includible in gross income certain amounts of unemployment compensation benefits apply to payments of unemployment compensation made after 1978, except payments for weeks of unemployment ending before December 1, 1978.

The provision permits taxpayers who are entitled as a result of the amendment made by the provision to a credit of any overpayment or refund, but for the operation of the statute of limitations or another rule of law (including res judicata), to obtain the credit or refund by filing a claim for it before the close of the one-year period beginning on the date of enactment.

Effective Date

The provision is effective on enactment.

Revenue Effect

The amendment made by the provision is estimated to result in refunds or credits of less than $1 million.

2. Employee Stock Options (secs. 826-827 of the bill and secs. 57, 83, and 422A of the Code)

Present Law

Under present law, the tax treatment of employee stock options generally is governed by section 83 and the regulations thereunder (Treas. Reg. §1.83-7). Under these rules, the value of a stock option constitutes ordinary income to the employee when granted only if the option itself had a readily ascertainable fair market value at that time. If the option does not have a readily ascertainable value when granted, it does not constitute ordinary income at that time.[1] Instead, when the option is exercised, the difference between the value of the stock at exercise[2] and the option price constitutes ordinary income to the employee.

An employer who granted a stock option generally is allowed a business expense deduction equal to the amount includible in the employee's income in its corresponding taxable year (sec. 83(h)).

In addition, present law provides for "incentive stock options", under which there are no tax consequences when the option is granted or, except for the alternative minimum tax, when the option is exercised, and the employee generally is taxed at capital gains rates when the stock received on exercise of the option is sold. No business expense deduction is allowed to the employer with respect to an incentive stock option (sec. 421(a)).

The option price of an incentive stock option must equal or exceed the fair market value of the stock at the time the option is granted. These options must not be exercisable while an earlier incentive stock option is outstanding. This rule prevents a downward adjustment in the option price by the granting of a new option where the stock has declined in value. These options may not be transferable by the employee other than by reason of death. A special rule provides that the change in terms of an option to meet the nontransferability requirements of section 422A(b)(5) will not be treated as the grant of a new option requiring the option price to be set by reference to the stock's fair market value on the modification date (sec. 425(h)(3)(B)).

Finally, the difference between the fair market value of the stock on the date the option is exercised and the option price of the stock is an item of tax preference for purposes of the individual alternative minimum tax.

[1] Section 83 does not apply to the transfer of an option without a readily ascertainable fair market value (sec. 83(e)(3)). Treas. Reg. §1.83-7(a) implies that no income is realized upon grant of such an option.

[2] For this purpose, the value of the stock is determined without regard to restrictions other than restrictions which by their terms will never lapse.

Reasons for Change

The committee believes that the deferral of tax until an employee disposes of the stock received through the exercise of an employee stock option will encourage employee ownership of the stock of an employer's business, and thus the employee will have a proprietary interest in its successful operation. The committee believes this benefit should not be conferred where the employer provides this stock ownership opportunity only to highly compensated officers of the company and to owner-employees.

Explanation of Provisions

a. Nonqualified stock options

The bill provides that an individual may defer the amount otherwise includible in income (under section 83(a)) upon the exercise of an employee stock option until the individual disposes of the stock. The employer's deduction will be deferred until the amount is included in the employee's income. For this provision to apply, the employer must make an election in accordance with Treasury regulations. The amount included in ordinary income upon disposition of the stock will not be affected by subsequent changes in the value of the stock. It will be added to the basis of the stock for purposes of determining gain or loss from the disposition of the stock. A disposition includes a sale, exchange, gift, transfer by reason of death[3] or other transfer of title other than certain tax-free exchanges or pledges.

In order to be eligible for the special treatment, the individual exercising the option, for the entire time from the date of granting the option until three months before the date of exercise, must be an employee either of the company granting the option, a parent or subsidiary of that corporation, or a corporation (or parent or subsidiary of that corporation) which has assumed the option of another corporation as a result of a corporate reorganization, liquidation, etc. This 3-month limitation is waived in the case of the retirement of the employee after age 55.

For an option to qualify for the special treatment an option must meet the following conditions:

(1) The option price must equal or exceed the fair market value of the stock (determined without regard to any restriction other than a restriction which, by its terms, will never lapse) at the time the option is granted.

(2) The option by its terms must be nontransferable other than at death and must be exercisable during the employee's lifetime only by the employee.

(3) The option by its terms is not exercisable while there is outstanding any such stock option or any incentive stock option which was granted to the employee at an earlier time. For this purpose, an option which has not been exercised in full is outstanding until the expiration of the period which under its initial terms it could have been exercised. Thus, the

[3] The income will be included on the decedent's last return.

cancellation of an earlier option will not enable a subsequent option to be exercised any sooner.

(4) The option is not an incentive stock option (sec. 422A) and is not an option granted pursuant to an employee stock purchase plan (sec. 423).

(5) The option by its terms requires that stock certificates issued upon exercise of the option be retained by the corporation or its agent for the benefit of the employee, or requires the use of restrictive legends or stop-transfer instructions with respect to the stock certificates. An option meets this requirement if the terms of the option require that any stock certificate issued upon exercise of the option indicates on its face that transfer of the stock is subject to the provision of notice to the corporation of the transfer.

The aggregate fair market value of the stock (determined at the time the option is granted) for which these employee stock options may be granted in any calendar year is $100,000 reduced by the value of stock for which incentive stock options are granted that year.

This special tax treatment will be available for an option only if at least forty percent of the value of the employee stock options granted is granted to persons other than either (i) 5-percent owners or (ii) officers of the company whose annual compensation exceeds two times the defined contribution limitation for pension plans (currently $60,000). These terms have the same meaning as given to them by section 416(i). In addition, if the employer discriminates in favor of these persons by offering different option terms or by failing to make elections for this new treatment for certain employees, the options will not qualify.

The amount deferred by reason of the election is to be treated as an item of tax preference for purposes of the individual minimum tax.

b. Incentive stock options

Two amendments are made to the incentive stock option provision to insure that the fair market value requirements of present law may not be avoided. First, the determination of fair market value is to be made without regard to any restriction other than a restriction which, by its terms, will never lapse. Second, a change in the terms of an option to make it nontransferable in order to qualify as an incentive stock option will be treated as the grant of a new option. The option will thus be required to meet the incentive stock option requirements, including the option price requirement, based on the later grant date.

Effective Date

The provisions relating to the new employee stock option will apply to options exercised after date of enactment.

The provisions relating to incentive stock options will apply to options granted, exercised, or modified (as the case may be) after March 20, 1984.

Revenue Effect

The provisions will reduce fiscal year budget receipts by less than $5 million in 1984 and 1985, by $5 million in 1986, by $10 million in 1987, and by less than $5 million thereafter.

3. Tax Treatment of Employee Awards (sec. 828 of the bill and secs. 74 and 274 of the Code)

Present Law

Code section 274(b) generally disallows business deductions for gifts to the extent that the total cost of all gifts of cash, tangible personal property, etc., to the same individual from the taxpayer during the taxable year exceeds $25. The statute expressly defines the term gift to mean any amount excludable from gross income under section 102 (relating to gifts and bequests).

A higher business deduction limitation applies in the case of business gifts of items of tangible personal property which are awarded to employees for certain specified purposes. Prior to enactment of the Economic Recovery Tax Act of 1981 (ERTA), this exception to the general $25 limitation applied to an item of tangible personal property only if the item's cost did not exceed $100, and only if the item was awarded to an employee by reason of length of service or for safety achievement.

ERTA increased the ceiling on deductions for business gifts to employees of items of tangible personal property in one year from $100 to $400 of cost for an item of tangible personal property which is awarded to an employee for the purposes specified in the statute. Also, ERTA expanded those purposes to include productivity, as well as length of service and safety achievement. Under these rules, a deduction is allowed up to $400 of cost of an item the cost of which exceeds $400.

In addition, the amount of the allowable deduction for such business gifts was further increased by ERTA in cases where the item of tangible personal property is awarded for the specified purposes as part of a permanent, written plan or program of the taxpayer that does not discriminate in favor of officers, shareholders, or highly compensated employees as to eligibility or benefits. A deduction is allowed for such qualified plan awards of tangible personal property only if the average cost of all awards under all such plans of the taxpayer during the taxable year does not exceed $400. In addition, no deduction may be claimed under such an award plan or program for a particular item of tangible personal property awarded to an employee for such purposes to the extent that the cost of the item exceeds $1,600.

Background

Section 102 exclusion for gifts

Under Code section 102, gross income does not include the amount of cash, or the value of property, received by an individual as a gift. The U.S. Supreme Court has long held that this exclusion does not apply to property received in a business or commercial context if the item is intended as additional compensation for past or future services, regardless of whether the payor and recipient designate the transfer as a "gift" (e.g., *Comm'r* v. *LoBue,* 351 U.S. 243 (1956)).

In the leading case involving payments made "in a context with business overtones" (*Comm'r* v. *Duberstein*), the Supreme Court stated as follows with respect to distinguishing excludable gifts from includable compensation:

> "* * * [A] voluntary executed transfer of * * * property * * *, without any consideration or compensation therefor, though a common-law gift, is not necessarily a 'gift' within the meaning of the [income tax] statute. For the Court has shown that the mere absence of a legal or moral obligation to make such a payment does not establish that it is a gift. * * * And, importantly, if the payment proceeds primarily from the 'constraining force of any moral or legal duty,' or from 'the incentive of anticipated benefit' of an economic nature * * * , it is not a gift. And, conversely, '[w]here the payment is in return for services rendered, it is irrelevant that the donor derives no economic benefit from it.' "[1]

Under *Duberstein,* the determination of whether property transferred from an employer to an employee (or otherwise transferred in a business context) constitutes a gift to the recipient is to be made on a case-by-case basis, by an "objective inquiry" of the facts and circumstances. If the transferor's motive was "the incentive of anticipated benefit," or if the payment was in return for services rendered (whether or not the payor received an economic benefit from the payment), then the payment must be included in income by the recipient.[2]

Section 274(b) limitation on deduction

Section 274(b) generally limits to $25 the amount deductible (either as business or investment expenses) "for any expense for gifts made directly or indirectly to any individual * * *." For this purpose, the statute expressly defines the term gift to mean "any item excludable from gross income of the recipient under section 102 which is not excludable from his gross income under any other provision" of the tax statute, subject to certain exceptions. Thus, section 274(b) comes into play in the case of a payment of cash or property if section 102 treats the payment as a gift, and provides rules for whether such payments may still be deductible by the payor even though the equation is then "unbalanced," i.e., where a deduction to the payor is not fully matched by income to the recipient.

[1] 363 U.S. 278(1960). In the *Duberstein* case, the Supreme Court upheld a Tax Court decision that an automobile given to the taxpayer by a business acquaintance was not excludable from income as a gift where the car was intended as remuneration for services rendered, even though there was no prior arrangement for compensation and the individual did not expect to be paid.

[2] Under the *Duberstein* test, for example, the Tax Court has held that bonus payments made by an aircraft manufacturer to distributors based on the number of aircraft sold through their distributorships are not excluded from income as gifts, even though the manufacturer did not claim a business deduction for such payments, since the effect of the payments "was as an 'incentive of anticipated benefit of an economic nature' " (*Hodge* v. *Comm'r,* 32 CCH Tax Ct. Mem. 277, 283 (1973)).

Section 274(b) was enacted by the Revenue Act of 1962. As passed by the House, the 1962 tax bill would have disallowed any deduction for business gifts exceeding $25 per recipient; there was no exception to this disallowance rule under the House bill for gifts of tangible personal property. The Senate Finance Committee amended the provision to add three exceptions to the $25 limitation, including an exception for an item of tangible personal property having a cost to the taxpayer (employer) not in excess of $100 if awarded to an employee by reason of length of service or safety achievement. The Finance Committee report on the 1962 bill states that this exception for certain business gifts of tangible property "relates only to deductibility by the employer" and "is not intended to have any effect in determining whether the employee who receives the award is to be taxed on its value." [3]

As described above, ERTA increased the ceiling on deductions for certain business gifts to employees of items of tangible personal property and expanded the specified purposes for which such gifts eligible for the increased deduction may be awarded to include productivity, as well as length of service and safety achievement. The legislative history of the ERTA provision, which was added to the bill by Senate floor amendment, reflects an intent to increase the original $100 tangible personal property deduction limit in view of the effect of inflation during the 20 years subsequent to enactment of that provision.[4]

Reasons for Change

The committee understands that disagreements have arisen between some taxpayers and the IRS as to whether or in what circumstances employee awards of tangible personal property made for length of service, safety, or productivity qualify for exclusion from gross income under Code section 102 as gifts, or constitute compensation includible in gross income under section 61. Accordingly, the bill provides a new income-tax exclusion to employees for specified types of achievement awards under the circumstances set forth in the bill.

The committee also is concerned that an unlimited exclusion might permit employers to convert taxable compensation into taxfree "awards," thereby eroding the income-tax base and creating disparate treatment of taxpayers depending on whether their employer gave them economic benefits in the form of such property. Thus, the committee has limited the types of qualifying transferred property to traditional awards, such as watches or emblematic jewelry, and placed dollar limitations on the exclusion and the employer's deduction. Other restrictions include limitations on the number of employees in a business who can be given productivity or safety awards; on how frequently a particular employee can receive productivity, etc. awards; and on the use of nominal awards in calculating the average cost limitation for purposes of the definition of a qualified plan award. Also, certain nondiscrimination

[3] Sen. Rpt. No. 1881, 87th Cong., 2d Sess. 171 (1962).

[4] See 127 Cong. Rec. S-8640 (daily ed. July 28, 1981) (remarks of Senators Garn and Dole); Staff of Jt. Comm. on Taxation, 97th Cong., 1st Sess., General Explanation of the Economic Recovery Tax Act of 1981 179-180 (Comm. Print 1981).

rules are to apply. The IRS is given authority to impose record-keeping and reporting requirements concerning employee awards.

Explanation of Provision

Overview

The bill provides a new exclusion from gross income, within certain limitations, for an "employee achievement award" which satisfies the requirements and conditions set forth in the bill. Also, the bill makes related changes to the present-law limited deduction allowed to the employer where transfers to employees qualify as section 102 gifts. Except to the extent that the new exclusion specifically applies, any amount of an employee award (whether or not satisfying the definition of an employee achievement award) is includible in the employee's gross income under section 61, and is not excludable under section 74 (as amended by the bill) or section 102 (gifts).

Employee achievement awards

The bill defines "employee achievement award" as an item of tangible personal property transferred by an employer to an employee for a qualifying achievement, other than such an item which the employer elects to treat in its entirety as compensation to the employee (and which the employer reports, in the manner required, to the IRS and to the employee as compensation). The three qualifying achievements are length of service (including retirement), productivity, and safety achievement. No item is to be treated as an employee achievement award for more than one such achievement.

An item, other than an exempted item, does not qualify as provided for length of service achievement (and hence cannot qualify for the new exclusion) if an employee achievement award other than an exempted item was provided by the employer to the employee for length of service achievement during the year or any of the prior three years. For this purpose, the term "exempted item" means an employee achievement award which is of nominal value, is provided as part of the replacement of one length of service plan by another, is a retirement award, or is an initial years award. The latter term means an employee achievement award provided to an employee for length of service achievement during the first five years of employment with the employer, but only to the extent that the cost of the award, when combined with the cost of all other such awards provided to that employee for those years, does not exceed $200.

An item provided by an employer to an employee is not treated as having been provided for productivity or safety achievement (and hence cannot qualify for the new exclusion) if, during the same year, employee achievement awards for productivity or safety achievement, other than awards of nominal value, have been previously awarded by the employer to, or earned by, more than ten percent of the employer's employees.

The bill also provides that an item provided to a key employee (generally as defined in Code sec. 416(i)(1)) does not constitute an excludable employee achievement award if more than ten percent of the cost paid or incurred by the taxpayer during the same year for items which (but for this provision) would constitute employee achievement awards is for items provided to such key employees.

Exclusion requirements

The amount of an employee achievement award is excludable from gross income, subject to certain limitations, if it—

(A) is awarded as part of a meaningful presentation;

(B) is awarded under conditions and circumstances that do not create a significant likelihood of the payment of disguised compensation;[5]

(C) constitutes (i) a watch, clock, or other timepiece, (ii) an item of emblematic jewelry or a ring that has been custom designed and manufactured to identify or symbolize the awarding employer or the achievement being recognized, (iii) to the extent provided in Treasury regulations, an item of a type traditionally used to make retirement awards, (iv) to the extent provided in Treasury regulations, an item which is of a type traditionally used to make nonretirement employee achievement awards, or (v) any accessory for personal wear, use, or display which is permanently and prominently affixed to an item described in (i) or (ii), provided that such accessory does not constitute a significant element of cost.

However, any such exclusion is to be reduced by any amount by which (1) the lesser of the cost to the employer or the value to the employee of the employee achievement award exceeds (2) the amount that is deductible by the employer within the limits of section 274 as amended by the bill (or would be so deductible if the employer were not tax-exempt under subtitle A of the Code).

Except to the extent that the new exclusion specifically applies, any amount of an employee award (whether or not satisfying the definition of an employee achievement award) is includible in the employee's gross income under section 61, and is not excludible under section 74 (as amended by the bill) or section 102 (gifts).[6]

The amount of an employee achievement award which is excludable from gross income under the bill is not excluded from wages for employment tax (e.g., FICA tax) purposes.

Deduction limitations

Under section 274 as amended by the bill, the employer's deduction for the cost of one or more employee achievement awards awarded to a particular employee during the taxable year as qualified plan awards for the same qualifying achievement is limited to $1,600 (i.e., an aggregate maximum of $4,800 if the employee receives awards deductible up to $1,600 for each of the three achievement categories). The deduction for the cost of such items awarded by an employer to an employee during the same year for the same

[5] For example, the making of employee awards at the time of annual salary adjustments, or as a substitute for a prior program of awarding cash bonuses, and the providing of employee awards in a way which discriminates in favor of highly paid employees, are the types of conditions and circumstances which are to be deemed to create a significant likelihood of payment of disguised compensation.

[6] The extension by the bill of the legislative moratorium on the issuance of Treasury regulations on nonstatutory fringe benefits does not apply to any employee awards.

qualifying achievement which are not qualified plan awards is limited to $400 (i.e., an aggregate maximum of $1,200 if the employee receives awards deductible up to $400 for each of the three achievement categories.) As a further limitation, except for employee achievement awards of nominal value, the maximum amount that an employer may deduct for the aggregate cost of all employee achievement awards provided to a particular employee for either productivity or safety achievement for any consecutive four-year period is $1,600 in each achievement category.

The bill defines qualified plan award as an employee achievement award provided under an established written plan or program of the employer to provide employee achievement awards which the employer elects to treat as a qualified plan award. However, an employee achievement award is not treated as a qualified plan award if the average cost per recipient of all employee achievement awards which were provided by the employer during the year for the same qualifying achievement, and which would be qualified plan awards but for this limitation, exceeds $400. (For this purpose, a recipient means any employee who received a qualified plan award for that qualifying achievement during the year.) In calculating average cost, the full cost of qualified plan awards provided for that qualifying achievement is to enter into the computation, and not just the cost up to $1,600 per recipient. Average cost is to be calculated without taking into account employee achievement awards of nominal value.

The bill also provides that an employee achievement award provided to a key employee does not constitute a qualified plan award if provided under a plan which discriminates in favor of key employees as to eligibility to receive qualified plan awards, or if the type and cost of qualified plan awards available under the plan discriminates in favor of participants who are key employees. Certain definitions and other rules are provided in the bill with respect to these nondiscrimination requirements.

Other rules

All employees who are treated as employed by a single employer under sections 414(b), 414(c), or 414(m) are treated as employed by a single employer for purposes of section 274.

In the case of an employee achievement award provided by a partnership, the section 274 deduction limitations apply to the partnership as well as to each partner.

Reporting, etc. requirements

The bill authorizes the Treasury Department to require, by regulations, any person to make returns, render statements, and keep records as appropriate with respect to the provisions of section 274, including (but not limited to) information with respect to the numbers, types, costs, and recipients of employee achievement awards, and the numbers and types of qualified plans maintained, the numbers and costs of items awarded under such plans, the employees eligible to receive awards under such plans, and the recipients of such awards.

Effective Date

The provision applies to awards made after the date of enactment of the bill.

Revenue Effect

The provision is estimated to reduce fiscal year budget receipts by $23 million in 1984, $55 million in 1985, $89 million in 1986, $144 million in 1987, $205 million in 1988, and $229 million in 1989.

4. Moratorium on Issuance of Fringe Benefit Regulations (sec. 829 of the bill)

Present Law

Moratorium

The Economic Recovery Tax Act of 1981 extended, through December 31, 1983, the legislative moratorium (first enacted in 1978) prohibiting the Treasury Department from issuing final regulations relating to the income tax treatment of nonstatutory fringe benefits. Also, the 1981 statute provided that no regulations relating to the treatment of such fringe benefits can be proposed which would be effective prior to expiration of the moratorium.

Employer-provided housing

Present law (Code sec. 119) excludes from an employee's gross income the value of lodging provided by the employer if (1) the lodging is furnished for the convenience of the employer, (2) the lodging is on the business premises of the employer, and (3) the employee is required to accept the lodging as a condition of employment. Several court decisions have held that on-campus housing furnished to faculty or other employees by an educational institution under the circumstances involved in those cases did not satisfy the section 119 requirements, and hence that the fair rental value of the housing (less any amounts paid for the housing by the employee) was includible in the employee's gross income and constituted wages for income tax withholding and employment tax purposes.[1]

Reasons for Change

Moratorium

The committee believes that a proper review of the important issues involved in the income and employment tax treatment of nonstatutory fringe benefits requires an additional period of time.

Faculty housing

The committee recognizes that certain court cases have upheld the Internal Revenue Service's position in those cases that the value of housing (including campus housing) provided by an em-

[1] *Bob Jones University* v. *U.S.*, 670 F.2d 167 (Ct.Cl. 1982); *Goldsboro Christian Schools, Inc.* v. *U.S.*, 79-1 CCH USTC para. 9266 (E.D.N.C. 1978) (value of lodging furnished to faculty constitutes wages subject to income tax, FICA, and FUTA withholding, in light of "long and consistent history of regulations and rulings, expressly and explicitly applying withholding taxes to lodging not furnished for the employer's convenience * * *"), aff'g order entered in *Goldsboro Christian Schools, Inc.* v. *U.S.*, 436 F.Supp. 1314 (E.D.N.C. 1977), aff'd per curiam in unpublished opinion (4th Cir. 1981), aff'd 103 S.Ct. 2017 (1983)); *Winchell* v. *U.S.*, 564 F.Supp. 131 (D.Neb. 1983) (value of campus home taxed to college president); and *Coulbourn H. Tyler*, 44 CCH Tax Ct. Memo. 1221 (1982).

ployer at below fair market value to an employee, less amounts paid by the employee for the housing, is includible in income and wages. At the same time, in view of its extension of the moratorium on fringe benefit regulations to allow further study of the issues, the committee believes that it is appropriate that the moratorium be applied during the two-year extension period with respect to certain campus lodging furnished by an educational institution during the extension period.

Explanation of Provisions

a. Moratorium on fringe benefit regulations generally

The bill extends the legislative moratorium on issuance of fringe benefits regulations through December 31, 1985.

Under the bill, the Treasury Department (Internal Revenue Service) is prohibited from issuing prior to January 1, 1986 final regulations, under Code section 61, relating to the income tax treatment of nonstatutory fringe benefits. In addition, no regulations relating to the treatment of nonstatutory fringe benefits under section 61 are to be proposed which would be effective prior to January 1, 1986.

Although the provision of the bill relates only to the issuance of regulations, it is the intent of the Congress that the Treasury Department (Internal Revenue Service) will not in any significant way alter, or deviate from, the historical income-tax treatment of traditional nonstatutory fringe benefits through the issuance of revenue rulings or revenue procedures, etc. The bill does not prevent the Treasury or Revenue Service from continuing to study the question of the appropriate tax treatment of nonstatutory fringe benefits.

b. Faculty housing

Under the bill, the extended legislative moratorium is applied to prohibit the issuance of income tax regulations providing for the inclusion in gross income of the excess of the fair market value of qualified campus lodging over the greater of the operating costs paid in furnishing the lodging or the rent received. The term qualified campus lodging means lodging furnished by an educational institution (within the meaning of sec. 170(b)(1)(A)(ii))[2] to any employee of the educational institution (or to the employee's spouse or dependents), including non-faculty employees. The bill applies only if the employer-furnished lodging is located on a campus of, or in close proximity to, the educational institution. Under the bill, the moratorium does not apply with respect to any amount of the value of lodging if such amount was treated as wages or included in income when furnished.

[2] An educational organization is described in sec. 170(b)(1)(A)(ii) "if its primary function is the presentation of formal instruction and it normally maintains a regular faculty and curriculum and normally has a regularly enrolled body of pupils or students in attendance at the place where its educational activities are regularly carried on. The term includes institutions such as primary, secondary, preparatory, or high schools, and colleges and universities," and includes both public and private schools (Treas. Reg. sec. 1.170A-9(b)(1)).

Effective Date

The general extension of the legislative moratorium is effective on enactment. The application of the extended moratorium with respect to qualified campus lodging applies with respect to lodging furnished after December 31, 1983 and before January 1, 1986.

Revenue Effect

The provisions are estimated to reduce budget receipts by a negligible amount in each of fiscal years 1984, 1985, and 1986.

5. Extension of Exclusion for Certain Educational Assistance Programs; Timing of Deduction for Deferred Educational Benefits (sec. 890 of the bill and secs. 127 and 404 of the Code)

Present Law

General rule

Under present law, amounts paid or expenses incurred by an employer for educational assistance provided to an employee are excluded from the employee's gross income if paid or incurred pursuant to a written plan that meets certain requirements and is for the exclusive benefit of the employees (Code sec. 127). The exclusion applies whether or not the education paid for, or furnished by, the employer is related to the employee's job.

Excludable benefits

Under this provision, an employee may exclude from income the value of educational assistance provided by the employer to the employee. Excludable amounts include tuition, fees, and similar expenses, as well as the cost of books, supplies, and equipment paid for, or provided by, the employer. (The exclusion is not available for the cost of tools or supplies provided by the employer if the employee may retain such tools or supplies after completion of the course of instruction.) However, meals, lodging, or transportation may not be excluded under this provision. The exclusion does not apply to educational assistance furnished for courses involving sports, games, or hobbies, unless the education provided involves the business of the employer.

For a program to qualify under this provision, the employee must not be able to choose taxable benefits in lieu of educational assistance benefits. In administering this rule, the business practices of an employer, as well as the written program, are to be taken into account. A qualified educational assistance program need not be funded or approved in advance by the Internal Revenue Service.

The employee may not claim a deduction (e.g., a business expense deduction) or a credit with respect to any amount that is excluded from income under this provision.

Nondiscrimination requirements

For the exclusion to be available, the educational assistance program also must meet certain requirements with respect to nondiscrimination in eligibility.

The program must benefit employees who qualify under a classification set up by the employer and found by the Internal Revenue Service not to be discriminatory in favor of employees who are officers, owners, highly compensated individuals, or their dependents.

The program must be available to a broad class of employees, rather than to a particular individual. However, employees may be excluded from a program if they are members of a collective bargaining unit and there is evidence that educational assistance benefits were the subject of good faith bargaining between the unit representatives and the employer or employers offering the program.

A program is not considered discriminatory merely because it is utilized to a greater degree by one class of employees rather than by another class or because successful completion of a course, or attaining a particular course grade, is required for, or considered in, determining reimbursement under the program.

The exclusion does not apply if the share of benefits received by certain employees under the program exceeds a specified level. Specifically, the benefits are not excludable if more than five percent of the benefits are paid to shareholders or owners (or their spouses or dependents, who are employees), each of whom (on any day of the year) owns more than five percent of the stock or of the capital or profits interest in the employer.[1]

Reasonable notification of the availability and terms of the program must be provided to eligible employees.

Treatment of self-employed individuals

An individual who qualifies as an employee within the definition of section 401(c)(1) also is an employee for purposes of these provisions. Thus, in general, the term employee includes self-employed individuals who have earned income for the taxable year, or any prior taxable year, as well as individuals who would have earned income except that their trades or businesses did not have net profits for the taxable year.

An individual who owns the entire interest in an unincorporated trade or business is treated as his or her employer. A partnership is considered the employer of each partner who is also an employee of the partnership.

Payroll tax treatment

Amounts excluded from income as educational assistance are not treated as wages subject to social security (FICA) or unemployment insurance (FUTA) taxes.

Expiration date

The provisions of Code section 127 expired for taxable years beginning after December 31, 1983.

Employer deduction for contributions to provide educational benefits

Under present law, an employer may deduct contributions to a pension, profit-sharing, stock bonus, or other plan, which provides for the deferral of compensation and which does not satisfy the requirements for qualified plan status, only when the employee in-

[1] For determining stock ownership in corporations, this provision uses the attribution rules provided under subsections (d) and (e) of section 1563 (without regard to sec. 1563(e)(3)(C)). Ownership interests in unincorporated trades or business are to be determined, under regulations, on the basis of similar principles.

clude the deferred amounts in gross income.[2] In contrast, if a plan or other arrangement is a welfare or similar benefit plan and if the employer contributions to the plan qualify as ordinary and necessary business expenses, the contributions are deductible in the year in which they are paid or accrued (Treas. reg. sec. 1.162-10(a)) without regard to when an employee includes the amounts in gross income. As a result of a recent court decision, the question has arisen as to whether a deferred educational benefit plan, i.e., a plan in which employer contributions are made to provide educational benefits to employees, their spouses, or their dependents in future years, is a plan of deferred compensation.

In this case, a professional corporation of doctors received a current deduction for amounts contributed to a trust to pay college tuition in the future to children of the employees even though no amounts were currently includible in the employees' income (*Greensboro Pathology Associates, P.A.* v. *United States,* 699 F. 2d 119C (Fed. Cir. 1982)). In 1974, Greensboro Pathology Associates, P.A., established a plan to pre-fund the costs of college education for children of the corporation's employees. At that time, the corporation had six employees, five of whom were doctor-shareholders (or became doctor-shareholders in the following year). Although all employees' children were eligible to receive benefits, only four of the doctor-shareholders had children; these 11 children were in grades kindergarten through seven at the plan's inception. Thus, under the facts in *Greensboro Pathology,* employer contributions were accumulated for at least seven years before any benefits would be paid and taxable to the doctor-shareholders.

The court concluded that the plan was not a deferred compensation plan because the receipt or amount of benefits was not linked to salary and because certain other tests established by the court were met. Thus, the professional corporation was entitled to a current deduction under sec. 162 as a welfare plan for the pre-funding of the educational benefits.

Reasons for Change

The committee recognizes that the exclusion from gross income of benefits provided under an educational assistance program may provide significant incentives to women, minority and other workers who use the program to upgrade their skills. Absent this exclusion, generally the value of these benefits is includible in gross income. Therefore, the committee believes it is appropriate to extend the exclusion for educational assistance programs for two years.

In addition, the committee is aware of situations in which corporations are establishing plans to pre-fund college educational benefits for the children of the corporation's employees. The committee is concerned that the growth of these plans will encourage an erosion of the tax base because employers will be permitted tax deductions many years before benefits are paid to employees, their

[2] If the plan is a tax-qualified pension, etc., plan within the meaning of sec. 401(a), an employer is permitted a deduction, within limits, for contributions to the plan even though the employee is not required to include any amounts in gross income until they are withdrawn from the plan.

spouses, or their dependents. Thus, the committee believes that these arrangements are, in fact, deferred compensation plans and should be subject to the rules governing deferred compensation plans.

Explanation of Provision

Extension of exclusion

The bill provides a two-year extension of the section 127 exclusion for certain educational assistance programs, so that the exclusion does not apply to taxable years beginning after December 31, 1985.

Employer deduction for contributions to provide educational benefits

The bill amends the rules relating to an employer's deduction for contributions to a deferred compensation plan to provide that any plan providing for deferred educational benefits for employees, their spouses, or their dependents shall be treated as a plan of deferred compensation.[3] Thus, an employer is not permitted to deduct contributions to a plan providing deferred educational benefits until the employee (1) includes the value of the benefits in gross income or (2) would include the value of the benefits as a scholarship (sec. 117) or as a benefit provided under an educational assistance program (sec. 127) but for the exclusions provided by those two sections. An arrangement or method having the effect of a plan providing deferred educational benefits is also treated as a plan of deferred compensation.

A plan providing for deferred educational benefits means any plan or other arrangement under which employer contributions to the plan or arrangement are not includible in the gross income of the employee (without regard to sec. 117 or 127) until a taxable year after the one in which the contributions are made.

The committee recognizes that employers may provide other types of benefits to employees, their spouses, or their dependents that have the effect of a plan of deferred compensation. The changes made by this bill do not otherwise change the treatment of these plans as deferred compensation plans and do not create a inference with respect to the treatment of these plans as other than deferred compensation plans.

Effective Date

These provisions are effective for taxable years beginning after December 31, 1983.

Revenue Effect

These provisions are estimated to decrease fiscal year receipts by $7 million in 1984 and $39 million in 1985 and to increase fiscal year receipts by $1 million in 1986, $22 million in 1987, $24 million in 1988, and $26 million in 1989.

[3] If a plan is a plan of deferred compensation, employer deductions for contributions to the plan are governed solely by the rules of sec. 404.

6. Treatment for Social Security Purposes of Employer Pickup of Employee Contributions Under State and Local Retirement Plans (sec. 830 of the Bill, sec. 209 of the Social Security Act, and secs. 3121 and 3306 of the Code)

Present Law

Prior to the Social Security Amendments of 1983, certain employer payments ("pickups") of employee contributions under a State or local retirement plan were treated as wages for social security and unemployment tax purposes only if the payments were made under a salary reduction arrangement. Under the Amendments, all such employer payments are treated as wages.

Reasons for Change

Congress intended, in the Amendments, merely to codify the prior law treatment of employer pickups.

Explanation of Provision

The bill provides that employer pickups are wages, for social security and unemployment tax purposes, only if the pickup is pursuant to a salary reduction agreement (whether evidenced by a written instrument or otherwise). The term salary reduction agreement also includes any salary reduction arrangement, regardless of whether there is approval or choice of participation by individual employees or whether such approval or choice is mandated by State statute.

Effective Date

This provision is effective as if it had been included in the Social Security Amendments of 1983.

Revenue Effect

This provision will have no effect on budget receipts.

E. Miscellaneous Treasury Administrative Provisions

1. Simplification of Certain Reporting Requirements (sec. 831 of the bill)

Present Law

The Department of the Treasury is required to report to the Congress regarding specific statutory provisions on an annual or other periodic basis. The provisions affected by the bill are discussed below.

DISC.—The Treasury Department is required by statute to submit an annual report on the Domestic International Sales Corporation (DISC) provisions of the Internal Revenue Code. This report is due 15½ months after the end of each calendar year.

International boycotts.—The Treasury Department is required by statute to submit an annual report on the international boycott provisions of the Internal Revenue Code. This report is to set forth the number of boycott reports filed for taxable years ending with or within that year, the number of such reports on which the taxpayer indicated boycott participation or cooperation, and a detailed description of the manner in which the boycott provisions of the Code have been administered during that calendar year. The Secretary is to transmit this report as soon after the close of each calendar year as the data become available.

Possessions corporations.—The committee reports on the Tax Reform Act of 1976 require an annual report to the House Committee on Ways and Means and the Senate Committee on Finance on possessions corporations. The committee reports stated that "The Treasury is to submit an annual report . . . setting forth an analysis of the operation and effect of the possessions corporation system of taxation. Among other things, the report is to include an analysis of the revenue effects of the provision as well as the effects on investment and employment in the possessions." The committee reports indicated that these annual reports are to be submitted within 18 months following the close of each calendar year.

High income taxpayers.—The Tax Reform Act of 1976 requires the Department of the Treasury to publish information annually on the amount of tax paid by individual taxpayers with high total incomes. The statute presently requires calculation of total income in the following three ways: (1) adjusted gross income (AGI) plus tax preference items (which are exclusions from gross income or deductions in arriving at AGI), (2) AGI less investment interest and expense (to the extent that it does not exceed investment income), and (3) AGI with both of these modifications. The statute also requires publication of the number of individuals with total incomes of over $200,000 who owe no Federal income tax and the deductions, exclusions, or credits they used to avoid tax.

Reasons for Change

The committee believes that the Treasury reporting requirements can be lessened without diminishing the usefulness of information supplied in the reports. The committee understands that the Treasury will make current the statistics of income reports relating to foreign income.

Explanation of Provision

The bill modifies several of the statutory Treasury Department reporting requirements.

DISC.—The Secretary of Treasury will be required to submit a report setting forth an analysis of the operation and effect of the DISC provisions for calendar 1981 and for each second calendar year thereafter. The DISC report will be due 27½ months following the close of each such second year.

International boycotts.—The bill requires the Secretary to submit an international boycott report for every four-year period. The first four-year period will begin with calendar year 1982. The data required would be the data required under current law, for a four-year period rather than a one-year period. The report will be due as soon after the close of each four-year period as the data become available.

Possessions corporations.—The Secretary will be required to submit a report setting forth an analysis of the operation and effect of the possessions corporations provisions for calendar 1981 and for each second calendar year thereafter. The possessions corporations report will be due 24 months following the close of each such second year.

High income taxpayers.—The bill requires the Secretary of the Treasury to publish information annually on the amount of tax paid by individual taxpayers with high total incomes. Total income could be calculated and set forth by adding to adjusted gross income any tax preference items excluded from or deducted in arriving at AGI, and by subtracting any investment expenses incurred in the production of such income to the extent of the investment income. The bill also requires publications of the number of individuals with total income of over $200,000 who owe no Federal income tax and the deductions, exclusions, or credits that they used to avoid tax.

Effective Dates

The new rule for DISC reports and possessions reports applies to reports for calendar years after 1980. The new rule for high income taxpayer reports applies to information published after the date of enactment. The new rule for international boycott reports applies to reports for periods after December 31, 1981.

Revenue Effect

This provision will have a negligible revenue effect.

2. Removal of $1 Million Limitation on Working Capital Fund (sec. 832 of the bill and sec. 322(a) of Title 31)

Present Law

Under present law, the Treasury Department's Working Capital Fund provides for the financing of centralized, Department-wide services such as printing procurement, reproduction, telephone, and teletype functions (31 U.S.C. 322(a)). The fund is limited to a capitalization of $1 million. This limitation was set in 1970 when the Fund was established.

Reasons for Change

The committee believes the ceiling on the Working Capital Fund is unnecessary and should be removed.

Explanation of Provision

Under the bill, the $1 million limit on the Working Capital Fund of the Department of Treasury is removed.

Effective Date

This provision will be effective upon enactment of the bill.

Revenue Effect

This provision will have a negligible revenue effect.

3. Increase in Limitation on Revolving Fund for Redemption of Real Property (sec. 833 of the bill and sec. 7810 of the Code)

Present Law

Under present law, if real property on which the United States has or claims a lien is sold to satisfy a lien prior to that of the United States, the Internal Revenue Service may redeem the property generally within 120 days of the sale date (sec. 7425). This redemption right is exercised, however, only when the Service concludes that the sale price of such real property is significantly below the fair market value and if the sale price does not provide sufficient receipts to cover the government's lien.

All expenses necessary for the redemption by the Service of such real property are chargeable to a revolving fund. The fund is repaid upon a subsequent sale of the property. Under present law, the authorization for this fund may not exceed $1 million. This figure was established in 1966. Because of increases in the numbers of taxpayer delinquencies, escalating real property values, and a greater frequency in foreclosures, the present $1 million authorization for the revolving fund is insufficient to provide for all those cases where redemption of real property sold to satisfy a lien prior to that of the United States would be prudent.

Reason for Change

The committee believes that the monetary interests of the United States would be better protected if additional funds were authorized for the revolving fund for the redemption of property.

Explanation of Provision

The authorization limitation on the real property redemption revolving fund will be increased to $10 million.

Effective Date

The provision will be effective upon enactment of the bill.

Revenue Effect

This provision will not have a direct revenue effect. If pursuant to the increased authorization, additional funds are appropriated for the revolving fund and redemption rights are exercised more frequently, revenues could be increased.

4. Removal of $1 Million Limitation on Authority to Dispose of Obligations (sec. 834 of the bill and sec. 324(b) of Title 31)

Present Law

Under present law, the Secretary of the Treasury has special authority, outside of the context of the Federal Property and Administrative Services Act of 1949, to dispose of obligations acquired by the Secretary for the United States or transferred to the Secretary by an executive agency. The Secretary may also make arrangements to extend the maturity of such obligations. The Secretary is authorized to dispose or extend the maturity of obligations "in the way, in amounts, at prices, and on conditions the Secretary considers advisable and in the public interest."

The provision was enacted in 1945, as part of the Public Debt Act of 1945. It was designed, among other things, to allow for the expeditious disposition of obligations without the market disruption and loss that might be attendant on lengthy disposal procedures, including a three-month advertising requirement then applicable. Since its enactment in 1945, it has contained a limitation of $1,000,000 on the maximum par value of obligations of one issuer that could be held for such disposition. If no-par obligations are involved, the $1,000,000 limitation applies to the stated or book value of such obligations.

Reasons for Change

Because of inflation and changes in the capitalization of entities in which the United States has acquired an interest, the committee believes that the $1 million limitation is no longer appropriate. It has restricted the ability of the Secretary to obtain the best value for the United States in disposition transactions.

Explanation of Provision

The bill repeals the $1,000,000 limitation of the Secretary's special authority to dispose of obligations.

Effective Date

The provision will be effective on date of enactment.

Revenue Effect

The provision will have a negligible revenue effect.

5. Secretary of Treasury Authorized to Accept Gifts and Bequests (sec. 835 of the bill and sec. 322(a) of Title 31)

Present Law

At present, the Treasury Department has authority to accept voluntary services in connection with the sale of public debt obligations (31 U.S.C. 21). Also, the Department has joint authority with the General Services Administration to accept gifts for the purpose of reducing the national debt (31 U.S.C. 3113) and for defense purposes (50 U.S.C. 1151). However, the Secretary of the Treasury does not have general authority to accept gifts and bequests on a department-wide basis to carry out departmental functions. The Comptroller General has ruled that agencies may not accept gifts and bequests for assisting them in carrying out governmental functions in the absence of specific authorization (36 Comp. Gen. 268). At present, there are numerous statutes authorizing various agencies to accept gifts in connection with their operations, *e.g.*, the Department of Commerce (15 U.S.C. 1522), the Department of Transportation (49 U.S.C. 1657(m)), and the Department of Housing and Urban Development (42 U.S.C. 3535(k)). In addition, department-wide gift authority is possessed by the Departments of Agriculture and State and numerous other agencies for the conduct of agency activities.

Reasons for Change

The committee believes that the Treasury Department should be authorized to accept departmental gifts in the same way as other departments are authorized.

Explanation of Provision

The bill authorizes the Secretary of the Treasury to accept gifts and bequests of property for the purpose of aiding or facilitating the work of the Department of Treasury. Gifts and bequests of money and the proceeds from sales of other property so received will be deposited in a separate fund of the Treasury to be disbursed upon the Secretary's order.

The Secretary annually must publicly disclose the source of the gifts and bequests and the purposes for which any expenditures are made.

Effective Date

The provision will be effective upon enactment.

Revenue Effect

The provision will have a negligible revenue effect.

6. Extension of Time for Court Review of Jeopardy Assessment Where Prompt Service Not Made on United States (sec. 836 of the bill and sec. 7429 of the Code)

Present Law

Generally, the Internal Revenue Service may not assess any income tax without sending a written notice of deficiency allowing the taxpayer 90 days in which to petition the Tax Court for review of the Service's determination.

No assessment may be made until after the 90-day period has expired or, if a petition is filed, until after a decision of the Tax Court is final.

These deficiency procedures need not be followed, however, when the I.R.S. reasonably believes that collection of an alleged deficiency would be jeopardized by delay. In such a case, the Service may immediately assess and collect the tax (secs. 6851 and 6861).

In jeopardy assessment cases, the taxpayer is entitled to an expedited review by the Secretary, through the district director, of whether the determination of jeopardy was reasonable under the circumstances and whether the amount assessed and demanded was appropriate under the circumstances (sec. 7429). After review by the district director, the taxpayer is also entitled to review by the appropriate United States District Court. Under present law, the District Court must decide whether the determination of jeopardy was reasonable under the circumstances and whether amount of the assessment was appropriate under the circumstances. This decision must be made within 20 days after an action by a taxpayer for review of the Secretary's determination is commenced. This action is a suit against the United States and, therefore, requires that the United States be given notice. However, neither the applicable statute (sec. 7429) nor the Federal Rules of Civil Procedure require service of notice of the action to be served on the United States within the 20-day period.

Reasons for Change

The committee wishes to assure adequate time for the United States to respond before a decision must be entered in any suit brought by a taxpayer for a review of a jeopardy action.

Explanation of Provision

Under the bill, if the District Court determines that proper service was not made on the United States within 5 days of the date on which the action is commenced, the 20-day period for action by the District Court will not begin to run until the day proper service was made on the United States.

Effective Date

This provision will apply to actions commenced after the date of enactment.

Revenue Effect

The provision will have a negligible revenue effect.

7. Extension of Period to Assess Unpaid Taxes (sec. 837 of the bill and sec. 6501 of the Code)

Present Law

Present law generally limits the period for assessing taxes to three years beginning with the date the return is filed or the due date of the return, whichever is later. This general rule is modified for fraudulent returns, returns involving a substantial omission of income and in several other appropriate circumstances. There is no provision, however, which permits extending the period for assessment solely for purposes of processing an amendment to an original return and assessing additional taxes due.

Reason for Change

Under present law it is very difficult for the Internal Revenue Service to assess additional tax reported on amended returns filed on, or just prior to, the expiration of the period for assessment of taxes on the original return. The committee's bill therefore extends the time for assessment of amounts shown on certain amended returns.

Explanation of Provision

Section 6501 is amended to provide that if a taxpayer amends an original return to show an increase in tax liability within 60 days of the expiration of the period for assessment of tax, the period for assessment will be extended solely to allow the IRS 60 days from the date the amendment received to process the amendment and assess the additional tax shown thereon. This change will assure that additional tax due as reported by a taxpayer on an amended return may be assessed and collected.

Effective Date

The provision is effective for amended returns received after date of enactment of the bill.

Revenue Effect

This provision will have a negligible effect on budget receipts.

8. Financial Accounting for the Investment Tax Credit (sec. 838 of the bill and sec. 101(c)(1)(C) of the Revenue Act of 1971)

Present Law

Prior to 1971, the Accounting Principles Board (APB) and the SEC permitted the use of either the "direct flow-through" method of accounting for the investment tax credit (which provides that the full amount of the credit reduces tax expense in the year earned) or the "deferral" method (which provides that the credit reduces tax expense ratably over the life of the asset involved). Because the flow-through method immediately increases earnings, most companies adopted it. However, in the view of some, the deferral method is the more theoretically correct method because it treats the credit in accordance with its true economic effect, i.e., as a subsidy that reduces the cost of the asset acquired.

In 1971, the APB tentatively concluded that permitting a choice of methods was inappropriate and issued a discussion draft statement suggesting that only the deferral method would be accepted. In connection with the restoration of the credit in the Revenue Act of 1971, Congress enacted a provision (section 101(c)(1)(A) of the Revenue Act of 1971) that limits the ability of any Federal agency to compel with respect to any taxpayer a particular method of accounting for the credit. Section 101(c)(1)(C) of that Act requires a taxpayer to use the same method of accounting for the credit in all reports subject to the jurisdiction of any Federal agency unless the Treasury Department approves a change to another method. Subsequently, the APB revoked its discussion draft.

Reasons for Change

The committee notes that the Revenue Act of 1971 provides no standards for the Treasury to use in acting upon requests to change a method of financial accounting for the credit. It also notes that no penalties are provided for failing to obtain Treasury approval. The committee does not desire that the Treasury consume further manpower in acting upon requests under such circumstances. Nor is the committee prepared to provide standards or propose penalties.

Explanation of Provision

The bill repeals section 101(c)(1)(C) of the Revenue Act of 1971.

Effective Date

The provision is effective as of the effective date of section 101(c)(1)(C) of the Revenue Act of 1971.

Revenue Effect

The provision will have no effect on revenues.

9. Report on Regulated Futures Contract Litigation (sec. 839 of the bill)

The bill requires the Treasury Department to report to the Finance Committee and the Ways and Means Committee by October 1, 1984, on progress in reducing the backlog of cases involving the treatment of futures contracts governed by the provisions of tax law applicable before the 1981 straddles legislation.

10. Lien on Assets of Financial Institutions for Unpaid Drafts (sec. 840 of the bill and sec. 6311(b) of the Code)

Present Law

Under present law (sec. 6311(b)(2)), if a certified, treasurer's or cashier's check received in payment of taxes is not duly paid, the United States has a lien upon all assets of the bank or trust company on which drawn. This rule also provides a lien against the assets of the issuer of a money order. The lien is a preferred claim and consequently permits the Service to treat such payments as the equivalent of cash for the purposes of releasing a Federal tax lien encumbering a taxpayer's property. The taxpayer retains ultimate liability if the IRS is unable to collect from the bank or trust company.

Reasons for Change

There have been many changes in the activities of financial institutions during the past few years. Mutual savings banks, credit unions and savings and loan associations generally provide checking account services that were not anticipated when the provisions of present law were enacted. In addition, these institutions may certify checks and issue instruments that are viewed by the general public as equivalent to the traditional cashier's check issued by a commercial bank, and should be so treated for purposes of collecting from the issuers.

Explanation of Provision

The bill extends the provision of section 6311(b)(2) to include guaranteed drafts of financial institutions other than banks and trust companies. It is expected that the regulations issued under this provision would define "financial institution" to include domestic building and loan associations, mutual savings banks, and credit unions.

Effective Date

This provision will be effective upon date of enactment.

Revenue Effect

This provision will have a negligible revenue effect.

11. Disclosure of Windfall Profit Tax to State Tax Agencies (sec. 841 of the bill and sec. 6103(d) of the Code)

Present Law

Present law (sec. 6103(d)(1)) authorizes the disclosure of returns and return information with respect to taxes imposed by chapters 1, 2, 6, 11, 12, 21, 23, 24, 31, 32, 44, 51, and 52 and subchapter D of chapter 36 to the State tax agencies which are principally charged with the primary responsibility for the administration of State tax laws. Present law does not authorize the Service to disclose windfall profit tax (chapter 45) information to State tax agencies.

Reasons for Change

The provision will provide States with a means of comparing and verifying information reported with State severance tax laws, by oil producers and purchasers, in compliance with information provided by the producers and purchasers to the Internal Revenue Service with respect to the windfall profit tax.

Explanation of Provision

The bill adds the windfall profit tax to the list of tax returns and return information which the Internal Revenue Service may disclose to State tax agencies for purposes of administering State tax laws.

Effective Date

This provision will be effective on date of enactment.

Revenue Effect

This provision will have no revenue effect.

12. Statute of Limitations Relating to Contributions to the Capital of a Corporation (sec. 842 of the bill and sec. 6501 of the Code)

Present Law

Under section 118, gross income does not include any contribution to the capital of a regulated public utility if the contribution is in aid of construction, is not included in the taxpayer's rate base, and, in the case of a contribution that is not an in-kind contribution, is expended before the end of the second taxable year (the expenditure year) after the year in which it was received. If the contribution is not expended by the end of the expenditure year, it is includible in gross income for the year of receipt. Under section 6501, the statute of limitations within which the IRS must assess any deficiency is 3 years from the filing of the return (absent fraud or intent to evade tax).

Reasons for Change

The proper tax treatment of a contribution of capital to a regulated public utility cannot be verified until the close of the expenditure year. By the time the Internal Revenue Service examines the return of tax for the expenditure year, the statute of limitations generally may have expired for the year of receipt. Consequently, if the taxpayer did not include in gross income in the year of receipt an amount that the taxpayer anticipated expending but that was not, in fact, expended by the close of the expenditure year, the IRS may not be able to assess and collect the deficiency because the statute of limitations for the year of receipt may have expired.

Explanation of Provision

The bill provides that the statute of limitations with respect to amounts received in aid of construction for the receipt year will not expire with respect to the receipt year (but only as to the issue of inclusion of the amount as income and any resulting adjustments in other items) until three years after failure to meet the expenditure rule of section 118(b)(2).

Effective Date

This provision will be effective for failures to meet the expenditure rule of section 118(b)(2) occurring after December 31, 1984.

F. Provisions Relating to Distilled Spirits

1. Repeal of Occupational Tax on Manufacturers of Stills and Condensers (sec. 843 of the bill and secs. 5101, 5105, and 5179 of the Code)

Present Law

Present law imposes an occupational tax of $55 per year on manufacturers of stills (sec. 5101). In addition, a tax of $22 is imposed on each still (or condenser to be used in distilling) manufactured. An exemption from these taxes is provided for stills manufactured by a proprietor of a distilled spirits plant exclusively for use in the proprietor's plant.

A manufacturer of stills is required to notify the Treasury Department, in writing, of the removal of a still, boiler, or other distilling vessel from the place of manufacture and the person and place to which it is being delivered (sec. 5105). The still (or other distilling apparatus) may be set up only upon receipt of a written permit from the Treasury. Further, every person having possession or control over a still is required to register with the Treasury immediately after setting up the still (sec. 5179). The registration must set forth the name and address of the owner and the location, capacity and purpose of the still.

Reasons for Change

The costs of administering the taxes on still manufacturers substantially outweigh the revenues derived from these taxes (less than $10,000 per year). The bill therefore repeals these taxes.

The committee has considered the notice requirement for removal of stills and other distilling apparatus and believes that this requirement serves a valid administrative purpose relating to the collection of alcohol taxes generally. However, in recognition of the costs to both the Treasury and private businesses of administering these provisions, the committee believes that the Treasury should be entitled to apply this requirement at its own discretion. Accordingly, the bill replaces the existing statutory notice requirement with a provision allowing the Treasury to require notice pursuant to regulations.

The committee understands that, because the excise tax liability for distilled spirits attaches upon production, the Treasury must be aware of the location of stills and other distilling apparatus in order to properly administer these taxes. The committee has therefore retained the mandatory requirement of registration immediately after setting up a still.

Explanation of Provisions

The bill repeals both the $55 per year occupational tax on manufacturers of stills and the additional $22 tax for each still.

The bill repeals the mandatory requirement of notice of manufacture and removal of a still and the requirement of permission prior to set up of a still. In their place, the bill provides that the Treasury Department may, pursuant to regulations, require manufacturers of stills, boilers, or other distilling vessels to give notice before removal of the facility. This notice (if required) would set forth the capacity of the facility, the time of removal, and the person by whom the facility is to be used. However, the bill retains the requirement of registration by the still user after setting up the facility.

Effective Date

The provision is effective on the first day of the first month beginning more than 90 days after the date of enactment.

Revenue Effect

This provision will have a negligible revenue effect.

2. Drawback of Taxes on Spirits Used for Food or Medicinal Purposes (sec. 844 of the bill and sec. 5134 of the Code)

Present Law

Present law imposes an excise tax of $10.50 per proof gallon of distilled spirits (sec. 5001). The law provides for the return (drawback) of the major portion of taxes on distilled spirits used in the manufacture of food products, flavorings, or medicines which are unfit for beverage purposes (sec. 5134). A drawback is claimed by submission of a properly executed claim by a qualifying user of the spirits.

Taxpayers claiming a drawback of distilled spirits taxes are required to keep the necessary books and records to establish that the spirits were used for food, medicinal or other nonbeverage pursposes (sec. 5132). Treasury regulations require that supporting data be maintained by the manufacturer, including quantitative formulae which must be filed prior to or at the time of manufacture (27 CFR Part 197.95). Failure to comply with these requirements results in a denial of the claim. For example, any deviation from a previously filed formula may result in denial of a substantial drawback claim.

Reasons for Change

The committee believes that failure to comply with various technical aspects of the drawback provisions should not result in denial of the taxpayer's claim. Accordingly, the bill provides that a penalty be imposed for such violations, in lieu of denying the claim. This is consistent with the treatment of other nonfraudulent regulatory violations under the Internal Revenue Code.

Explanation of Provision

The bill provides that the Treasury Department shall not deny a drawback claim because of failure to comply with laws or regulations, it if is established to the Treasury's satisfaction that the distilled spirits have been used for food, medicinal or other nonbeverage purposes. In lieu of denial, the claimant will be liable for a $1,000 penalty for each failure to comply with the applicable laws or regulations, including recordkeeping requirements, (unless it is shown that the failure was due to reasonable cause). The aggregate amount of the penalties may not exceed the amount of the taxpayer's claim.

The committee intends that, if nonbeverage products deviate from previously filed formulae, the determination of a failure to comply with the regulations would be made with respect to each separate product reflected in a drawback claim. For example, if a manufacturer of two distinct flavors or extracts were to submit a drawback claim, and some portion of each flavor deviated from the previously filed formula, the claimant would be liable for a penalty of $2,000 for formula noncompliance (unless the failure to comply was due to reasonable cause).

Effective Date

The provision is effective on the first day of the first calendar month beginning more than 90 days after the date of enactment.

Revenue Effect

This provision will reduce revenues by less than $1 million annually.

3. Disclosure of Alcohol Fuel Producers to Administrators of State Alcohol Fuels Laws (sec. 845 of the bill and sec. 6103 of the Code)

Present Law

Present law (sec. 6103) prohibits the Treasury Department from disclosing individual tax return information (including the indentity of taxpayers), without the taxpayer's consent, except under certain specified circumstances. In general, disclosure is permitted where necessary for the enforcement or administration of the tax laws (including tax legislation), in connection with criminal investigations, and in certain cases including an overriding public policy interest (e.g., disclosure to state child support enforcement agencies). Disclosure may also be made to other Federal agencies for certain specified purposes.

Under present law (sec. 6103(d)), tax return information may be disclosed to State agencies charged with responsibility for adminstration of State tax laws. Such disclosure may be only to the extent necessary for the administration of State tax laws.

The names and addresses of distillers who produce alcohol for fuel use qualify as tax return information under present law. Acccordingly, this information may be disclosed only under the circumstances specified by the Code (e.g., to State tax agencies).

Reasons for Change

The committee believes that disclosure of the identity of alcohol fuel producers will be useful to State governments in monitoring the production of alcohol fuels. Such disclosure is consistent with the general Federal policy of encouraging the development and use of these fuels. However, the committee believes that this disclosure should be subject to reasonable safeguards to preserve the confidentiality of the information.

Explanation of Provision

The bill allows the Treasury Department to disclose the names, addresses, and business locations of persons producing alcohol for fuel use to State agencies (or their legal representatives) charged with responsibility for the administration of State alcohol or fuel laws. The information is to be disclosed solely for use in the administration of State alcohol laws.

The disclosure allowed by the bill is subject to the safeguards established by present law (sec. 6103(p)(4)) for disclosure to other Federal and State agencies. These safeguards are designed to preserve the confidentiality of information once it has been provided to another agency.

Effective Date

The provision is effective on the first day of the first calendar month beginning more than 90 days after the date of enactment.

Revenue Effect

The provision will have no revenue effect.

4. Elimination of Government-supplied Strip Stamps for Distilled pirits Containers (sec. 846 of the bill and secs. 5205, 5604, and new sec. 5301(d) of the Code)

Present Law

Present law (sec. 5205) requires distilled spirits containers transported or sold in the United States to bear a stamp indicating tax determination and compliance with the Federal excise tax on distilled spirits. Strip stamps which satisfy this requirement are printed by the Bureau of Engraving and Printing at an estimated cost of $1.7 million per year and are distributed to importers and bottlers free of charge. Although regulations first effective in 1980 authorize the use of alternate methods of indicating payment of tax, most distillers have continued to use the Government-supplied strip stamps on distilled spirits containers.

Government-supplied strip stamps must generally be broken in order to open a distilled spirits container. Thus, the stamps act as closure devices for the containers.

For many years, strip stamps were numbered and generally controlled by employees of the Treasury Department's Bureau of Alcohol, Tobacco, and Firearms. The stamps were applied after these employees had determined the appropriate tax and had been satisfied that the spirits had been bottled in conformance with Federal laws. However, the Distilled Spirits Tax Revision Act of 1979 (P.L. 96-39) significantly modified the determination of tax on distilled spirits. The new method of determining tax when spirits are withdrawn from bond eliminated the need for Federal employees to be present at distilled spirits plants to regulate operations and to determine the tax before bottling. Consequently, strip stamps are now provided to distillers and, in most cases, are placed on distilled spirits containers before the tax has been determined.

Reasons for Change

The committee understands that, pursuant to the Distilled Spirits Tax Revision Act of 1979, the Treasury Department has eliminated regular on-site supervision of distilled spirits plants and concentrating its effort on an audit-based approach to tax compliance. The committee further understands that, because strip stamps are now generally placed on distilled spirits containers before the tax is determined, the stamps no longer provide evidence of payment of the tax. For these reasons, and because of the costs of supplying the stamps, the bill provides that government-supplied strip stamps will be eliminated. However, to prevent tampering with the contents of distilled spirits containers, the bill requires that alternate closure devices be used.

Explanation of Provision

The bill repeals the strip stamp requirement for distilled spirits containers (sec. 5205) and associated penalty provisions (sec. 5604). However, the bill requires that distilled spirits containers, on determination of tax, bear a closure or other device which is designed to require breaking in order to gain access to the contents of the container (new sec. 5301(d)). The provision applies to domestically produced, imported distilled spirits, and distilled spirits coming into the United States from Puerto Rico and the Virgin Islands. Closure devices are not required for containers having a capacity in excess of one wine gallon.

The committee intends that government-supplied strip stamps may be affixed to containers of distilled spirits only until July 1, 1985. However, in cases where strip stamps are affixed to containers of distilled spirits before that date, the containers may be imported or brought into the United States, released from Customs custody, or withdrawn from internal revenue bond with the stamps affixed. In such cases, the committee intends that the Federal strip stamp on such containers be considered to meet the bill's requirement for an antitampering device on distilled spirits containers.

Effective Date

These provisions are effective on July 1, 1985.

Revenue Effect

The provision will have no effect on budget receipts. However, the elimination of strip stamps will save the Federal Government an estimated $1.7 million per year in printing costs.

5. Modification of Payment Date and Requirement of Electronic Funds Transfer for Alcohol and Tobacco Excise Taxes (sec. 847 of the bill and secs. 5061 and 5703 of the Code)

Present Law

Present law requires payment of the Federal excise taxes on alcohol and tobacco products upon removal of the products from bonded premises (including customs custody). If a bond is posted with the Treasury, payment of tax may be deferred until the due date of the applicable tax return.

Returns of alcohol and tobacco excise taxes are required to be made on a semimonthly basis. The returns are due a specified number of days after the conclusion of the relevant semimonthly period (30 days for domestically produced distilled spirits, 15 days for beer and wine, and 25 days for most tobacco products).

Importers of alcohol and tobacco products are required to pay the excise taxes on those products no later than 15 days after their removal from customs custody.

Regulations proposed by the Treasury Department in January 1981 would have required payment of alcohol and tobacco taxes by electronic transfer in the case of taxpayers who paid $5 million or more in those taxes in the previous fiscal year. These regulations have never become effective because of restrictions included in the continuing appropriations Acts for the Treasury Department.

Reasons for Change

The committee believes that a uniform payment date should be established for payment of the excise taxes on alcohol and tobacco products. The committee further determined that the present extended periods available in the case of domestically produced distilled spirits and tobacco products are not appropriate in light of present budgetary constraints.

Electronic transfer of funds is an established practice in many segments of the economy and has proven to be an accurate and effective method of transferring large sums of money. The committee believes that requiring electronic transfers of excise tax payments for alcohol and tobacco products is more efficient than the present system where taxpayers attach a check to a return which is then mailed to the Treasury Department. However, to prevent any undue burden on taxpayers liable for small amounts of tax, the committee decided to require payment by electronic funds transfers only by taxpayers who paid $5 million or more in the applicable tax during the preceding calendar year.

Explanation of Provisions

Due date for payments of tax

The bill retains the present-law requirement that alcohol and tobacco excise taxes be paid with respect to semimonthly periods and the rule that returns (where required) be filed with respect to semimonthly periods, or such other periods as the Treasury Department prescribes. However, the bill changes the due date for payment of these taxes. Under the bill, payment of the excise taxes on all distilled spirits, wine, beer, and tobacco products must be made not later than 14 days after the close of the semimonthly period during which the products subject to tax are removed from bonded premises (including customs custody). This new uniform rule applies both to domestic producers and manufacturers (including Puerto Rican and Virgin Islands manufacturers and producers) and to importers. Additionally, under the bill, if the regular due date for payment of tax (i.e., the 14th day after close of a semimonthly payment period) is a Saturday, Sunday, or legal holiday, payment of tax and filing of any return is required on the last regular business day preceding the otherwise established due date.

Method of payment for certain persons

The bill further requires persons who were liable for $5 million or more in any alcohol or tobacco excise tax during the preceding calendar year to pay that tax by electronic funds transfer to the Treasury account at a Federal Reserve Bank on each semimonthly due date during the succeeding calendar year. This requirement applies regardless of the amount of such excise tax for which the person is liable during the succeeding year. The committee intends that the Treasury Department may identify a specific Federal Reserve Bank and any specific method of electronic funds transfer by use of which this requirement is to be satisfied.

Like the new due date for payments of tax, discussed above, the requirement of payment by electronic funds transfer applies both to domestic producers and manufacturers (including Puerto Rican and Virgin Islands producers and manufacturers) and to importers of taxable alcohol and tobacco products.

The determination of whether a person owed $5 million or more in alcohol or tobacco tax in any calendar year is to be made by reference to the person's gross tax liability (without regard to any drawbacks or refunds). The term person includes all members of a controlled group of corporations (sec. 1563); likewise all plants at which a person carries on business are to be aggregated. Additionally, this determination is to be made treating all types of distilled spirits as one product. Likewise, all types of beer will be treated as one product, and all types of wines will be treated as one product. In the case of tobacco, the determination is to be made by reference to all types of taxable tobacco products (e.g., a person liable for tax with respect to cigarettes, cigarette papers, and cigars would be treated as liable for tax with respect to one product).

Effective Dates

The provision changing the due date for payments of excise tax applies generally to semimonthly periods ending on or after June 30, 1984. The provision requiring certain persons to pay alcohol and tobacco excise taxes by electronic funds transfers applies to such taxes required to be paid after June 30, 1984.

Because the present extended due dates for payment of excise taxes on tobacco products and domestically produced distilled spirits could result in some payments with respect to removals during the two semimonthly periods of June 1984 occurring out of sequence and/or within three consecutive days, the bill includes a special transitional rule for these semimonthly periods. Under this transitional rule, payment of taxes with respect to removals of tobacco products and domestically produced distilled spirits during the semimonthly periods ending on June 15, 1984 and June 30, 1984, will be due not later than July 16, 1984. In the case of persons otherwise subject to the bill's electronic funds transfer requirement, taxes with respect to both of these semimonthly periods must be paid by such transfer.

Revenue Effect

These provisions of the bill will result in an increase in fiscal year budget receipts of $683 million in 1984 and $8 million in 1985, a decrease of $159 million in 1986, and an increase of $7 million annually in 1987, 1988, and 1989.

6. Removal of Distilled Spirits for Use in Production of Certain Nonbeverage Wine Without Payment of Tax (sec. 848 of the bill and sec. 5214 of the Code)

Present Law

An excise tax equal to $10.50 per proof gallon is imposed on distilled spirits produced in or imported into the United States (sec. 5001). This tax is determined upon removal of the distilled spirits from the distilled spirits plant or customs custody (sec. 5006). In certain cases, distilled spirits may be removed without payment of tax (sec. 5214). Present law does not permit removal without payment of tax of distilled spirits other than wine spirits or brandy for use in wine production. Therefore, distilled spirits (other than wine spirits) used in a nonbeverage wine product must be removed taxpaid and a claim for refund made.

Reasons for Change

The committee determined that producers of nonbeverage wine products such as cooking wine should be permitted to use any type of distilled spirits in the production of those products without the necessity of paying tax on removal of the spirits and then claiming a refund. This treatment will enable U.S. producers of nonbeverage wine products to compete more effectively with producers of similar imported goods.

Explanation of Provision

The bill expands the circumstances under which distilled spirits may be removed from a distilled spirits plant without payment of tax to permit such a removal of any type of distilled spirits for use in producing nonbeverage wine products (e.g., cooking wine). This provision would not permit the use of wine products thereby produced in any beverage product.

Effective Date

This provision is effective on the date of the bill's enactment.

Revenue Effect

This provision is estimated to reduce fiscal year budget receipts by less than $1 million annually.

G. Simplification and Extension of Income Tax Credits

1. Simplification of Income Tax Credits (secs. 850-854 of the bill and new secs. 21-53 of the Code)

Present Law

Present law provides a series of nonrefundable income tax credits which are allowable to reduce a taxpayer's tax liability. The credits have been added to the Internal Revenue Code over the years on an ad hoc basis, and presently the various credits are allowable against tax in the chronological order they were added to the Code. This results in several effects which probably were not intended. For example, certain credits for which no carryover is provided may become unusable while a lower-numbered credit for which a carryover is provided is used up. If the order had been reversed, a different result would have occurred.

Differences exist in the manner the various business credits may be used to reduce tax liability. First, credit carryovers are usable in different chronological orders—the investment credits are used on an earliest year first (FIFO) basis, and the other credits are used on a current year first basis. Next, the tax liability limitations for the different business credits differ. The investment tax credit (other than the energy tax credit) may be used to reduce 100 percent of the first $25,000 of tax and 85 percent of the tax in excess of $25,000. The targeted jobs credit may be used against 90 percent of tax liability; the ESOP credit may reduce 100 percent of the first $25,000 of tax liability and 90 percent of the tax in excess of $25,000. The remaining business credits, including the energy tax credit, may reduce 100 percent of tax liability. In each case, tax liability means the income tax imposed reduced by lower numbered credits. Finally, the investment credit, targeted jobs credit, research activities credit, and ESOP credit have a 3-year carryback period whereas the alcohol fuels credit has no carryback period; these credits have a 15-year carryforward period.

Reasons for Change

The committee believes that the present income tax credit mechanism is complex and, at times, not rationally structured. The committee believes that the computations of these credits should be rationalized and simplified. This can be accomplished by allowing the personal income tax credits to be placed first in order, and by combining the business credits into one credit with uniform carryover and tax liability limitations. The committee also believes taxpayers should generally not be able to eliminate their entire tax liability by use of the credits which provide business incentives. However, the committee believes that the research credit is of such importance that it should not be restructured at this time.

The committee recognizes that the foreign tax credit is different in purpose and concept from the personal credits and the incentive credits, and should not be included in such a uniform credit.

Explanation of Provision

Under the bill, the personal income tax credits—the dependent care credit, credit for elderly and disabled, residential energy credit and political contribution credit—will be allowable against tax before all other credits. Next the foreign tax credit, credit for clinical testing of certain drugs, and fuel production credit will be allowable against tax under the conditions of present law.

The business income tax credits—the investment tax credit (both the regular and the energy credits), targeted jobs credit, alcohol fuels credit, and ESOP credit—will be combined into one general business credit. This credit will be allowable against 100 percent of the first $25,000 of tax liability and 85 percent of the remaining tax liability. Tax liability generally means the income tax imposed reduced by other nonrefundable credits. The credit will be used on a FIFO basis with a 3-year carryback and 15-year carryforward period. The research activities credit will continue to be allowed against 100 percent of a taxpayer's tax liability.

Effective Date

The provision will be effective for taxable years beginning after 1983. Credits earned in pre-1984 years will continue to be carried to post-1983 years under the substantive rules (apart from the tax liability limitations) under which they were earned. Likewise, credits earned in post-1983 year may be carried back to pre-1984 years, subject to the new tax liability limitation rules imposed by the bill. Thus, for example, where a taxpayer made an investment entitling it to claim the employee plan percentage, the taxpayer may continue to make an election to claim that percentage as a carry forward from the earlier year under the rules in effect for the year the investment was made.

Revenue Effect

The provision will increase revenues by $100 million in fiscal 1984, $186 million in fiscal 1985, $195 million in fiscal 1986, $213 million in fiscal 1987, by $126 million in fiscal 1988 and by $30 million in fiscal 1989.

2. Energy Tax Credits (sec. 855 of the bill and secs. 44C,[1] 46, and 48 of the Code)

Present Law

Residential energy credits

Individuals are allowed a 15-percent credit on the first $2,000 of qualifying expenditures, up to a maximum credit of $300, for installations made through 1985 of eligible insulation and other energy conservation items. Each conservation item must be capable of reducing heat loss or gain, increasing the efficiency of the heating system, or reducing fuel consumption.

Individuals are allowed a 40-percent credit on expenditures up to $10,000, for a maximum credit of $4,000, for renewable energy source property (i.e., solar, wind, and geothermal energy property). The credit for individuals for renewable energy sources applies to expenditures made through 1985.

Installations of qualified renewable energy property must be made in or on a taxpayer's principal residence. The conservation credit is available only for expenditure with respect to equipment installed in or on a principal residence in existence or substantially completed on April 19, 1977. There is a credit carryover provision that allows unused credits for both energy conservation property and renewable energy source equipment to be carried over to subsequent taxable years but not to any taxable year beginning after 1987.

As defined in the regulations, renewable energy source property includes equipment (and parts solely related to the functioning of such equipment) necessary to transmit or use energy from a geothermal deposit. A geothermal deposit is defined as a geothermal reservoir consisting of natural heat, which is from an underground source and is stored in rocks or in an aqueous liquid or vapor, having a temperature exceeding 50 degrees Celsius, which is 122 degrees Fahrenheit. The regulations also provide that equipment which serves both a geothermal function and a nongeothermal function does not qualify as geothermal energy property. However, the existence of a backup system designed for use only in the event of failure of the geothermal energy system would not be disqualifying.

Business energy credits

General rules.—Prior to 1983, the Code provided a general 10-percent investment credit for certain energy property in addition to the regular investment credit. Property eligible for the general 10-percent energy credit included alternative energy property, special-

[1] Section 866 of the bill will redesignate section 44C of the Code as section 23.

ly defined energy property, recycling equipment, shale oil equipment, equipment for producing natural gas from geopressured brine, and cogeneration equipment. The general energy credit for most of these types of property terminated after 1982, except that the credit will be allowed through 1990 for long-term projects for which certain affirmative commitments (described below) were made.

As an exception to the general 1982 expiration date for the business energy investment credits, a 15-percent energy credit is allowed through 1985 for solar, wind, geothermal, and ocean thermal property. (The rate was increased from 10 to 15 percent starting in 1980.) Qualified intercity buses and biomass property are eligible for a 10-percent energy credit through 1985. No affirmative commitment rule applies to the credits for these properties.

Affirmative commitment rules.—The 10-percent energy tax credit remains available after 1982 for credits that expired in 1982, if specified affirmative commitments requirements are satisfied with respect to qualified property that is part of a project with a normal construction period of two years or more. The credit is allowed through December 31, 1990, for property that is constructed or acquired after 1982 if (1) all engineering studies on the project were completed, and applications for all environmental and construction permits required to commence construction were filed, before 1983, (2) before 1986, binding contracts are entered into to construct or acquire equipment that is specially designed for the project and which represents at least 50 percent of the aggregate cost of all such equipment, and (3) the project is completed before January 1, 1991.

Biomass property.—In general, biomass property is defined as a boiler or burner that uses an alternate substance and as equipment for converting an alternate substance into a qualified fuel. An alternate substance with respect to biomass property means any property other than oil or natural gas, or any product of oil or natural gas, except that an alternate substance does not include any inorganic substance and does not include coal (including lignite) or any product of such coal. Qualified fuel is defined as any synthetic solid fuel, and alcohol for fuel purposes, if the primary source of energy for the facility producing the alcohol is not oil or natural gas (or a product of oil or natural gas).

Geothermal energy property.—The term "geothermal deposit" has the same meaning for the business energy investment tax credit as that provided in the Treasury regulations for the residential energy credit.

Reasons for Change

When the present energy tax credits were enacted in 1978 and expanded in 1980, Congress saw them as temporary incentives to encourage the private sector to conserve energy and to develop alternative energy sources. The committee has reviewed the experience with these credits and concluded that some should be extended and others terminated prior to their original expiration date.

The committee decided that highest priority should be given to incentives for renewable energy sources and synthetic fuels. The development of these industries has been retarded by the decline in the price of oil in recent years, and tax incentives are still needed if these industries are to become viable.

In the case of the residential energy conservation credit, the committee decided that a tax incentive was no longer necessary. The American people are much more aware today than in 1978 of the benefits of residential energy conservation expenditures, and have made substantial investments in conservation since 1978. The committee believes that the additional conservation stimulated by a continuation of the credit would not be significant in comparison with its revenue cost and the complexity added to the tax law.

Explanation of Provisions

a. Residential energy credits

Renewable energy credits.—The bill extends the tax credits for residential renewable energy source property as they are in present law for an additional two years. As a result, this credit will be available for qualified expenditures made before January 1, 1988. Credits earned before the expiration date but unused at that time may be carried over for two additional years, i.e., through December 31, 1989.

The temperature requirement for a qualified geothermal deposit is lowered to 40 degrees Celsius (or 104 degrees Fahrenheit). A geothermal reservoir will qualify so long as the highest temperature of the liquid or vapor from a single reservoir is 40 or more degrees Celsius. The temperature may be measured at the wellhead of at the intake to the distribution system, in the case of a natural hot spring where no well is drilled.

Insulation and energy conservation credits.—The bill terminates the residential energy tax credits for insulation and other energy conservation equipment as of the date of enactment. As is allowed under present law, unused credits may be carried forward through taxable years beginning before January 1, 1988.

b. Business energy credits

In general, the energy tax credits for certain renewable energy property and synthetic fuels property will continue to be available for three years past the termination dates in present law. An extension also is made for certain property under the affirmative commitment rules.

Renewable energy property.—The bill continues the 15-percent business energy credits for solar, wind, and geothermal energy property and for ocean thermal property at their present law rate for an additional three years, through December 31, 1988. The 10-percent energy credit for biomass property is extended for an additional three years, through December 31, 1988. Qualifying biomass property, under the credit extension, also includes methane-containing gas for fuel or electricity, produced by anaerobic digestion from nonfossil waste materials at farms or other agricultural facilities, and at facilities for the first processing of agricultural products. The extension of the credit will not apply, however, to biomass property used in a trade or business included in the forest or paper products industries.

The qualifying water or steam temperature for geothermal deposit is reduced from 50 degrees to 40 degrees Celsius. In addition, fluid temperatures from some outlets from a geothermal reservoir may be less than 40 degrees Celsius (104 degrees Fahrenheit), if the highest fluid temperature from any outlet is 40 or more degrees Celsius. This definition is identical to the definition of a qualifying geothermal deposit for the residential renewable energy credit.

The bill also modifies the rules regarding eligibility for the alternative energy credit when qualified property is used at least 50 percent of the time with nonqualifying property. Under these rules, dual purpose property that serves both alternative energy property and nonqualified property will be eligible for the energy credit, if at least 50 percent of the energy used comes from qualified property. For example, 75 percent of the cost of a pipe that distributes hot water from a hot water heater, as well as hot geothermal water, would be eligible for the credit if 75 percent of the water distributed through the pipe is geothermal water. If less than 50 percent of the energy used comes from a geothermal source, the qualified investment in the property will be eligible for a partial energy credit that is equal to the percentage of geothermal source energy to the total energy used.

Oil shale hydrogenation property.—The bill extends the 10-percent energy tax credit to oil shale hydrogenation equipment and to tar sands equipment. Both extensions of the credit will make it allowable through December 31, 1988. The amendment making shale oil hydrogenation equipment eligible for the credit is the same as that which applied in 1981 and 1982 under the Miscellaneous Revenue Act of 1982.

Tar sands property.—Qualified tar sands equipment, which becomes eligible for the alternative energy property credit under the bill, includes equipment used to mine or quarry tar sands or to extract oil from sands (including by hydrogenation and similar processes applied in the vicinity of the mine which is necessary to bring the oil to a grade and quality suitable for transportation to and processing in a refinery). Qualified equipment, however, does not include any equipment used in a refining process.

Affirmative commitment rules.—The bill amends these rules to provide additional time for completion of synthetic fuels projects that involve coal and shale oil. Availability of the credit for synthetic fuels projects will be continued through December 31, 1992, if (1) all engineering studies in connection with the study are completed before January 1, 1987, and applications are filed before January 1, 1987, for all environmental and construction permits required before the start of construction, and (2) binding contracts are entered into before January 1, 1990, to acquire or construct at least 50 percent of all equipment that is specially designed for the project.

A special affirmative commitment rule extends the solar, wind, ocean thermal, and geothermal credits through December 31, 1989 for projects on which the engineering and permitting requirements are met by the end of 1988 and the contracting requirements are met by July 1, 1989.

Effective Date

The energy tax credit provisions are effective on the date of enactment.

Revenue Effect

It is estimated that the business energy tax credit amendments will reduce fiscal year budget receipts by $3 million in 1984, $26 million in 1985, $170 million in 1986, $274 million in 1987, $296 million in 1988, and $228 million in 1989.

The amendments to the residential energy credits will increase fiscal year budget receipts by $8 million in 1984, $169 million in 1985, and $262 million in 1986, and the amendments will reduce fiscal year budget receipts by $494 million in 1987, $665 million in 1988, and $134 million in 1989.

The combined revenue effect of these energy tax credit provisions will reduce fiscal year budget receipts by $768 million in 1987, $961 million in 1988, and $362 million in 1989, and increase fiscal year budget receipts by $5 million in 1984, $143 million in 1985, and $92 million in 1986.

3. Extension of Targeted Jobs Credit (sec. 856 of the bill and sec. 51 of the Code)

Present Law

Background

The targeted jobs credit was enacted in the Revenue Act of 1978 as a substitute for the expiring credit for increased employment (the "new jobs credit"). The new jobs credit was available in 1977 and 1978.

As initially enacted, the targeted jobs credit was intended to be available for qualified wages paid before 1982.[1] The Economic Recovery Tax Act of 1981 extended the availability of the targeted jobs credit to qualified wages paid to individuals beginning work for the employer before 1983. The Tax Equity and Fiscal Responsibility Act of 1982 (TEFRA) extended the availability of the credit to qualified wages paid to individuals who begin work for the taxpayer before 1985. TEFRA also authorized the appropriation for fiscal years 1983 and 1984 of such sums as may be necessary for the expenses of administering the certification system and of providing publicity regarding the targeted jobs credit to employers.

Present law targeted jobs credit rules

The targeted jobs tax credit is presently available on an elective basis for hiring individuals from one or more of nine targeted groups. The targeted groups are (1) vocational rehabilitation referrals; (2) economically disadvantaged youths; (3) economically disadvantaged Vietnam-era veterans; (4) SSI recipients; (5) general assistance recipients; (6) economically disadvantaged cooperative education students; (7) economically disadvantaged former convicts; (8) AFDC recipients and WIN registrants; and (9) economically disadvantaged youths aged 16 or 17 for summer employment. In general, an individual is not treated as a member of a targeted group unless certification that he is a member of such a group is received or requested in writing by the employer from the local agency designated to perform certification on or before the day on which the individual begins work.

The credit generally is equal to 50 percent of the first $6,000 of qualified first-year wages and 25 percent of the first $6,000 of qualified second-year wages paid to a member of a targeted group. Thus, the maximum credit is $3,000 per individual in the first year of employment and $1,500 per individual in the second year of employment. With respect to economically disadvantaged summer youth employees, however, the credit is equal to 85 percent of up to

[1] As a result of a clerical error, the Revenue Act of 1978 limited the credit to wages paid before 1981. The error was corrected in the Technical Corrections Act of 1979.

$3,000 of wages, for a maximum credit of $2,550. The employer's deduction for wages must be reduced by the amount of the credit.

The credit may not exceed 90 percent of the employer's tax liability after being reduced by certain other nonrefundable credits. Excess credits may be carried back three years and carried forward 15 years.

Reasons for Change

The committee believes that experience with the targeted jobs credit since its enactment in 1978 has been sufficiently promising to warrant a further extension of the credit. In the view of the committee, a three-year extension is appropriate in order to give employers and employment security agencies greater certainty about the availability of the credit as they seek to broaden employment opportunities for economically disadvantaged persons, disabled persons, and recipients of payments under means-tested transfer programs. Such an extension will also provide Congress and the Treasury Department an opportunity to gather more information on the operation of the credit program so that its effectiveness as a hiring incentive can be more fully assessed.

Explanation of Provision

The bill extends the targeted jobs credit for three more years. Under the bill, the credit will be available for qualified wages paid to individuals who begin work for the employer on or before December 31, 1987. Thus, if an individual begins work on December 31, 1987, the employer will be permitted to claim the credit for qualified first-year and qualified second-year wages paid to the individual for services performed in 1988 and 1989, respectively. The bill also extends the authorization of appropriations for administrative expenses to fiscal years 1985, 1986 and 1987.

Effective Date

This provision of the bill is effective on the date of enactment.

Revenue Effect

This provision will reduce fiscal year budget receipts by $163 million in 1985, $536 million in 1986, $914 million in 1987, $797 million in 1988 and $521 million in 1989.

H. Tax Treatment of Capital Gains and Losses

1. Decrease in Holding Period Required for Long-Term Capital Gain Treatment (sec. 858 of the bill and sec. 1222 of the Code) [1]

Present Law

Gains or losses on sales or exchanges of capital assets held for more than 12 months are considered long-term capital gains or losses (sec. 1222). For noncorporate taxpayers, only 40 percent of net long-term capital gains are included in taxable income, while 100 percent of net short-term gains are included. However, net capital losses are deductible against $3,000 of ordinary income to the extent of 100 percent of short-term losses and 50 percent of long-term losses.

For corporate taxpayers, net long-term capital gains are subject to an alternative tax rate of 28 percent, while net short-term gains are taxed at ordinary corporate rates. Capital losses of corporations are not deductible against ordinary income.

Reasons for Change

The differential tax treatment of short-term and long-term transactions creates incentives for investors not to realize short-term gains. Studies of capital asset sales data confirm that investors are "locked-in" to investments because they do not desire to realize short-term gains. This reduces capital market efficiency because investors hold assets longer than they otherwise might in the absence of tax considerations. Prior to 1977, the holding period was 6 months. By reducing the capital gains holding period from 12 to 6 months, the committee believes that the lock-in effect and its adverse impact on capital market efficiency will be reduced.

Explanation of Provision

The holding period for determining whether gain or loss on the sale or exchange of a capital asset or certain business property is long-term or short-term is reduced from 1 year to 6 months. Thus, property held for more than 6 months will be eligible for long-term capital gain or loss treatment.

Effective Date

The amendment applies to assets acquired after February 29, 1984.

[1] This provision was contained in S. 2062, reported by the Senate Committee on the Budget on November 4, 1983. However, that bill contained an effective date of November 1, 1983.

2. Deduction of Capital Losses Against Ordinary Income (sec. 859 of the bill and secs. 1211 and 1212 of the Code) [2]

Present Law

Capital losses of individuals are deductible in full against capital gains. In addition, unused capital losses may be carried forward to future years indefinitely. A limited amount of capital losses may also be deducted against ordinary income. The present $3,000 limitation was adopted by the Tax Reform Act of 1976, which increased the limitation, from $1,000 under prior law, to $2,000 in 1977 and $3,000 in 1978 and subsequent years. For losses from years after 1969, only 50 percent of net long-term capital losses in excess of net short-term capital gains may be deducted from ordinary income. Thus, $6,000 of net long-term capital losses is required to offset $3,000 of ordinary income.

Reasons for Change

By limiting the amount of capital losses that can be used to offset ordinary income, but allowing an unlimited capital loss carryforward, the capital loss rules create an incentive for continued capital investment by taxpayers incurring capital losses. In addition, the limitation on the deduction of capital losses against ordinary income protects the tax base, since it is within the discretion of taxpayers to time their dispositions so as to realize capital losses while deferring the realization of capital gains. The committee believes these policies can be served better by reducing the $3,000 limitation of present law to $1,000.

In addition, in the interests of tax simplification, it is now appropriate to repeal the special rules applicable to unused capital losses incurred before 1970, since taxpayers have had 15 years to use these losses to reduce taxable income, and the special rules add considerable complexity to individual tax forms.

Explanation of Provision

The bill reduces the ceiling on the deduction of net capital losses against ordinary income from $3,000 to $1,000. The special treatment applicable to capital losses sustained before 1970 is repealed.

Effective Date

The bill applies to the deduction of capital losses against ordinary income for taxable years beginning after December 31, 1984.

[2] This provision was contained in S. 2062, reported by the Senate Committee on the Budget on November 4, 1983. However, that bill contained an effective date of December 31, 1983.

3. Revenue Effect of Capital Gains and Loss Provisions

The capital gains and loss provisions together will reduce fiscal year budget receipts by less than $10 million in 1984, $60 million in 1985, and increase them by $307 million in 1986, $315 million in 1987, $333 million in 1988 and $350 million in 1989.

I. Other Provisions

1. Modification of Rules Governing Rehabilitation Investment Credit (sec. 860 of the bill and sec. 48(g) of the Code)

Present Law

A three-tier system of investment credits is provided for qualified rehabilitation expenditures incurred in connection with certain buildings. The credit is equal to 15 percent of qualified expenditures in the case of buildings at least 30 years old, but fewer than 40 years old. In the case of buildings at least 40 years old, the credit is equal to 20 percent of qualified expenditures, and in the case of certified historic structures, the credit is equal to 25 percent of qualified expenditures.

In the case of the 15- and 20-percent credits, a full basis adjustment for the amount of the credit is required; a one-half basis adjustment is required for the 25-percent credit. Additionally, these credits are available only if the taxpayer elects to use the straight-line method of cost recovery.

Rehabilitation expenditures are qualified for the credit only if certain requirements are satisfied as to amount of expenditures and type of work performed on the building. One of these requirements is that at least 75 percent of the external walls of the building before the beginning of rehabilitation must be retained in place as external walls after completion of rehabilitation.

Reasons for Change

The committee believes that an alternative test to the 75-percent-of-external-wall test should be provided to enable buildings of other than square or rectangular shapes to qualify more easily for the rehabilitation credit.

Explanation of Provision

The investment credit for otherwise qualified rehabilitation expenditures is extended to rehabilitations of buildings where—

(1) at least 50 percent of the building's external walls are retained in place as external walls;

(2) at least 75 percent of the building's external walls are retained in place as either external walls or internal walls; and

(3) at least 75 percent of the building's internal structural framework is retained in place.

The bill does not change the present method under which the determination of the percentage of a building's external walls that are retained is made. The committee intends comparable rules to those present rules will apply under this alternative test in determining what percentage of internal walls (and external walls converted to internal walls) are retained following rehabilitation. The committee further intends that all load-bearing internal walls and any other internal structural supports present in a building before the beginning of rehabilitation, including the columns, girders, beams, trusses, spandrels, and all other members that are essential to the stability of the building, will be treated as part of the building's internal structural framework.

Effective Date

This provision applies to qualified rehabilitation expenditures incurred with respect to property placed in service after December 31, 1983.

Revenue Effect

This provision will reduce fiscal year budget receipts by less than $5 million annually.

2. Tax Treatment of Regulated Investment Companies (sec. 861 of the bill and secs. 851-52 of the Code)

Present Law

General rules

Regulated investment companies.—Under present law, a regulated investment company (RIC) is treated, in essence, as a conduit for tax purposes. If a corporation qualifies as a RIC, it is allowed a deduction for dividends paid (or deemed paid) to its shareholders. Thus, a corporate level tax on such earnings is not payable.

In order for a corporation to be a RIC, it must meet several requirements.

First, a RIC must be a domestic corporation which (1) at all times during the taxable year is registered under the Investment Company Act of 1940, as amended, either as a management company or as a unit investment trust, or (2) which is a common trust fund which meets certain requirements.[1]

Second, the corporation must elect RIC status for the taxable year (or must have made such an election for a previous taxable year).

Third, the corporation must not be a personal holding company for the taxable year.

Fourth, the corporation must meet certain gross income and investment requirements. In general, at least 90 percent of the corporation's gross income must be derived from dividends, interest, certain payments with respect to securities loans, and gains from the sale or other disposition of stock or securities. In addition, less than 30 percent of its gross income can be derived from the sale or other disposition of stock or securities held for less than three months. At the close of any quarter, at least 50 percent of its total assets must be represented by cash, cash items, government securities, securities of other RICs, and certain other securities. Not more than 25 percent of the value of the total assets of the corporation can be invested in securities (other than government securities or securities of other RICs) of any one issuer, or of two or more issuers controlled by the taxpayer and determined to be engaged in the same, a similar, or a related trade or business.

Fifth, a RIC must distribute at least 90 percent of its investment company taxable income for the taxable year (determined, in general, without regard to the dividends paid deduction), and 90 percent of the amount of its tax exempt interest income over the deductions allocable to such exemption (and disallowed as deductions for that reason).

[1] These requirements are that the corporation be a common trust fund or similar fund excluded by section 3(c)(3) of the Investment Company Act of 1940 from the definition of "investment company" and not included in the definition of common trust fund by Code section 584(a).

As indicated above, if a corporation qualifies as a RIC, it is allowed a deduction for distributions paid to its shareholders. The RIC shareholder is taxed on the amount of dividends received or deemed received. Special rules apply with respect to capital gains income and exempt-interest dividends.

If any of the requirements for RIC status are not met for the taxable year, then the RIC is taxed as a corporation for that taxable year and is not entitled to the special RIC deduction for dividends paid.

Personal holding companies.—A personal holding company (PHC) is subject to a special 50 percent tax on any undistributed personal holding company income. In general, a personal holding company is any corporation, other than certain types of corporations,[2] at least 60 percent of the adjusted ordinary gross income of which is dividends, interest, rents, royalties, or other types of passive income. In addition, at any time during the last half of the taxable year, more than 50 percent of the value of the corporation's outstanding stock must be owned (directly or indirectly) by or for not more than five individuals.[3] Certain attribution rules apply to determine the number of shareholders in a PHC.

Accounting for short-term government obligations

In the case of any short-term obligation of the United States, a state, or any possession of the United States, or any political subdivision of the foregoing, or the District of Columbia, issued at a discount and redeemable at maturity without interest, the amount of the issue discount is deemed to accrue at the earlier of the date the obligation is paid at maturity, or the date the obligation is sold or otherwise disposed of. For this purpose, an obligation is a short-term obligation if it has a fixed maturity date not exceeding one year from the date of issue. Thus, with respect to such obligations, accrual basis taxpayers are not taxable on the discount until the obligation matures.

Reasons for Change

The recent enactment of the Subchapter S Revision Act of 1982 allows a personal holding company to elect subchapter S status and thereby have its income taxed directly to the shareholders without the imposition of a corporate tax. The subcommittee believes that a PHC should also be able to elect regulated investment company (RIC) status so that its earnings may be taxed to the shareholders rather than the corporation.

The committee is concerned that an operating company would accumulate earnings and profits as a regular corporation, sell its operating assets, invest the profits in passive investment assets, and then elect to be one of the types of entities that is treated as a conduit for tax purposes. In such a case, the shareholders, in essence, are able to change their holdings from operating assets into

[2] The corporations excluded from the definition of personal holding company include tax-exempt corporations, banks, savings and loans, life insurance companies, certain lending or finance companies, certain foreign held corporations, and small business investment companies.

[3] For this purpose, a trust created or organized in the United States and forming part of a qualified stock bonus, pension, or profit sharing plan and certain private foundations are included in the definition of individual.

investment assets without distributing the earnings from the operating activities. For this reason, the Subchapter S Revision Act of 1982 limited the use of subchapter S by any corporation with both passive income and undistributed corporate earnings accumulated when the corporation was not an S corporation. Similarly, the Tax Reform Act of 1976 limited the use of the corporate merger rules involving investment companies. Consistent with such prior legislation, the committee also believes that a corporation with earnings that accumulated while the corporation did not have RIC status, and have not been taxed to their shareholders, should not be able to elect RIC status and thereby exempt themselves from corporate tax in the absence of a shareholder tax on these prior earnings.

Finally, the committee believes that a RIC should be able to account for issue discount on short-term government obligations on the accrual basis. This method is consistent with the method used by RICs in accounting for, and computing distributions to, shareholders.

Explanation of Provision

Qualification of a RIC

The bill repeals the prohibition of present law which denies eligibility for RIC status to a PHC. However, the undistributed investment company taxable income of any RIC which is a PHC will be subject to tax at the highest corporate rate (presently 46 percent).

The bill also provides that no corporation may qualify for treatment as a RIC, for any taxable year, unless (1) the RIC provisions applied to the company for all taxable years ending after November 8, 1983, or (2) at the close of the taxable year, the company had no accumulated earnings and profits from a taxable year in which it was not subject to the RIC provision. Thus, in the future, any corporation with accumulated earnings and profits attributable to a non-RIC year will be ineligible to elect RIC status without a distribution of those earnings.

The bill provides rules to allow a company to be eligible to be treated as a RIC, notwithstanding the new earnings and profits rule, for any taxable year subsequent to a taxable year with respect to which it is determined that the RIC qualification requirements were not met. Under these rules, a corporation may requalify as a RIC if the corporation, within 90 days after a determination[4] is made, distributes property in an amount equal to the accumulated earnings and profits (as of the determination date) attrib-

[4] The term "determination" includes a final court decision, a closing agreement, a determination by the investment company filed with the Secretary, or other agreement between the Internal Revenue Service and the company. The committee expects that the Internal Revenue Service will establish a procedure to determine the amount of the company's earnings and profits attributable to non-RIC years by the time of the determination date and to extend the 90-day period if the company and the Internal Revenue Service cannot agree on such earnings and profits until such time as there is a resolution of that amount by agreement among the parties or by a final court decision. Moreover, where a company determines that it did not qualify as a RIC for a year and determines its tax liability and distributes its earnings and profits accordingly, but it is later determined that the company had additional earnings and profits from that non-RIC year, the committee expects that the Internal Revenue Service will make a determination in order that these subsequently determined earnings and profits may be timely distributed.

utable to the non-RIC year,[5] less any interest charge. The distribution must be designated as being taken into account for the disqualified year and will not be deductible in computing the taxable income of the company. The interest charge is computed for the period from the filing date for the disqualified year to the determination date on an amount equal to 50 percent, (i.e., the highest rate of tax applicable to individuals) of the earnings and profits for the non-RIC year. The period of limitation on assessment and collection of the interest will be determined as if the interest arose from a tax imposed in the year the determination is made. These procedures will not apply in the case of fraud.

Accounting for short-term government obligations

The bill provides that the issue discount accruing with respect to any short-term government obligation will be taxable to the RIC as it accrues, if the company so elects in a manner prescribed by the Internal Revenue Service. This provision permits RICs to conform the income tax accounting rules for short-term government obligations with the book accounting methods.

Effective Dates

The new RIC qualification rules will apply to taxable years beginning after December 31, 1982. In the case of any corporation which was a RIC for any taxable year ending before November 8, 1983, earnings and profits from any taxable year ending before that date shall be disregarded in applying the new E&P requirement. Also, in the case of any corporation beginning business in 1983, E&P from that initial year shall be disregarded in applying this rule.

The accounting rule will apply to taxable years beginning after December 31, 1978.

Revenue Effect

The provisions of the bill are estimated to have a negligible effect on budget receipts.

[5] The accumulated earnings and profits from a non-RIC year is the earnings and profits from the non-RIC years reduced by a deficit in earnings and profits subsequent to the non-RIC year and before the determination date.

3. Tax Treatment of Cooperative Housing Corporations (sec. 862 of the bill and sec. 216 of the Code)

Present Law

Treatment of housing cooperatives

Under present law (sec. 216), a tenant-stockholder in a cooperative housing corporation is entitled to deduct amounts paid to the cooperative which represent his or her proportionate share of allowable real estate taxes and interest (e.g. mortgage interest) relating to the land and buildings held by the cooperative. In general, for a cooperative to qualify for this pass-through treatment, (1) each stockholder of the cooperative must be entitled to occupy a house or apartment owned or leased by the cooperative, (2) no stockholder may receive any distribution from the cooperative (other than distributions out of earnings and profits) except on a liquidation of the cooperative, and (3) tenant-stockholders qualifying for pass-through treatment must have paid amounts for their stock which bear a reasonable relationship to the value of that portion of the cooperative's land and building which is attributable to their house or apartment.

In addition, to qualify for pass-through treatment, 80 percent or more of the cooperative's gross income must be derived from tenant-stockholders. For purposes for this rule and the rules above, tenant-stockholders are generally limited to individuals. Thus, corporations, trusts, and other similar entities generally do not qualify for pass-through treatment under present law. An exception is provided where a person (including a corporation) sells property or leasehold interests to a cooperative and acquires stock in the cooperative within one year after making such transfer. In such cases, the person selling the property is treated as a tenant-stockholder for a period not exceeding three years from the date of acquisition of the stock. This treatment applies even if, by agreement with the cooperative, such person or its nominee may not occupy the house or apartment without prior approval of the cooperative.

Also under present law, a bank or other lending institution which obtains stock in a cooperative housing corporation by foreclosure is treated as a tenant-stockholder for up to three years after the date of acquisition (even if the lending institution or its nominee may not occupy the unit without prior approval of the cooperative.)

For purposes of the 80 percent test, stock owned and dwellings leased by governmental entities for the purpose of providing housing facilities are not taken into account.

Allowance of depreciation deduction

In addition to deductions for rent and taxes, to the extent a tenant-stockholder uses depreciable property leased from the cooperative in a trade or business or for production of income, the tenant-stockholder is allowed a deduction with respect to the stock which gives him the right to lease the property. This deduction is generally limited to the extent of that portion of the taxpayer's adjusted basis for the stock which is allocable to the depreciable property. Present law provides that the allowance of this deduction is not to be construed to limit or deny a depreciation deduction by the cooperative itself with respect to leased property.

Reasons for Change

The committee believes that the tax treatment of corporations, trusts, and other non-individual entities which own stock in cooperative housing corporations should be the same as that of individuals. To allow cooperatives to maintain control over occupancy of individual units, the committee believes that this treatment should apply although the cooperative retains the right to approve any individual who occupies a house or apartment as a nominee of an entity owning stock in the cooperative.

In connection with the above change, the bill disallows maintenance and lease deductions by tenant-stockholders in situations where the property used by such stockholders is properly chargeable to the capital account of the cooperative. This change eliminates the ability of a tenant-stockholder to obtain deductions for the capital costs of his cooperative unit more quickly than if he had owned the unit.

Explanation of Provision

Extension of pass-through treatment to non-individual stockholders

The bill amends the definition of tenant-stockholder to mean any person (rather than any individual) who satisfies the requirements otherwise applicable to tenant-stockholders. Thus, under the bill, corporations, trusts, estates, partnerships, associations, or companies (as well as individuals) may be tenant-stockholders qualifying for pass-through treatment.

If a person other than an individual acquires stock in a housing cooperative, there shall not be taken into account, for purposes of determining whether the person is a qualifying tenant-stockholder, the fact that, by agreement with the cooperative, such person's nominee may not occupy the house or apartment without prior approval of the cooperative. This change enables (e.g.) a corporation owning stock in the cooperative to qualify for pass-through treatment although the cooperative retains the right to approve any individuals who occupy units under arrangements with the corporation.

The bill further provides that, in the case of an original seller of houses or apartments to a housing cooperative (including individuals or other entities), there shall not be taken into account the fact that, by agreement with the cooperative, the original seller or its nominee may not occupy a house or apartment without prior approval of the cooperative. This rule applies where the original seller acquires stock not later than one year after transferring houses or apartments (or leaseholds therein) to the cooperative.

Also under the bill, where any person acquires stock of a cooperative housing corporation by operation of law (e.g. by inheritance or foreclosure), for purposes of determining whether such person is a qualifying tenant-stockholder, there shall not be taken into account the fact that, by agreement with the cooperative, such person or his nominee may not occupy the house or apartment without prior approval of the cooperative.

The present law rules regarding original sellers and foreclosures by lending institutions are made unnecessary by these changes and are therefore repealed.

Limitation on depreciation deduction

Under the bill, a tenant-stockholder using depreciable property in a trade or business or for the production of income is allowed a deduction as under present law to the extent of that portion of his adjusted basis for his stock which is allocable to such depreciable property. The bill further allows deductions exceeding this basis to be carried over to succeeding taxable years. However, the bill provides that no deduction may be allowed to a stockholder for any amount paid or accrued to the cooperative (in excess of proportionate interest and real estate taxes) to the extent that, under Treasury regulations, such amount is properly allocable to amounts chargeable to the cooperative's capital account. Any deduction disallowed under this rule will be applied to increase the stockholder's adjusted basis for his stock. This rule generally prevents a tenant-stockholder (including a corporation) from obtaining deductions for the capital costs of his cooperative unit more quickly than if he had owned the unit.

Effective Date

This provision is effective on the date of enactment of the bill.

Revenue Effect

This provision is estimated to reduce budget receipts by less than $10 million annually.

4. Extension of Exemption from FUTA for Wages of Certain Fishing Boat Crew Members (sec. 863 of the bill and sec. 3306 of the Code)

Present Law

For purposes of social security taxes and income tax withholding, members of the crew on a boat in a fishing operation engaged in catching fish or other forms of aquatic animal life are considered to be self-employed if (1) their remuneration is a share of the boat's catch (or cash proceeds from the sale of a share of the catch and no other cash remuneration is provided), (2) their share depends on the amount of the boat's catch, and (3) if the crew of the boat normally is made up of fewer than ten individuals. If these requirements are met, remuneration paid to these crew members is exempt from the Federal Insurance Contributions Act (FICA) tax and income tax withholding, and is subject to the Self-Employment Contributions Act (SECA) tax (Code secs. 3121(b) (20), 3401(a)(17), and 1402(c)(2)(F)).

Prior to the Economic Recovery Tax Act of 1981 (ERTA), remuneration paid to fishing boat crew members was not exempt from tax under the Federal Unemployment Tax Act (FUTA) if the services performed were related to catching halibut or salmon for commercial purposes or if the services were performed on a vessel of more than ten net tons (sec. 3306(c)(17)).

Section 822 of ERTA amended the definition of employment for purposes of FUTA taxes to exempt from FUTA taxes remuneration paid during 1981 to fishing boat crew members who were treated as self-employed for social security tax purposes and thus exempt from FICA. Section 203 of the Miscellaneous Revenue Act of 1982 (P.L. 97-362) amended ERTA to provide that the exemption from FUTA taxes also was effective for remuneration paid in 1982.

Reasons for Change

The committee believes that a two-year extension of the FUTA exemption for wages of certain fishing boat crew members is appropriate to give the Congress an opportunity to determine the best long-term solution to the problem of unemployment insurance coverage of fishing boat crew members who are permanently exempt for purposes of social security tax and income tax withholding, but who are not treated as self-employed for purposes of the unemployment tax provisions.

Explanation of Provision

The bill amends section 822 of ERTA so that the exemption from FUTA tax for remuneration paid to fishing boat crew members who are exempt from FICA is effective for remuneration paid before January 1, 1985.

Effective Date

This provision will be effective upon enactment with respect to remuneration paid in 1983 and 1984.

Revenue Effect

This provision will reduce fiscal year receipts by $1 million in 1984 and $1 million in 1985.

5. Extension of the Special Tax Rules for the Payment-in-Kind Program (sec. 864 of the bill and P.L. 98-4)

a. Description of the 1984 Payment-in-Kind Program

Overview

The Department of Agriculture ("USDA") announced a 1984 payment-in-kind ("PIK") program on August 9, 1983. The 1984 PIK program is a program for diverting from production land which otherwise would be used to produce wheat. Under the program, producers are provided a quantity of wheat as compensation for diverting acreage normally planted in that crop.

Present law limits to $50,000 the amount of payments USDA can make to a producer under crop acreage reduction programs. When the PIK programs were first announced in January 1983, USDA announced that the $50,000 limit applied only to cash payments—not to payments-in-kind. On November 1, 1983, the General Accounting Office issued a determination that the $50,000 limit applies to payments under all acreage reduction programs, whether made in cash or in kind.

USDA conducted a similar PIK program during the 1983 crop year for wheat, corn, grain sorghum, rice, and upland cotton. There are three main differences between the 1983 and 1984 programs: the 1984 program is limited to in-kind payments of wheat; in 1984 no payments will be made from Commodity Credit Corporation stocks—payments will be made only from commodities held under reserve loans, regular loans and "harvest-for-PIK" loans; and farmers will not be able to divert their whole crop acreage base in 1984, as was possible under the 1983 program.

PIK Program

General rules

Under the 1984 PIK program, farm producers generally may elect to divert from 10 to 20 percent of their wheat acreage base[1] from active crop production in exchange for a payment-in-kind equal to an established quantity of the wheat normally grown on the property. The established quantity is 75 percent of the farm's program yield.[2]

Property withdrawn from crop production under a 1984 PIK program is required to be devoted to conservation uses. Harvesting of any crop from land diverted under a 1984 PIK program generally is prohibited.

[1] The term "wheat acreage base" means the average of the acreage planted and considered planted to wheat in 1982 and 1983.

[2] The term "farm program yield" means the yield of wheat from the farm property during an established historical reference period.

Executed PIK contracts are transferable by the farmer under certain circumstances; however, transfer of a PIK contract terminates the farmer's qualification for special tax treatment. Therefore, upon assignment of a PIK contract, the farmer recognizes income, which income is not treated as income derived from the active conduct of farming.

Payment procedures

Participating farmers are eligible for payment-in-kind on a date established for their locality which reflects the usual harvest dates of wheat in different regions. Farmers may receive payment on the established availability date, or they may elect to defer receipt of the payment for any period of time up to 5 months thereafter. The Federal Government bears all risk of loss and storage costs until payment is received by the farmer.

In-kind payments of wheat are to be paid only from wheat acquired by the Federal Government through transactions the substance of which is forfeiture of collateral for regular and Farmer-owned Reserve ("FOR") price support loans made under price support programs administered by the Commodity Credit Corporation ("CCC").[3] In the case of payment from farm-stored FOR stocks, unlike the 1983 participants, farmers in the 1984 PIK program will not be eligible for additional storage costs beyond the normal 5 months allowed under the PIK program.

Producers with no outstanding loans must agree to harvest for PIK in order to receive a PIK payment, i.e., to grow their own PIK commodities on other land they farm. Price support loans will be made to farmers growing their own PIK. These loans will be secured by the commodities to be produced. Those producers with no outstanding loans who are unable to harvest for PIK will not receive a PIK payment.

The method of payment under the PIK program takes the form of a three-step transaction. First, the farmer repays outstanding loans (reserve loans, regular loans, or harvest-for-PIK loans) equal to the PIK payment.[4] At that time, the collateral for the repaid loans is released. Second, the Government repurchases the released commodities for an amount equal to the amount of the repaid loan (plus any accrued interest and charges paid by the farmer on repayment of the loan). Finally, the Government returns the commodities to the farmer as a payment-in-kind under the PIK contract.

Farmers may elect to have cooperatives receive payments otherwise due them provided the farmers have no outstanding CCC loans themselves. The payment procedures for cooperatives are generally the same as for individual farmers dealing directly with

[3] The CCC is a Federally owned corporation which administers the farm price support program through grants of loans on crops eligible for support. The CCC establishes an annual loan rate per unit for each crop eligible for Government price supports. CCC then makes nonrecourse loans to farmers for their crops based upon this rate. If the market price for the crop rises above the loan rate, the farmer can redeem the crop, sell it, and retain any excess proceeds over the loan rate plus accrued interest and other charges. If the market price does not rise above the loan rate before the loan's due date, the farmer can forfeit the crop to the Government in full satisfaction of the loan.

[4] Producers with reserve loans will be required to use those loans before a regular loan can be used. If a producer has more than one reserve loan, the producer may choose which reserve loan to repay.

the Government. The cooperative's wheat loans must be used to satisfy the PIK requirements in the following order: reserve loans, regular loans and, finally, harvest-for-PIK loans. To meet the harvest-for-PIK requirement, the cooperative must obtain loans on eligible 1984 crop wheat to satisfy the designated PIK quantity in excess of outstanding reserve or regular loans. The cooperative will not be permitted to repay 1984 crop wheat loans unless a sufficient quantity of wheat remains under loan to satisfy PIK needs. PIK payments to cooperatives are to be held in pools separate from other crops held by the cooperatives.

Cash Payment Acreage Reduction Programs

As under the 1983 PIK program, farmers are required to participate in the acreage limitation and paid diversion programs as a prerequisite of eligibility for the 1984 PIK program.

Under the 1984 wheat program, producers must limit 1984 wheat planted acreage to no more than 70 percent of the farm's wheat base (i.e., the acreage reduction requirement is 30 percent), and devote to conservation use an acreage of eligible cropland equal to 42.86 percent of the 1984 planted and PIK acreage.

Participation in the acreage reduction programs also entitles the farmer to price support loans and deficiency payments with respect to crops actually produced. The deficiency payments are equal to the excess of an established "target" price over the greater of the year's CCC loan value for the crop or the crop's national average market price. The 1984 target price for wheat is $4.45 per bushel and the national average loan rate is $3.30 per bushel.

b. Tax Treatment of Participants in Payment-in-Kind Programs

Present Law

Overview

The tax treatment of income from commodities produced by farmers is subject to numerous special rules under the Internal Revenue Code. Similarly, eligibility for a number of special income and estate tax provisions depends upon whether a taxpayer is (or a decedent was) either (1) engaged in the trade or business of farming, or (2) has income derived from the active conduct of the trade or business of farming.

Had the Payment-in-Kind Tax Treatment Act of 1983 (the "1983 Act") [5] not been enacted, participants in a 1983 PIK program could have been ineligible for many of the special income and estate tax provisions that are available to farmers since PIK commodities generally are not produced by the recipient in the active conduct of a farming operation. Even if such commodities are so produced, they have in effect been sold to the Government and returned to the PIK participant as consideration for withdrawal of farm land from production.

The 1983 Act modified the tax law to provide that participants in a 1983 PIK program generally are treated in a manner similar to that which would apply if they had actually grown the PIK commodities on the land withdrawn from production. Since the provisions of the 1983 Act apply only to land withdrawn from production during the 1983 crop year, payments received with respect to land withdrawn from production during the 1984 crop year generally will not be treated as income received from commodities produced by PIK participants in the active conduct of a farming operation.[6]

Income tax treatment of farmers

Timing of income

Generally, taxpayers engaged in farming may determine their income for Federal income tax purposes under either the cash or

[5] Public Law 98-4, March 11, 1983. H.R. 1296, a bill relating to the tax treatment of commodities received under the 1983 payment-in-kind program, was the subject of hearings on February 23, 1983 held by the Subcommittee on Select Revenue Measures of the Committee on Ways and Means. The bill, as amended, was reported by the Committee on Ways and Means on March 2, 1983 (H. Rept. 98-14). The House approved the bill on March 8, 1983, by a record vote of 401 to 1 under suspension of the rules. The Senate approved thę bill on March 8, 1983, with amendments. On March 9, 1983, the House concurred in the Senate's amendment with amendment. On March 10, 1983, the Senate concurred in the House amendment, clearing the measure for the President.

[6] Winter wheat received as a PIK payment with regard to land withdrawn from production under a PIK program for the 1984 crop year remains eligible for the special treatment otherwise accorded only payments with respect to land withdrawn from production during the 1983 crop year. This rule applies only if the 1984 crop would have been planted before January 1, 1984, but for participation in a 1984 PIK program.

accrual method of accounting. However, corporations (other than certain "family owned" corporations, subchapter S corporations and certain corporations with annual gross receipts of less than $1 million) and certain partnerships must use the accrual method of accounting for farm operations (Code sec. 447).

A taxpayer may elect to consider amounts received as loans from the CCC as income in the year in which received (sec. 77). If the election is made, the taxpayer takes a basis in the crop equal to the amount included in income. If the commodity securing such loan is later forfeited, no income would be recognized at the time of such forfeiture to the extent of such basis.

Generally, a taxpayer may elect to defer the income from the discharge of indebtedness on qualified business indebtedness. The deferral of the income is achieved by excluding from income the amount of the debt discharged (sec. 108) with a corresponding reduction in the basis of certain assets (sec. 1017).

If a commodity is produced by a farmer, the farmer generally recognizes income only (1) when the commodity is sold or otherwise disposed of to a third party, or (2) when livestock, etc., to which a commodity is fed is sold or otherwise disposed of to a third party. Because the 1983 Act treats PIK commodities as produced by the PIK participants, these rules apply to such commodities. Had the 1983 Act not been enacted, however, under both the cash and accrual methods of accounting, farmers would have recognized income when the commodities were made available to them regardless of when actually received. The amount to be included in income would have been the fair market value of the commodity on the date the taxpayer recognized the income.

Other income tax provisions

Under the 1983 Act, for all purposes of the Internal Revenue Code, income from the sale or exchange of PIK commodities is treated as income from the trade or business of farming and the taxpayer is treated as using in the trade or business of farming any land diverted from production under a 1983 PIK program. Thus, income with respect to the sale or exchange of such commodities is treated as gross income from farming for purposes such as the following:

Estimated tax payments.—In general, a taxpayer is required to pay the tax shown on a tax return on the due date for filing the return (determined without regard to any extensions of time for filing the return). Corporations generally must pay at least 90 percent, and individuals 80 percent, of their current year's tax liability in quarterly estimated tax payments during the taxable year.

However, an individual whose estimated gross income from farming for the taxable year is at least two-thirds of his or her total estimated gross income from all sources for the taxable year (or whose gross income from farming shown on the preceding year's tax return is at least two-thirds of total gross income from all sources) must pay the estimated tax for a taxable year in full on or before January 15 of the succeeding taxable year.

Additionally, the requirement to make payments of estimated tax is considered met if, on or before March 1, the taxpayer files a return for the taxable year for which estimated tax payments are required and pays in full the amount of tax due (secs. 6015(g), 6073(b), and 6153(b)). Corresponding payment dates apply to taxable years beginning on a date other than January 1st. Further, the addition to the tax with respect to underpayment of estimated taxes will not be imposed if the estimated tax payments are at least 66⅔ percent of the tax liability for the year (sec. 6654(d)).

Soil and water conservation expenditures.—Under present law, a taxpayer engaged in the business of farming may claim a current deduction for amounts which are paid or incurred during the taxable year for the purpose of soil or water conservation in respect of land used for farming, or for the prevention of erosion of land used for farming (sec. 175). The maximum amount that may be expensed in any taxable year may not exceed 25 percent of the taxpayer's gross income derived from farming during the taxable year.

The term "land used in farming" means land used (before or simultaneously with the expenditures described above) by the taxpayer or his or her tenant for the production of crops, foods, or other agriculture products or for the sustenance of livestock.

Expenditures by farmers for fertilizer, etc.—Under present law, a taxpayer engaged in the business of farming may elect to expense amounts that otherwise must be capitalized which are paid or incurred during the taxable year for materials to enrich, neutralize, or condition land used in farming, or for the application of such materials to the land (sec. 180). For this purpose, land is used in farming if it is used, either before or simultaneously with the expenditures described above, by the taxpayer or his or her tenant for the production of crops, fruits, or other agricultural products, or for the sustenance of livestock.

Expenditures by farmers for clearing land.—Under present law, a taxpayer engaged in the business of farming may elect to treat expenditures paid or incurred in a taxable year to clear land for the purpose of making such land suitable for use in farming as a currently deductible expense (sec. 182). However, this deduction for any taxable year may not exceed the lesser of $5,000 or 25 percent of the taxable income derived from farming during the taxable year (as defined).

Activities not engaged in for profit.—Under present law, if an individual or a subchapter S corporation engages in an activity not for profit, no deduction (other than itemized deductions) attributable to such activity is allowable in excess of the income from that activity (sec. 183). Under those rules, an activity generally is presumed to be not engaged in for profit unless the activity generates a profit at least two years out of the most recent five-year period.

Gain from disposition of property used in farming or farm losses offsetting farm income.—Under section 1251, any person carrying on a trade or business of farming, other than any person utilizing the accrual method of accounting, is required to maintain an excess deductions account (EDA). Prior to taxable years beginning after December 31, 1975, any person having a farm net loss (the excess of farm deductions over gross income derived from farming), was obligated to add such amount to his EDA.

If, at the end of any taxable year, the EDA has a positive balance, then the amount of the EDA is reduced (1) for any farm net income (the excess of farming gross income over farm deductions for that taxable year), (2) for any amounts with respect to deductions which do not result in a tax reduction for the taxpayer, and (3) the amount realized from the sale, exchange, or involuntary conversion of farm recapture property. Farm recapture property includes depreciable personal property held for more than one year, certain cattle or horses, land held for more than one year, and unharvested crops growing on land which has been held for more than one year.

Limitation on deduction of investment interest.—In general, all interest paid or accrued during the taxable year on indebtedness is allowable as a deduction. However, if a taxpayer other than a corporation pays or accrues an amount of investment interest, then the otherwise allowable deduction with respect to that interest cannot exceed $10,000 ($5,000 in the case of a separate return by married individual), plus net investment income (sec. 163).

Imposition of tax on unrelated business income of charitable, etc. organizations.—A tax is imposed for each taxable year on the unrelated business taxable income of certain exempt organizations. The term "unrelated business taxable income" means the gross income derived by an organization from any unrelated trade or business regularly carried on by it, less deductions allowed which are directly connected with the carrying on of such trade or business. In general, all rents from real property are excluded from the computation of unrelated business taxable income.

Imposition of personal holding company tax.—A tax in addition to the regular corporate income tax is imposed on the undistributed personal holding company income of every personal holding company. This tax is equal to 50 percent of the undistributed personal holding company income. In general, a personal holding company is any corporation, other than certain specified types of corporations, at least 60 percent of the adjusted ordinary gross income of which is personal holding company income. In addition, more than 50 percent in value of the outstanding stock of a personal holding company must be owned, directly or indirectly, by 5 or fewer individuals during the last half of the taxable year. The term "personal holding company income" includes adjusted income from certain rents and royalties.

Employment tax treatment of farmers

A self-employment tax is imposed on net earnings from self-employment as defined by section 1402. Net earnings from self-employment means gross income derived by an individual from any trade or business, less allowable deductions attributable to such trade or business. Rentals from real estate including rentals paid in crop shares are excluded in determining net earnings from self-employment, unless such rentals are received in the course of a trade or business as a real estate dealer. However, this exemption does not apply to any income derived by a landlord if (1) the income is derived under an arrangement entered into between the landlord and another individual which provides for the landlord's material participation in the production or management of the production of the agricultural or horticultural commodities to be produced on the land by the individual, and (2) there is material participation by the landlord with respect to any such commodity.

Thus, income which is received by a farmer who materially participates in the production of the income is treated as self-employment income. In addition, eligibility for the earned income tax credit is determined by reference to the earnings from self-employment.

Estate tax treatment of farmers

The estate tax current use valuation provision and installment payment provisions are available only in cases where property used in an active trade or business is included in the decedent's gross estate. The current use valuation provision requires that the decedent or a member of the decedent's family have materially participated for specified periods in the farming operation in which specially valued real property was used.

The current use valuation provision permits executors of decedents whose estates are comprised largely of real property used in the trade or business of farming to elect to value the real property for estate tax purposes based upon its current use rather than its full fair market value (sec. 2032A). The installment payment provision permits similarly situated estates to pay estate tax attributable to a closely held business in installments over up to 14 years (sec. 6166). In addition, certain amounts of the tax paid in installments under section 6166 accrue interest at a special 4-percent rate rather than at the higher deficiency rate otherwise applicable when payment of a tax is delayed (sec. 6601(j)).

The 1983 Act treats land withdrawn from production under a 1983 PIK program as used in the active trade or business of farming for purposes of these two estate tax provisions. In addition, material participation in the conservation use to which land withdrawn from production under a 1983 PIK program is put is treated as material participation for purposes of the current use valuation provision's requirement that such participation in the farming operation occur.

Income tax treatment of cooperatives

A cooperative is an organization, usually operating in corporate form, which is established and operated for the mutual benefit of its members and patrons by selling goods to them or purchasing products from them and returning to them any income in excess of costs. Unlike other corporations, a cooperative is allowed a deduction from its taxable income to the extent patronage source income is distributed to its members or patrons as a patronage dividend or in redemption of a nonqualified written notice of allocation. In addition, a cooperative may exclude from gross income amounts attributable to qualified per-unit retain allocations and redemptions of nonqualified per-unit retain certificates.

Patronage dividends (whether paid in cash, qualified written notices of allocation, in redemption of nonqualified written notices of allocation, or in other property other than nonqualified written notices of allocation) are includible in the income of a member or patron when paid or allocated. In general, an amount is a patronage dividend if it is payable out of patronage source income to all patrons of the cooperative equally on the basis of business done with or for patrons.[7] A per-unit retain allocation is, in general, an amount retained by the cooperative with respect to goods marketed by the cooperative for the patron.

Patronage source income is income directly related to business done with or for patrons. Thus, for example, investment income or income derived from the sale or exchange of capital assets is nonpatronage source income. A patron is any person doing business with the cooperative on a mutual basis.

Exempt farmers' cooperatives are allowed more beneficial tax treatment than nonexempt cooperatives in two respects. First, they are allowed a deduction for dividends paid from nonpatronage source income (including income from business done with or for the United States) to their patrons (not including the United States or its agencies). Second, they are allowed a deduction for amounts paid as dividends on their capital stock during the taxable year as long as the dividends do not exceed the greater of eight percent or the legal rate of interest in the State of incorporation.

A nonexempt cooperative is any cooperative other than an exempt farmers' cooperative. Nonexempt cooperatives cannot deduct dividends of nonpatronage source income, but they are not limited in the sources or amounts of their nonpatronage source income.

Taxpayers eligible for special treatment

Only qualified taxpayers are eligible for the special treatment accorded by the 1983 Act. A qualified taxpayer is a taxpayer who is a producer (as defined in Department of Agriculture regulations) of agricultural commodities within the meaning of a 1983 PIK program and who diverts farm acreage from production and devotes such acreage to conservation uses in return for receiving a commodity under the program. Thus, a taxpayer who receives income from assignment of a PIK contract or an assignee of such a contract is not a qualified taxpayer under the Act.

Anti-speculation rule

The 1983 Act provides a special anti-speculation provision which generally limits application of the special income and estate tax treatment accorded interests in real property withdrawn from production under a PIK program and commodities received with respect to such interests to persons who owned the property on February 23, 1983.

Interests in real property acquired after February 23, 1983, and commodities received with respect to such interests, will remain eligible for the special income and estate tax treatment if—

(1) The interest is acquired by reason of death of the person who owned the interest on February 23, 1983;

(2) The interest is acquired by gift from the person who owned the interest on February 23, 1983;

[7] A patronage dividend must be payable (1) on the basis of the quantity or value of business done with or for the patron, (2) under an obligation to pay such amount which obligation existed when the cooperative received the amount, and (3) with reference to the net earnings of the cooperative from business done with or for its patrons.

(3) The interest is acquired from the person who owned it on February 23, 1983, by a person who is a member of the transferor's family; or

(4) The interest is acquired from a person who received the property in a transfer described in the above paragraphs, and, the current transfer also meets those requirements except for the fact that the current transferor did not own the interest on February 23, 1983.

Reasons for Change

The committee believes that farmers should not be discouraged from participating in the 1984 PIK program merely because of potentially adverse income and estate tax consequences. The committee is disturbed, however, over the extremely large payments received by some farmers under the 1983 PIK program. These large payments are especially disturbing in light of the General Accounting Office's determination on November 1, 1983, that payments under the Department of Agriculture's (USDA) acreage reduction programs in excess of $50,000 per farmer are not authorized under the applicable agriculture statutes.

All of these factors have led the committee to provide special tax treatment for 1984 PIK participants under modified rules. These new rules will provide tax treatment similar to that provided 1983 PIK participants only to the extent that payments received by a farmer under all USDA acreage reduction programs are determined to have been authorized under the Agriculture and Food Act of 1981. This limit on the special tax treatment applies to all PIK income with respect to which wheat would otherwise have been planted and harvested in 1984. Additionally, because the USDA has only announced a 1984 PIK program for wheat at the present time, the special tax rules provided by the committee amendment apply only with respect to that crop.

Explanation of Provisions

Overview

The bill extends to participants in the 1984 PIK program for wheat the same favorable tax treatment accorded participants in the 1983 program, with one modification. Under the committee amendment, the amount of PIK payments eligible for special income tax treatment is limited to the maximum authorized Federal acreage reduction program payments, reduced by any cash payments received by the producer under USDA acreage reduction programs. The term producer is to have the same meaning as under USDA regulations governing acreage reduction programs, as those regulations are in existence on the date of the amendment's enactment. This limit is to apply to payments received (and land withdrawn from production) with respect to crops that would have been planted and harvested during 1984 but for participation in the PIK program. Therefore, the limit does not apply with respect to winter wheat that would otherwise have been planted in 1983 but harvested during 1984 since that wheat is provided for under the 1983 Act.

Income tax treatment of farmers

Timing of income.—The bill provides that a qualified taxpayer will not be treated as having realized income when he or she receives, or has the right to receive, a commodity under a 1984 payment-in-kind program for wheat. Thus, both accrual and cash basis taxpayers can defer the recognition of income that would otherwise be recognized in the year the commodities are received, until the year the commodities are sold, exchanged, or otherwise disposed of.

For purposes of determining the gain or loss from the sale, exchange or other disposition of the commodity, the unadjusted basis of the commodity will be zero. The commodity will be treated as produced by the taxpayer for purposes of determining the character of the gain (ordinary income or capital gain) from the sale of the commodity.

In cases where a CCC loan is involved, the committee understands that the payment-in-kind of a commodity to a taxpayer is to be achieved by a 3-step process: the repayment by the taxpayer of the loan from the CCC, the purchase by the CCC of the commodity securing the loan at the redemption price of the loan, followed by the receipt of the commodity by the taxpayer as a payment-in-kind. In any such case, the taxpayer who receives the commodity as payment-in-kind (in the third step of this 3-step process) will be entitled to the same tax treatment on such receipt as a taxpayer who receives a payment-in-kind where a CCC loan is not involved.

If the taxpayer has made an election under section 77 to recognize income in the year the CCC loan proceeds were received, the repayment of the loan and the purchase by the CCC of the commodity (the first and second steps of the 3-step process) will be treated by the taxpayer as a purchase of the commodity at an amount equal to the then outstanding balance of the loan (the original amount of the loan plus interest and storage costs) followed by a sale to the CCC at the same amount. Thus, the taxpayer will be allowed a deduction for the accrued interest and storage costs and must recognize in income an equal amount which represents the difference between then outstanding balance of the loan and the taxpayer's basis.

In the case of a taxpayer who has not made an election under section 77, the repayment of the CCC loan and the purchase by the CCC of the commodity securing the loan (the first and second steps of the 3-step process) will be treated by the taxpayer as a repayment of the then outstanding balance of the loan (the original amount of the loan plus interest and storage costs) followed by a sale to the CCC at the same amount. Thus, the taxpayer will be allowed a deduction for the accrued interest and storage costs and will recognize in income an amount equal to the then outstanding balance of the loan.

Other income tax provisions.—Under the bill, for all purposes of the Internal Revenue Code, income from the sale or exchange of PIK commodities will be treated as income from the trade or business of farming and the taxpayer will be treated as using in the trade or business of farming any land diverted from production under the 1984 PIK program for wheat. Thus, income with respect to the sale or exchange of wheat received under the 1984 PIK program will be treated as gross income from farming for all purposes of the Code, including (but not limited to):

(1) payments of estimated tax;

(2) method of accounting by corporations engaged in farming;

(3) expensing of certain soil and water conservation expenditures;

(4) expensing of certain expenditures by farmers for fertilizer;

(5) expensing of certain expenditures by farmers for clearing land;

(6) deductibility of expenses attributable to activities not engaged in for profit;

(7) gain from disposition of property used in farming or farm losses offsetting farm income;

(8) limitation on deduction of investment interest;

(9) tax on unrelated business income of charitable, etc., organizations; and

(10) tax on personal holding companies.

Employment tax treatment of farmers

Under the bill, income from the sale or exchange of wheat received in the 1984 PIK program will be subject to the tax on net earnings from self-employment for any individual who materially participates in the diversion and devotion to conservation uses of the PIK program.

Estate tax treatment of farmers

Current use valuation (Code sec. 2032A).—The bill provides that real property removed from production under a 1984 PIK program will be treated as used in an active farming (i.e., qualified) use for purposes of the estate tax current use valuation provision.

The bill also provides that, in the case of property removed from production under the 1984 wheat PIK program, the material participation requirements of the current use valuation provision will be satisfied if an individual otherwise required to materially participate in the active farming use of specially valued real property materially participates in the conservation use to which the property is devoted.

Installment payment of estate tax (Code sec. 6166).—The bill provides that real property withdrawn from production under a 1984 PIK program that was used in the conduct of an active trade or business before being so withdrawn will be treated as used in such trade or business. Therefore, in determining whether at least 35 percent of the value of an individual's adjusted gross estate consists of the value of an interest in a closely held business, real property withdrawn from production under the 1984 PIK program will be treated as used in the closely held business. Similarly, such property will be treated as used in an active trade or business in determining whether an individual's interest in such a business is an interest in a closely held business within the meaning of the installment payment provision.

In adopting these rules, the committee does not intend generally to change the present law rules governing the type of business which constitutes an active trade or business under the installment payment provision. Instead, the provisions of the bill merely treats real property withdrawn from production under the 1984 PIK program which is part of a business that otherwise qualifies for the installment payment provision as continuing to be used in such business.

No inference as to diversion programs other than programs involving a payment-in-kind.—These estate tax provisions of the bill apply only to real property withdrawn from production under the 1984 PIK program, i.e., a program under which a payment of commodities is made. The committee is aware that the Federal Government also conducts other farm real property diversion programs. The committee understands that, at the present time, these other programs either provide for cash payments in exchange for withdrawal of the property from production or require withdrawal of the property from production as a condition of eligibility for price support payments.

The committee intends that no inference be drawn that real property diverted from production under other Federal Government farmland removal programs is, or is not, used in the active business of farming from the fact that the bill only applies to real property withdrawn from production under the 1984 PIK program.

Income tax treatment of cooperatives

As was true under the 1983 PIK tax rules, PIK wheat received by a cooperative on behalf of a member or patron who is a qualified taxpayer is treated as (1) produced by that member or patron in his or her business of farming and (2) received by the cooperative from the member or patron.

Taxpayers eligible for special tax treatment

As under the 1983 PIK rules, only qualified taxpayers are eligible for the special tax treatment provided by the committee amendment. A qualified taxpayer is any taxpayer who meets the following two requirements. First, the taxpayer must be a producer (as defined in the Department of Agriculture regulations) of wheat. Second, the taxpayer must divert farm acreage from production and devote such acreage to conservation uses in return for receiving any commodity under the 1983 payment-in-kind programs.

The committee understands that, for purposes of the requirement that a person divert acreage from production and devote such acreage to conservation uses, the term "person" includes not only the person who actually diverts the acreage from production (such as a land owner) but also any other producer who receives a payment-in-kind with respect to such acreage (such as a sharecropper).

An assignee of a PIK contract or a producer receiving a payment for assignment of such a contract is not a qualified taxpayer.

Anti-speculation rule

To prevent speculation in farm land as a result of a PIK program, the bill retains for the 1984 PIK program the special anti-speculation rule that generally limits application of the special income and estate tax treatment accorded interests in property withdrawn from production to persons who owned the withdrawn property on February 23, 1983. Certain property interests acquired by reason of death, gift, or otherwise from a family member continue to qualify for the special treatment after the interests are transferred.

Determination of maximum amount of authorized payments and limitation of special tax treatment

As stated in the explanation of the PIK program, USDA in a published regulation and GAO in a General Counsel's opinion have reached conflicting results on the maximum authorized payments per producer under Federal acreage reduction programs. The special tax provisions provided by the bill for the 1984 wheat program apply only to legally authorized payments. To facilitate a determination of whether acreage reduction payments in excess of $50,000 generally are authorized by law if the excess amounts are paid in kind rather than in cash, the bill directs the Comptroller General to seek a declaratory judgment in the U.S. District Court for the District of Columbia. This proceeding is to be commenced within 60 days of the date of enactment of the bill.

If the court determines that the $50,000 limit on acreage reduction payments applies both to cash and in kind payments, producers will not be eligible for the special income tax treatment provided for the 1984 wheat program by the amendment to the extent that they receive acreage reduction payments in excess of $50,000. In such cases, PIK payments eligible for the special tax treatment will be equal to the excess of the maximum authorized acreage reduction payment over the amount of such cash payments received by the producer. For purposes of this determination, the value of in kind commodities will be equal to their fair market value (based upon the value of like commodities in the locality of the recipient's farm) on the date of receipt (or constructive receipt).

The bill also provides that the income tax treatment of cooperatives is not to be affected by any determination in the declaratory judgment proceeding (i.e., as a result of disqualification of any PIK payment accepted by the cooperative on behalf of a member or patron). Also, availability of the special estate tax provisions (secs. 2032A and 6166) is not to be affected.

The special tax treatment previously accorded participants in the 1983 PIK program (including that accorded producers of winter wheat that would be planted in 1983 and harvested in 1984 but for PIK participation) is not to be affected by any court decision as to whether payments over $50,000 made in the 1983 program were authorized by applicable agriculture acts. This is true even though the holding of the court may be that the payments were not authorized by the applicable agriculture acts.

Effective Date

The income tax provisions of the bill apply to wheat payments received in the 1984 PIK program; the estate tax amendments apply to land withdrawn from production in that program.

Revenue Effect

Based upon information provided by the Department of Agriculture, the bill is estimated to reduce fiscal year budget receipts by $7 million in 1984, and by $8 million in 1985. Fiscal year budget receipts are estimated to increase by $15 million in 1986, and by a negligible amount in 1987.

6. Acquisition Indebtedness of Certain Educational Institutions and Certain Corporations Managing Property for Tax-exempt Organizations; Tax-exemption for Such Corporations (sec. 865 of the bill and secs. 501 and 514 of the Code)

Present Law

Unrelated business income tax on debt-financed property

Under present law, any qualified pension trust or organization that is otherwise exempt from Federal income tax generally is taxed on income from trades or businesses that are unrelated to the organization's exempt purposes (Code sec. 511). Specific exclusions are provided for certain types of income, including rents, royalties, dividends, and interest.

Present law (sec. 514(a)) provides that an exempt organization's income from "debt-financed property" generally is subject to tax as unrelated business income in the proportion in which the property is financed by debt. Debt-financed property is defined as any property held to produce income with respect to which there is acquisition indebtedness at any time during the taxable year, or during the 12 months prior to disposition if the property is disposed of during the taxable year (sec. 514(b)). A debt constitutes acquisition indebtedness if the debt was incurred in acquiring or improving the property, or if the debt would not have been incurred but for the acquisition or improvement of the property (sec. 514(c)).

Present law provides an exception to the rule requiring taxation of debt-financed property. Under this exception, indebtedness incurred by a qualified pension trust as a result of the acquisition or improvement of real property is not considered "acquisition indebtedness" (sec. 514(c) (9)). Thus, income or gain received from, or with respect to, such debt-financed real property is not treated as income from debt-financed property. However, this exception does not apply if any of the following conditions are not met: (1) if the acquisition price is not a fixed amount determined as of the date of acquisition; (2) if the amount of the indebtedness, or the amount payable thereon, or the time for making any payments, is dependent (in whole or in part) upon revenues derived from the property; (3) if the property is leased by the qualified pension trust to the seller or a person related to the seller; (4) if the property is acquired by the qualified trust from a person related to the plan under which the trust is formed or if such property is leased to such a related person; and (5) if the seller, a person related to the seller, or a person related to the plan provides nonrecourse financing for the transaction, and the debt is subordinate to any other indebtedness on the property or the debt bears a less than arm's-length interest rate.

Title holding corporations

Under present law, a corporation that is organized for the exclusive purpose of holding title to property, collecting income therefrom, and distributing the income (less expenses) to a tax-exempt organization is itself exempt from Federal income tax (Code sec. 501(c)(2)). Present law is unclear whether an exempt title holding company may have more than one parent. The Internal Revenue Service has taken the position, in a General Counsel Memorandum (G.C.M. 37351, December 20, 1977) that this provision means that the title holding corporation may distribute income only to one or more related tax-exempt organizations.

Reasons for Change

The committee believes that it is appropriate to extend the special exception for debt-financed property held by a qualified trust to similar property held by an educational organization or a tax-exempt title holding company that meets certain requirements. However, the committee feels that this exemption should be extended only if certain of the present law requirements are expanded.

Currently, small tax-exempt organizations are precluded from investing in real estate because of the large capital requirements for real estate investments. The committee believes that it is desirable to permit these organizations to pool their resources in order to invest in real estate.

Explanation of Provisions

a. Exception from debt-financed property rules

Under the bill, the present law exception to the debt-financed property rules for real property of a qualified pension trust is extended to certain educational institutions (and certain affiliated support organizations) and to the tax-exempt title holding corporations that are described below. This exception does not apply to any organization (including a qualified pension trust) if (1) the acquisition price is not a fixed amount determined as of the date of acquistition, (2) the amount of the indebtedness, or the amount payable thereon, or the time for making any payments, is dependent (in whole or in part) on the future revenues derived from the property, (3) if the property is leased by a qualifying organization to the seller or a person related to the seller, (4) if the property is acquired by a qualified pension trust from a person related to the plan under which the trust is formed or if such property is leased to such a related person, (5) if the property is acquired by a title holding company from a person who is a disqualified person with respect to a private foundation that is a shareholder or beneficiary of the title holding company or if such property is leased from a disqualified person, or (6) if the seller or a person related to the seller provides financing in connection with the acquisition. In addition, the exception does not apply if the real property is acquired or held by a partnership and any of the partners (whether general or limited) is not an organization that is entitled to this exception from the debt-financed property rules.

b. Title holding corporations

Under the bill, tax exemption is provided to any corporation or trust that is organized for the exclusive purposes of acquiring and holding title to property, collecting income from the property, and remitting the income to certain tax-exempt organizations. This tax exemption applies only if no individual (including a partner, director, officer, or person in a similar position) of an organization that is providing investment advice to the title holding company is an officer of, member of the board of directors of, or an individual with a similar position in the title holding company. A trust that meets all of the requirements of these title holding corporations may also be entitled to use the exception from the exception from the debt-financed property rules for real property.

Organizations eligible to invest in a title holding corporation include (1) a qualified pension, profit-sharing, or stock bonus plan, (2) a governmental pension plan (sec. 414(d)), (3) the United States, or any State or political subdivision, or (4) any charitable organization described in section 501(c)(3).

The provision does not change present law with respect to organizations described in sec. 501(c)(2).

Effective Dates

The provision with respect to the special exception for debt-financed real property is effective for indebtedness incurred after the date of enactment. The effective date of the provisions relating to title holding companies is taxable years beginning after December 31, 1984.

Revenue Effect

These provisions will reduce fiscal year budget receipts by $24 million in 1984, $46 million in 1985, $58 million in 1986, $73 million in 1987, $91 million in 1988, and $114 million in 1989.

7. Physicians' and Surgeons' Mutual Protection Association (sec. 866 of the bill and sec. 821 of the Code)

Present Law

Taxation of mutual insurance companies

In general, the gross income of a mutual insurance company (other than a life insurance company) includes gross premiums and other consideration, gross investment income, and gain from the sale or other disposition of property. Present law provides a specific deduction for dividends and similar distributions paid to policyholders in their capacity as such.

In the case of nonmutual corporations, gross income does not include any contribution to capital (sec. 118). However, the provisions covering the taxation of nonlife mutual insurance companies have no specific provisions regarding paid in capital or the distribution of such capital.

Taxation of members of mutual insurance companies

Under present law, premiums for liability insurance in carrying on any trade or business are deductible in the year they are paid or incurred. For example, premiums paid by a physician for medical malpractice insurance generally are deductible. However, no deduction is allowed as an expense paid or incurred during the taxable year for a contribution to capital.

Reasons for Change

Although medical malpractice insurance has been available from independent commercial insurers, mutual malpractice insurance associations have been organized and operated by doctors within the last 20 years as a form of broad-based mutual self-insurance in an effort to provide low cost medical malpractice insurance for its members. Currently, over half the medical malpractice insurance is provided by these associations.

Generally, the "capital surplus" of a mutual insurance company is derived from the payment of premiums. Amounts collected in excess of the amount needed annually to cover the cost of insurance may be retained in surplus by the company or may be paid out to policyholders as policyholder dividends. However, in the case of these mutual malpractice insurance associations, the associations often require that a member policyholder make an initial payment of capital upon joining in addition to the annual premium charged for the medical malpractice coverage, in order to have sufficient capital surplus for the insurance written. Unless the surplus gained from the initial payments of capital has been used (for example, to cover extraordinary losses suffered by the association), the initial payment of capital often is refunded (in whole or in part) when a policyholder terminates membership in the association.

A mutual insurance company, by definition, does not have shareholders but is owned by its policyholders or members. As a result, the committee understands that the tax treatment of the initial payments of capital in operating these mutual medical malpractice associations may be unclear for both the company and the policyholder. Because of the social benefit that can arise from the efficient operation and provision of low cost medical malpractice insurance, the committee believes that special tax provisions for the operation of such associations is appropriate. The special tax provisions will apply only to associations already in operation, because the committee understands that new associations can structure themselves to avoid the necessity for payments of capital.

Explanation of Provision

The bill provides special rules for the tax treatment of certain physicians' and surgeons' mutual protection and indemnity associations. Under these rules, the gross income of such associations will not include any payment made by a member as an initial payment (or capital contribution) upon joining the association, if the payment does not release the member from obligations to pay current or future dues, assessments or premiums, and if the initial payment is a condition precedent to receiving benefits of membership. Any repayment of an amount so excluded will not be deductable (as a policyholder dividend or otherwise) by the association. For purposes of determining whether such an amount has been repaid, all amounts distributed to policyholders will be treated as paid first out of capital surplus in excess of amounts excluded as initial payments of capital; this ordering rule will not apply in the case of the termination of a member's interest in the association.

The new rules for exclusion of initial payments of capital from the income of the association will not apply to the extent the member makes an election to treat the initial payment as a trade or business expense. Generally, a member making the election will be able to deduct the initial payment of capital (or portion thereof) during each of the first 6 years of membership, to the extent the annual premium that would be payable to an independent insurance company for similar coverage exceeds the dues, assessments, or premiums paid during the taxable year to the association. The election must be made upon joining the association, with notice to and the consent of the association, and in the manner provided for by the Secretary of the Treasury. In addition, any refunded amounts of the deducted portion of the initial payment of capital will be included in the gross income of the member when received. Also, the bill provides for limited retroactive application of the election provision.

The special rules for physicians' and surgeons' mutual protection and indemnity associations will apply only to those organizations that were operating and providing medical malpractice liability protection under State laws prior to January 1, 1984. For these purposes, a physicians' and surgeons' mutual protection and indemnity association is a mutual insurance association that provides solely medical malpractice liability protection for its members.

Effective Date

The provision applies to payments made to, and receipts of, mutual protection and indemnity associations, and refunds of payments by such associations, after the date of enactment.

Revenue Effect

This provision will reduce fiscal budget receipts less than $5 million annually.

8. Sale-leasebacks of Principal Residences (sec. 867 of the bill and secs. 72, 121, 167, 183 and 453 and new sec. 121A of the Code)

Present Law

Overview

A sale-leaseback is a transaction in which the owner of property sells the property and then leases it back from the purchaser. In general, if a valid sale-leaseback occurs, the purchaser-lessor is entitled to depreciate the cost basis of the property and to deduct any property taxes and any interest paid or accrued on indebtedness incurred to purchase the property. If the seller-lessee uses the property in a trade or business or holds the property for the production of income, he or she may deduct rents paid to the lessor.

Under present law, it is possible for a homeowner to make a sale-leaseback of his or her principal residence that will be recognized for tax purposes. If the transaction is so recognized, the sale and the leaseback are treated as separate transactions, and the purchaser-lessor will generally be entitled to the tax benefits that flow from ownership of property (*e.g.*, deductibility of depreciation and expenses incurred in connection with the ownership and operation of the property). If the sale-leaseback is not entered into by the purchaser-lessor for profit, however, depreciation and expense deductions may be limited.[1]

Whether a sale-leaseback transaction will be respected for tax purposes is largely a question of fact. Some of the relevant factors include whether (1) the sale price equals the property's fair market value, (2) a reasonable rate of interest is charged on any purchase money indebtedness, (3) the rent equals the fair rental value of the property for the term of the lease and any renewals, (4) the benefits and burdens of ownership fall on the purchaser-lessor (and not on the seller-lessee as, for example, with a repurchase option at a fixed price), (5) the parties intend a sale-leaseback (as opposed to a mere purchase option, financing device, or tax-avoidance scheme), and (6) the transaction is structured as a sale-leaseback (as a opposed to a sale of a remainder interest only or some other transaction).[2]

A sale at less than fair market value, or a lease at less than fair rental value, will not necessarily render a sale-leaseback transac-

[1] If an individual or an S corporation engages in an activity not for profit, no deductions (other than for interest and taxes) attributable to such activity are allowable in excess of the gross income from the activity less interest and taxes attributable to the activity (sec. 183). The Tax Court has held that the purchase and leaseback of a principal residence in a sale-leaseback can be a transaction entered into for profit by the purchaser. *Langford* v. *Commissioner*, 42 T.C.M. 1160 (1981).

[2] Although a sale of a remainder interest in property may in substance resemble a sale-leaseback, the purchaser of a remainder interest is not entitled to depreciate the property. Rather, the entire depreciable interest is deemed to remain with the holder of the life estate (sec. 167(h)).

tion invalid for tax purposes. Such a discounted purchase price or discounted rentals may, however, be treated as a payment to the benefited party. Thus, if a homeowner engages in a sale-leaseback of a principal residence and discounts the sale price in return for a less than fair market rental, the homeowner could be deemed to have received a fair market value sale price and to have prepaid the difference between the discounted value of the rent actually payable and the discounted value of a fair market rental on the property.[3]

Exclusion from gross income of proceeds from sale of principal residence by seller 55 or older

Under present law, a taxpayer may elect to exclude from gross income up to $125,000 ($62,500 in the case of a married individual filing a separate return) of any gain realized on the sale or exchange of the taxpayer's principal residence (sec. 121). This one-time election is available only if the taxpayer has attained the age of 55 before the date of the sale or exchange, and only if the property sold was owned and used by the taxpayer as his or her principal residence for periods aggregating at least 3 years during a 5-year period ending on the date of the sale or exchange.

The sale by a taxpayer of his or her principal residence in a valid sale-leaseback transaction will generally qualify under section 121.

Installment sales

In general, the sale by a taxpayer of his or her principal residence may be reported as an installment sale. Subject to certain exceptions, a sale is an installment sale if at least one payment is to be received after the close of the taxable year in which the sale (or other disposition) occurs. If a sale is an installment sale, any gain on the sale is recognized by the seller on a deferred basis, as payments are received. Nonetheless, the purchaser is generally entitled to commence depreciating the entire cost of the property immediately.

In general, the term "payment" under the installment sales provisions does not include receipt of an evidence of indebtedness of the purchaser. However, payment generally does include receipt of an evidence of indebtedness of a person other than the purchaser.

The installment sale rules may also apply to contingent payment sales. A contingent payment sale is any sale or other disposition of property in which the aggregate purchase price cannot be determined at the close of the taxable year in which the sale or other disposition occurs. Under present law, if all or a portion of the purchase price consists of an annuity, the annuity may (depending upon its terms) be viewed as a payment to the extent of its fair market value in the year of receipt. However, if the purchaser is the issuer of the annuity, the transaction could be viewed as a contingent payment sale.

[3] Compare *Alstores Realty Corp.* v. *Commissioner,* 46 T.C. 363 (1966), acq. 1967-2 C.B. 1, and *Giberson* v. *Commissioner,* 44 T.C.M. 154 (1982), with Rev. Rul. 77-413, 1977-2 C.B. 298.

Reasons for Change

Because the determination of the validity of a sale-leaseback is such a highly factual one, it is often difficult for homeowners and purchasers to know whether the transaction will be respected for Federal income tax purposes. The committee believes that in the case of older taxpayers, who may wish to realize the equity built up in their homes without immediately relinquishing their occupancy rights, it is appropriate to provide greater certainty as to the tax consequences of a sale-leaseback of a principal residence.

Explanation of Provision

The bill establishes a safe harbor and certain tax benefits for certain homeowner sale-leaseback transactions.

Definition of sale-leaseback

The bill applies to sale-leaseback transactions that meet certain requirements. As under section 121, the seller-lessee must have attained the age of 55 before the date of the transaction. In addition, the property must have been owned and used by the seller-lessee as his or her principal residence for at least 3 of the 5 immediately preceding years and never have been depreciable property in his or her hands. The sale price must be a fair market value amount, taking into account the burden of the lease on the property. The seller-lessee must retain occupancy rights in the property pursuant to a written lease requiring the payment of a fair rent. Finally, the purchaser-lessor must be a person who is entitled to the benefits, and contractually responsible for the risks and burdens, of ownership after the date of the transaction. For example, the seller-lessee may not be granted an option to repurchase the property for less than its fair market value (determined without regard to the lease).

The bill does not apply to sale-leasebacks involving related parties (as defined in sec. 267(b)) or to sale-leasebacks in which the purchaser-lessor is a tax shelter. A tax shelter for this purpose means (1) a partnership or other enterprise (other than a corporation which is not an S corporation) in which interests have been offered for sale, at any time, in an offering required to be registered with a Federal or State agency, (2) a partnership or other enterprise if more than 35 percent of the losses are allocable to limited partners or limited entrepreneurs (generally, investors who do not actively participate in the management of the enterprise), or (3) any partnership, entity, plan, or arrangement which is a tax shelter within the meaning of section 6661(b) (i.e., the principal purpose of which is the avoidance or evasion of Federal income tax). The committee intends that an offering required to be registered with any Federal or State agency will include any offering filed with such an agency, or with respect to which such an agency is given notice.

The term "occupancy rights" as used in the bill means the right to occupy the property for any period of time, including a period of time measured by the life of the seller-lessee (or the joint life expectancies of the seller-lessees in the case of jointly-held occupancy rights) on the date of the transaction.

The adequacy of the rent provided in the lease is determined only with respect to the initial year, without regard to its reasonableness in future periods. That is, if the annual rent is a fair market value amount for the initial year of the lease, it need not increase in later years to take into account inflation, increases in taxes, or other factors which normally influence the amount of rent charged for real property, provided it remains at least equal to fair rental value in the initial year. However, annual rent in later years generally is not to exceed fair rental value at that time.

Treatment of transactions

Exclusion from gross income and amount realized.—Under the bill, a sale or exchange for purposes of section 121 includes the sale of a principal residence in a sale-leaseback transaction under the bill. Thus, a qualified seller may elect to exclude from gross income up to $125,000 of gain from the sale or exchange.

The bill also adds new section 121A to the Code. Under this provision, the excess of the fair market value of any occupancy rights reserved or retained by the seller in a sale-leaseback under the bill over the rent charged under the lease is excluded from the gross income of the seller. Furthermore, none of such excess is included as an amount realized on the sale under section 1001. Finally, any rent discount is excluded from the gross income of the purchaser.

Application of installment sale provisions.—The bill provides a special rule for certain cases in which part or all of the consideration paid to the seller-lessee in a sale-leaseback under the bill is in the form of an annuity. In the case of an annuity purchased by the purchaser-lessor for the seller-lessee from a third party, the cost to the purchaser of the annuity is deemed to be received by the seller in the year of the sale, even if payments on the annuity are deferred and contingent. If the seller-lessee receives such an annuity, the amount paid by the purchaser-lessor for the annuity is treated as an investment by the seller-lessee in the annuity contract for purposes of section 72.

Depreciation and expense deductions by purchaser-lessor.—The purchaser-lessor will be entitled to claim depreciation on the property as if he or she is the sole owner. However, depreciation must be computed using the straight-line method and a 40-year useful life.

Any sale-leaseback transaction covered by the bill, for purposes of section 183, will be presumed to be one engaged in for profit unless the Secretary of the Treasury establishes to the contrary.

The sale-leaseback safe harbor provided in the bill is not intended to create any inference as to the correct tax characterization or treatment of any transactions falling outside the provision or entered into prior to the date of enactment.

Effective Date

The provisions apply to sales or exchanges after the date of enactment, in taxable years ending after such date. However the provisions do not apply to transactions entered into after December 31, 1988.

Revenue Effect

This provision will decrease fiscal year budget receipts by $6 million in 1985, $20 million in 1986, $35 million in 1987, $56 million in 1988, and $84 million in 1989.

9. Changes in the Earned Income Credit (sec. 868 of the bill and secs. 43 and 3507 of the Code)

Present Law

An eligible individual is allowed a refundable tax credit equal to 10 percent of the first $5,000 of earned income (for a maximum credit of $500). The credit is refunded to the individual to the extent it exceeds tax liability. The maximum allowable credit is phased down as income rises above $6,000. Specifically, the allowable earned income credit for any taxable year is limited to the excess of $500 over 12.5 percent of the excess of adjusted gross income (or, if greater, earned income) over $6,000. Thus, the credit is zero for families with incomes over $10,000. The particular amount of any eligible individual's credit is determined under tables prescribed by the Secretary of the Treasury. In addition, eligible individuals may receive the benefit of the credit in their paychecks throughout the year by electing advance payments.

Earned income eligible for the credit includes all wages, salaries, tips, and other employee compensation, plus net earnings from self-employment. Amounts received as pension or annuity benefits may not be taken into account for purposes of the credit, nor is the credit available with respect to income of nonresident alien individuals which is not connected with a U.S. trade or business. For purposes of the credit, earned income is computed without regard to State community property laws.

Individuals eligible for the credit are married individuals filing joint returns who are entitled to a dependency exemption for a child, surviving spouses (who, by definition, must maintain a household for a dependent child), and heads of households who maintain a household for a child. In each case, for a taxpayer to qualify for the credit, the child must reside with the taxpayer in the United States. Furthermore, in order to claim the credit, an individual must not claim benefits under Code section 911 (relating to income earned by, and housing costs of, U.S. citizens and residents living abroad), or section 931 (relating to income from sources within possessions of the United States). No credit is allowed for a taxable year of less than 12 months unless the taxable year was closed by reason of the taxpayer's death.

The credit was originally enacted in 1975.

Reasons for Change

The committee believes that the earned income credit is an effective way to provide relief from social security and income taxes to low-income families who might otherwise need large welfare payments. The credit was last increased in 1978. The zero bracket amount, which also effectively provides tax relief to low-income families, likewise has not been increased since 1978.

Because the purpose of the credit has been in part to offset social security taxes, and, thus, to provide a work incentive, the committee believes it appropriate to increase the amount of the credit to take into account increases in social security taxes since 1978. Thus, the committee has decided that the rate of the credit should be increased from 10 percent to 10.5 percent. In addition, in order to provide some compensation for inflation since 1978, the committee has decided to raise the income level at which the credit is fully phased out from $ 10,000 to $11,000.

Explanation of Provision

Under the bill, an eligible individual will be allowed a refundable credit against tax equal to 10.5 percent of the first $5,000 of earned income. Thus, the maximum allowable earned income credit will be $525. This amount will be phased down as income rises above $6,000. Specifically, the allowable earned income credit for any taxable year will be limited to the excess of $525 over 10.5 percent of the excess of adjusted gross income (or, if greater, earned income) over $6,000. Thus, the credit will not be available to individuals with incomes over $11,000. Conforming changes are made in the tables used for advance payments of the credit.

Effective Date

The changes in the earned income credit will be effective for taxable years beginning after December 31, 1984.

Revenue Effect

This provision is estimated to increase outlays and reduce fiscal year receipts by $8 million in 1985, $222 million in 1986, $205 million in 1987, $187 million in 1988, and $173 million in 1989. (To the extent that the earned income credit exceeds tax liability, it is treated as an outlay under budget procedures.)

10. Shore-based Fishery Processing Facilities (sec. 869 of the bill and sec. 46(g) of the Code and sec. 607 of the Merchant Marine Act)

Present Law

The Merchant Marine Act

The Merchant Marine Act, as amended (the Act), porovides certain Federal income tax incentives for U.S. taxpayers owning or leasing vessels operating in the foreign or domestic commerce of the U.S. or in U.S. fisheries (46 U.S.C. sec. 1177).

In general, such taxpayers are entitled to deduct from income certain amounts deposited in a capital construction fund pursuant to certain agreements. Furthermore, earnings from the investment or reinvestment of amounts in such a fund are excluded from income. The purpose of the Act is to provide a tax inducement to aid the U.S. shipping and shipbuilding industries.

A nonqualified withdrawal of previously deducted or excluded monies by a taxpayer from such a fund will generate income to the taxpayer. However, a qualified withdrawal will not. A qualified withdrawal is a withdrawal, made in accordance with the terms of the applicable agreement, which is for the acquisition, construction, or reconstruction of a qualified vessel or for the payment of principal on indebtedness incurred in connection with the acquisition, construction, or reconstruction of a qualified vessel. A qualified vessel is a vessel (including barges and containers which are part of the complement therefor) constructed or reconstructed in the U.S. and documented under U.S. laws which is to be operated in the U.S. foreign, Great Lakes, or noncontiguous domestic trade or in U.S. fisheries.

Cost recovery

Since the Act provides for the deduction (or exclusion) of certain amounts deposited in a capital construction fund and their tax-free withdrawal in the case of a qualified withdrawal, the Act also requires a reduction in the tax basis of the qualified vessel in an amount based on the amount of funds withdrawn. Without that rule, a taxpayer would be entitled to cost recovery deductions with respect to amounts the taxpayer had already deducted from (or never included in) income.

Investment tax credit

In general, the amount of investment tax credit for eligible new property (new section 38 property) is determined with reference to the basis of such property to the taxpayer. Under Treasury regulations, if the basis of new section 38 property is reduced, for example, as a result of a refund of part of the cost of the property, then investment credit is recaptured (Treas. reg. sec. 1.47-2(a)(1)).

Prior to 1976, the law made no explicit provision for the effect of the Act's basis reduction rules on the amount of investment credit to be allowed with respect to a qualified vessel constituting new section 38 property which was financed in whole or in part by qualified withdrawals from a capital construction fund. However, the Tax Reform Act of 1976 provided, only for purposes of determining the investment credit, that basis is to be reduced by not more than 50 percent of the amount of a qualified withdrawal of previously deducted or excluded funds (sec. 46(g)). That rule was made applicable with respect to investment credits claimed in years beginning after 1975. However, section 46(g)(3) and its legislative history make it clear that the new rule established only a floor for, and not a ceiling on, the amount of basis which a qualified vessel would be treated as having for investment credit purposes. In other words, after the Tax Reform Act of 1976, a taxpayer could seek to establish that no investment credit should be lost merely because a qualified withdrawal of previously deducted or excluded funds had been used in financing the acquisition, construction, or reconstruction of a qualified vessel.

Reasons for Change

The United States suffers from a $3 billion annual trade deficit for fishery products. This trade deficit is due to insufficiencies in U.S. fish processing facilities rather than a lack of available fish or a deficiency in our harvesting capacity. U.S. processors have not expanded or modernized their facilities to handle the type and volume of fish available.

The current capital construction fund program has greatly contributed to modernizing and expanding the capacity of the U.S. fishing fleet. Improved fishery processing facilities are vital to U.S. efforts to utilize our fishery resources and to reduce this portion of our annual trade deficit. By extending the benefits of the capital construction fund program to domestic on-shore fishery processing facilities, the committee believes the necessary capital improvements in the processing industry will be stimulated.

Explanation of Provision

The bill generally makes the benefits of the Act available to U.S. citizens (including, in some cases, citizens of the Northern Mariana Islands) owning or leasing a fishery facility in the United States. In addition, the bill generally extends the Act by providing that a withdrawal from a capital construction fund which is used for the acquisition, construction, or reconstruction (not including routine minor repair and maintenance) of a qualified fishery facility is to be treated as a qualified withdrawal. With respect to the reconstruction of a qualified fishing vessel or qualified fishery facility, the taxpayer is not to be required to make any minimum withdrawal.

A fishery facility is to be defined as in 46 U.S.C. 1271(k). In general, a fishery facility includes land, structures (including appurtenances thereto), and equipment used for the unloading and receiving from vessels, the processing, the holding, and the distribution of fish from fisheries. In general, to be a qualified fishery facility, a fishing facility must, among other things, be located in the United States, American Samoa, the Virgin Islands, the Northern Mariana Islands, Guam, or any other commonwealth, territory, or possession of the United States, e.g., Puerto Rico.

The bill also provides that the rules of section 46(g) (relating to the investment credit with respect to qualified withdrawals from capital construction funds for qualified vessels) are to apply to qualified withdrawals from capital construction funds for qualified fishery facilities.

No inference is intended as to which Senate committee has jurisdiction of the subject matter of the provision.

Effective Date

The provisions are effective upon enactment.

Revenue Effect

This provision will decrease fiscal year budget receipts by $14 million in 1984, $24 million in 1985, $20 million in 1986, $16 million in 1987, $14 million, and $15 million in 1989.

Revenue Effect

This provision will decrease fiscal year budget receipts by $6 million in 1985, $20 million in 1986, $35 million in 1987, $56 million in 1988, and $84 million in 1989.

11. Treatment of Certain Motor Vehicle Operating Agreements as Leases (sec. 23 of the bill and sec. 7701 of the Code)

Present Law

Treatment of leases

Cost recovery (ACRS) deductions and investment credits are allowed for property that is used for a business or other income-producing purpose. These tax benefits generally are allowed only to the person who is, in substance, the owner of the property.

If the property is used in a transaction that is considered a lease for Federal income tax purposes, the lessor is treated as the owner, entitled to ACRS deductions and investment credits. If the property is used in a transaction that is considered a financing arrangement or conditional sale, the user of the property is considered the owner for tax purposes.

In general, the determination of whether a transaction is a lease or a conditional sale requires a case-by-case analysis of all facts and circumstances. Although the determination of whether a transaction is a lease is inherently factual, a series of general principles has been developed in court cases, revenue rulings, and revenue procedures. Under these general principles, the lessor must show that the property is being used for a business or other income-producing purpose. To establish a business or other income-producing purpose, the lessor must have a reasonable expectation of deriving a profit from the transaction, independent of tax benefits. See *Hilton* v. *Comm'r,* 74 T.C. 305 (1980), *aff'd,* 671 F.2d 316 99th Cir. (1982). This requirement precludes lease treatment for a transaction that is intended merely to reduce the user's costs by utilizing the lessor's tax base.

However, the fact that the lessor can show a business or other income-producing purpose does not automatically result in lease treatment, since a profit motive also exists in a financing arrangement. In addition, the lessor has to retain meaningful benefits and burdens of ownership. See *Frank Lyon Co.* v. *U.S.* 435 U.S. 561 (1978) *rev'g* 536 F.2d 746 (8th Cir. 1976). Thus, lease treatment may be denied if the user of the property has an option to purchase the property at the end of the lease term for a price that is nominal in relation to the value of the property at the time of exercise (as determined at the time the parties entered into the transaction), or for a price that is relatively small when compared with the total payments required to be made. See Rev. Rul. 55-540, 1955-2 C.B. 39 (and cases cited therein).

If the residual value to the lessor is nominal, the lessor may be viewed as having transferred full ownership of the property for the rental fee. If the price under a purchase option is more than nominal but low in comparison to fair market value, the lessor may be viewed as having transferred full ownership because of the likelihood that the lessee will exercise the bargain purchase option. See *M&W Gear Co.* v. *Comm'r,* 446 F.2d 841 (7th Cir. 1971). Further, if the nominal lessor of property has a contractual right to require the nominal lessee to purchase the property (a "put"), the transaction could be denied lease treatment because a put eliminates the risk borne by owners of property that there will be no market for the property at the end of the lease term.

Under the general principles described above, one U.S. Court of Appeals has held that a motor vehicle lease containing a terminal rental adjustment clause is, in substance, a conditional sale for Federal income tax purposes. *Swift Dodge* v. *Commissioner,* 696 F.2d 651 (9th Cir. 1982), rev'g. 76 T.C. 547 (1981).

Terminal rental adjustment clauses

Lease agreements for motor vehicles often contain a terminal rental adjustment clause. A terminal rental adjustment clause permits (or requires) an upward or downward adjustment of rent to make up for any differences between the projected value of a vehicle and the actual value upon lease termination.

Effect of TEFRA provision

The Internal Revenue Service has taken (and continues to take) the position that the presence of a terminal rental adjustment clause in a motor vehicle lease causes the transaction to be treated as a conditional sale for tax purposes. However, section 210 of TEFRA prevents the Internal Revenue Service from denying, with respect to leases entered into before the issuance of regulations, lease treatment for certain motor vehicle leases (including leases of trailers) by reason of the fact that those leases contain terminal rental adjustment clauses.

Section 210 of TEFRA does not address the legal effect of terminal rental adjustment clauses. Nor does it prevent the issuance of regulations addressing the legal effect of these clauses on a prospective basis (although no final regulations on the issue have been promulgated). The TEFRA provision applies only to operating leases in which the lessee uses the property for business, as opposed to personal, purposes. The application of the TEFRA provision is also limited to cases where the lessor acquires the property with cash or recourse indebtedness. Thus, the provision does not apply to leveraged leases financed with nonrecourse debt.

Reasons for Change

Leases containing terminal rental adjustment clauses have been widely used by the motor vehicle leasing industry for more than 30 years. These leases were devised for the nontax purpose of providing a financial incentive for the lessee-user, who is the party to the transaction who is best able to control the maintenance of the vehicle, to use the vehicle properly. This objective is achieved by requiring that the lessee bear the cost of any reduction in value of the vehicle resulting from the failure to maintain the vehicle during the lease term. The committee is of the view that motor vehicle lessors should not be forced to change the way many of them have been doing business for 30 years.

Explanation of Provision

The bill provides that the presence of a terminal rental adjustment clause in a motor vehicle operating agreement shall not be taken into account in determining whether an agreement is a lease. Thus, in evaluating the lessor's residual interest under a lease containing a terminal rental adjustment, the transaction is treated as if the property will be returned to the lesscr at the end of the lease term without any terminal rental adjustment. The provisions of the bill apply to operating leases in which the lessee uses the property for business or personal purposes. The provisions of the bill do not apply to leveraged lesases financed with nonrecourse debt.

The bill defines the term "terminal rental adjustment clause" as a provision of an agreement that permits or requires the rental price to be adjusted upward or downward by reference to the amount realized by the lessor under the agreement upon sale or other disposition of the property.

Effective Date

The provision is generally effective for motor vehicle agreements entered into before, on, or after the enactment of the bill. However, the provision does not apply to deny a deduction for interest claimed by a lessee with respect to an agreement on a Federal income tax return filed before the enactment of TEFRA, or to deny an investment credit in depreciable property claimed by a lessee on such a return pursuant to an agreement with the lessor that the lessor would not claim the credit.

Revenue Effect

The provision will decrease fiscal year budget receipts by $38 million in 1984, $41 million in 1985, $9 million in 1986, $2 million in 1987, $3 million in 1988, and by $4 million in 1989.

12. Nonimposition of Interest and Penalties on Tax Liability With Respect to Home Won as Prize and Designed for Handicapped Foster Child of the Taxpayer (sec. 871 of the bill)

Present Law

Under present law, gross income generally includes amounts received as prizes, such as cash or property won in a lottery, sweepstakes, or other contest (Code sec. 74(a)).

Reasons for Change

The committee has become aware of a situation in which the mother of a handicapped foster child won a $75,000 house in a contest involving more than one million entries. The developer custom-built the house to meet the needs of the 13-year-old boy, who has had kidney and heart surgery and is paralyzed. The taxpayer was unable to obtain a mortgage on the house to timely pay the entire tax liability due with respect to inclusion of the fair market value of the house in her gross income, because of her low salary as a school computer operator, and has been unable to work out a schedule for installment payment of the tax liability which is acceptable to the IRS. As a result, a lien has been placed on the house, and she may be forced to sell it.

The committee also understands that a donor has offered, as an act of private charity, to pay the tax liability resulting from inclusion of the house in gross income, but not any interest or penalties imposed for prior nonpayment of that liability (understood to amount to about $20,000). Under these circumstances, the committee believes that it would not be appropriate to impose interest and penalties with respect to the tax liability to be paid by the charitable-minded donor so that the handicapped child may continue to live in the house which was specially designed to meet his needs.

Explanation of Provision

Under the provision, no interest, penalty, or similar addition to tax is payable on the amount of Federal income tax (computed without regard to such amounts) attributable to receipt of a residence won as a prize, where certain conditions apply, but only if such tax liability (as so computed) is paid within one year after the date of enactment of the provision. The provision only applies to a residence which (1) was won by the taxpayer in a local radio contest; (2) was specially designed to meet the needs of a handicapped foster child of the taxpayer; (3) is the principal residence (within the meaning of sec. 1034) of the taxpayer; and (4) had a lien placed on it by the Internal Revenue Service on May 24, 1983, after an Internal Revenue Service supervisor had overruled two payment schedules negotiated with the taxpayer for the payment of taxes, interest, and penalties on income attributable to such residence for the taxpayer's 1980 taxable year.

Effective Date

The provision is effective on enactment.

Revenue Effect

The provision is estimated to have a negligible effect on budget receipts.

13. Transitional Rule Effective Date for Ruling on Minister's Expenses Allocable to Tax-Free Housing Allowance (sec. 870 of the bill and sec. 107 of the Code)

Present Law

In 1983, the IRS ruled that a minister may not take deductions for mortgage interest and real estate taxes on a residence to the extent that such expenditures are allocable to tax-free housing allowances provided for ministers under Code section 107. The 1983 ruling revoked a 1962 ruling which took a contrary position (Rev. Rul. 83-3, 1983-1 C.B. 72).

The new deduction disallowance rule generally applies beginning July 1, 1983. However, for a minister who owned and occupied a home before January 3, 1983 (or had a contract to purchase a home before that date), the deduction disallowance rule will not apply until January 1, 1985 (IRS Ann. 83-100).

Reasons for Change

The committee believes that where a minister had incurred an obligation to purchase a personal residence prior to the date the IRS issued its 1983 ruling, the minister and his or her employer should be given an additional year (i.e., through December 31, 1985) during which to seek to adjust the minister's compensation or housing allowance to account for the loss of the double tax benefit previously allowed by the IRS.

Explanation of Provision

The January 1, 1985 transitional rule date applicable to certain ministers in the circumstances defined in IRS Ann. 83-100 is extended until January 1, 1986. No change is made in the general effective date of July 1, 1983 for Rev. Rul. 83-3, or in any aspect of that ruling not relating to ministers.

Effective Date

The provision is effective on enactment.

Revenue Effect

The provision is estimated to result in a one-time reduction in budget receipts of less than $5 million in fiscal years 1985 and 1986.

14. Church Audits (sec. 872 of the bill and secs. 6501, 7428 and 7605(c) of the Code)

Present Law

Internal Revenue Service authority to examine taxpayers' records

IRS summons authority

Present law provides the Internal Revenue Service with authority to examine taxpayer records for the purpose of assessing or collecting tax. In addition, the IRS may summon any individual to appear before a revenue agent to give testimony under oath or to produce books and records (Code sec. 7602).

The U.S. Supreme Court has held that, for a summons to be enforceable in a civil tax proceeding, the IRS must demonstrate (1) that the investigation will be conducted pursuant to a legitimate purpose, (2) that the material sought is relevant to this purpose, (3) that the information is not already in the possesssion of the IRS, and (4) that the proper administrative procedures have been followed (*Powell* v. *Commissioner,* 379 U.S. 48 (1964)).

Conduct of examinations

Under present law, the IRS must conduct examinations of taxpayers, and their records, in a reasonable manner. The IRS is specifically prohibited from inspecting a taxpayer's records twice for the same tax year without notifying the taxpayer in writing that such additional inspection is necessary (sec. 7605(b)).

Examination of churches

Churches, like other organizations organized and operated exclusively for religious, charitable, or educational purposes, are exempt from Federal income tax (sec. 501(c)(3)). However, exempt organizations, including churches, are subject to tax on income from the conduct of any trade or business which is not substantially related to the organization's exempt purpose (secs. 511-14).

The Tax Reform Act of 1969 (P.L. 91-172) imposed special restrictions upon IRS examination of churches for the purpose of determining whether a church may be engaged in activities which result in unrelated business taxable income (sec. 7605(c)). These restrictions have also generally been applied, at the administrative level, to investigations of church tax-exempt status. These restrictions include special rules concerning the extent of any examination of church books of account and the notice required to be given in advance of such examination. The law also provides further restrictions on the examination of church religious activities.

Examination of church books of account

Notice requirement

Under present law, the IRS is prohibited from examining the books of account of a church (including conventions or associations of churches) unless (1) the IRS regional commissioner believes that such examination is necessary, and (2) the regional commissioner so notifies the organization in advance of the examination. The IRS has interpreted "books of account" to include accounting and bookkeeping records (e.g., cash books, ledgers, etc.) kept in the regular course of business to provide detailed financial records (Internal Revenue Manual 7(10)71.22(1)). Third party records (e.g., cancelled checks held by a bank) are not considered to be books of account. However, access to such materials by the IRS is subject to the general provisions of the Code regarding third party summonses (sec. 7609).

Treasury regulations provide that notification to a church must be made in writing at least 30 days prior to examining church books of account. The regulations provide further that the regional commissioner may conclude that an examination is necessary only after reasonable attempts have been made to obtain information by written request and the regional commissioner has determined that the information cannot be obtained fully or satisfactorily in that manner. Treas. Reg. sec. 301.7605-1(c)(2).

Treasury regulations further state that the purposes of the restrictions upon examinations concerning unrelated business income are to protect churches from undue interference in their internal financial affairs, and to limit the scope of the examination to matters directly relevant to the existence or amount of such unrelated business income. Treas. Reg. sec. 301.7605-1(c)(1).

Scope of examination

Present law provides that the books of account of an organization that claims to be a church may be examined only to the extent necessary to determine the amount (if any) of tax. Under Treasury regulations, this may include examinations (1) to determine the initial or continuing qualification of the organization as a tax-exempt entity under section 501(c)(3); (2) to determine whether the organization qualifies to receive tax-deductible contributions; (3) to obtain information for the purpose of determining the tax liability of a recipient of payments (e.g., minister's salaries) from the organization; or (4) to determine the amount of tax, if any, which is to be imposed on the organization. The regulations provide further that, in any examination of a church for the purpose of determining liability for tax on unrelated business income, church books of account may be examined only to the extent necessary to determine such liability. Treas. reg. sec. 301.7605-1(c)(2).

In *United States v. Dykema*, 666 F.2d 1096 (7th Cir. 1981), *cert. den.* 496 U.S. 983 (1982), the United States Court of Appeals for the Seventh Circuit held that the limitation to "necessary" examinations of churches applied only to investigations of unrelated business income. The case involved an IRS summons for various church books of account as part of an investigation of the church's tax-exempt status. The court held that the IRS could examine any church records relevant and material to a determination of tax-exempt status.

Examinations of religious activities

Present law provides that, when an organization claims to be a church, the religious activities of the organization may be examined only to the extent necessary to determine whether the organization actually is a church. Treasury regulations provide that this includes (1) a determination of the initial or continuing qualification of the organization as a tax-exempt entity; (2) a determination of whether the organization qualifies to receive tax-deductible contributions; and (3) a determination of whether the organization is subject to the provisions of the Code regarding unrelated business taxable income. Once it has been determined that an organization is a church, no further examination of its religious activities may be made in connection with determining its liability for tax on unrelated business income. Treas. Reg. sec. 301.7605-1(c)(3).

Present law does not require a regional commissioner of the IRS to give special notice before examining the religious activities of a church for the purposes described above. However, the IRS has administratively adopted such a procedure (Internal Revenue Manual 7(10)71.21(4)).

Period of limitations for assessment or collection of tax

Under the general limitation provisions of the Code (sec. 6501), the IRS is required to assess income taxes, or to initiate a proceeding for collection without assessment, within three years after the return was filed. Where a taxpayer fails to file a return, the three-year limitation is inapplicable, and the tax may be assessed at any time. The tax may also be assessed at any time in the case of a false or fraudulent return, or a willful attempt to defeat or evade tax in any manner.

Declaratory judgment actions

Present law (sec. 7428) allows a taxpayer to bring a declaratory judgment action in any case (including an adverse IRS determination or failure to make a determination) involving a determination of tax-exempt status under section 501(c)(3). The action may be brought in the Tax Court, the Claims Court or the United States District Court for the District of Columbia.

The court may issue a declaratory judgment only upon determining that the taxpayer has exhausted administrative remedies available within the IRS. This generally requires a final adverse determination by the IRS. Alternatively, an organization is deemed to have exhausted its administrative remedies if the IRS fails to make a determination within 270 days after the determination was requested and the organization has taken all timely and reasonable steps to secure a determination.

Taxpayers generally are prohibited from seeking injunctions against assessment or collection of tax (sec. 7421).

Reasons for Change

The committee's actions concerning church audits were motivated by two competing considerations. First, the committee is aware of the special problems that arise when the Internal Revenue Service (or any governmental agency) examines the records of a church, including problems of separation of church and state and the special relationship of a church to its members. These problems may be compounded by the relative inexperience of churches in dealing with the IRS and the resulting occasional misunderstandings between churches and the IRS. While present law imposes limitations on the examination of church records, these limitations are somewhat vague and rely heavily on internal IRS procedures to protect the rights of a church in the audit process. Additionally, there is some uncertainty regarding the scope of the investigations to which the existing law applies and the nature of the records which are protected by the law.

While desiring to protect churches from undue interference, the committee recognizes that an increasing number of taxpayers have, in recent years, utilized the church form primarily as a tax-avoidance device. The committee believes that the IRS must retain an unhindered ability to pursue individuals who use the church form in this manner.

The bill attempts to resolve these competing considerations by providing a detailed series of rules that the IRS is to follow in investigating churches, both as to their tax-exempt status and as to the existence of unrelated business income. These provisions emphasize the need for a speedy determination of church tax liabilities and, where possible, a determination without unnecessary examination of church books and records. The committee believes that these provisions will protect the rights of legitimate churches without unduly hindering IRS investigations of tax-avoidance schemes posing as religious organizations. Further, the committee believes that the adoption of detailed statutory rules will reduce misunderstandings between churches and the IRS and allow for a more stable and cooperative audit process.

The bill effectively incorporates the present-law examination rules in the new provisions regarding church audits. Thus, there will be no diminution of any rights presently held by a church.

Explanation of Provisions

Overview

The bill allows the IRS to investigate an organization claiming to be a church only if an IRS regional commissioner reasonably believes, on the basis of facts and circumstances recorded in writing, that the organization is engaged in taxable activities or does not qualify for tax-exemption. The bill also provides expanded notice requirements that must be satisfied before the IRS may examine any church records, including a requirement that church officials have an opportunity to meet with IRS representatives before an examination of such records. Examinations of church records are limited to the extent necessary to determine tax liability. The bill also adds special procedural provisions designed to hasten the determination of church tax liabilities, including a requirement that church audits generally be completed within two years after commencement of an investigation.

Restrictions on investigation of churches generally

The bill prohibits the IRS from commencing any investigation or proceeding to determine whether a church (including a convention or association of churches) is engaged in taxable activities, or whether an organization qualifies for tax-exemption as a church under section 501(c)(3) of the Code, unless an IRS regional commissioner reasonably believes, on the basis of facts and circumstances recorded in writing, (1) that the church actually is engaged in taxable activities, or (2) that the organization does not qualify for tax-exemption as a church. The committee intends that this standard will provide a basis for judicial review of the IRS action in commencing the investigation which would not exist if a mere belief standard were applied (*Veeders* v. *Commissioner,* 36 F. 2d 343, 345 (7th Cir. 1929)). The committee further intends that the facts and circumstances which form the basis for a reasonable belief must be derived from information lawfully obtained by the IRS. Information obtained from informants used by the IRS for this purpose must not be known to be unreliable.

Before commencing an investigation or proceeding for the purposes described above, the IRS is required to provide written notice to the organization against which the investigation or proceeding is initiated. The notice of commencement of an investigation must include (1) a list of the Code provisions which authorize the investigation or proceeding, (2) a general explanation of the applicable administrative and Constitutional rights of the organization in connection with the audit (including the right to a pre-examination conference regarding the organization's tax liabilities and the right to request relevant material under the Freedom of Information Act), and (3) an explanation of the concerns which gave rise to the investigation and the general subject matter of the investigation.

The explanation of the church's administrative and Constitutional rights (item (2)) may be of a general nature and need not explain all possible legal and Constitutional aspects of a church audit. However, this statement should include a brief general description of the various stages of the church audit procedures contained in this bill (including the right to a pre-examination conference) and the principle of separation of church and state under the First Amendment.

The explanation of the concerns and general subject matter of the investigation (item (3) above) should be sufficiently specific to allow the church to understand the particular area of church activities or behavior which is being investigated. For example, in an investigation of unrelated business income, the notice should indicate the general activities of the church which may result in unrelated income (e.g. use of a particular property or facility for other than tax-exempt purposes). For an investigation of tax-exempt status, the notice should indicate those general aspects of the church's operations or activities which have given rise to questions regarding its tax-exempt status. The IRS is not to be precluded from expanding its investigation beyond the concerns expressed in the notice as a result of facts and circumstances which subsequently come to its attention (including, where appropriate, an expansion of an unrelated income investigation to include questions of tax-exempt status, or vice-versa).

The notice requirement is not to be interpreted to require the IRS to share particular items of evidence with the church, or to identify its sources of information regarding church activities, where providing such information would be damaging to the investigation or to the sources of IRS information. For example, in an investigation of unrelated business income, the IRS might indicate that its investigation was prompted by a local newspaper advertisement regarding a church-owned business; however, the IRS would not be required to reveal identity of any so-called "informers" within a church (including present or former employees).

The requirement of notice upon commencement of an investigation does not apply to criminal investigations.

Examination of church records and activities

Notification of regional counsel

Under the bill, the IRS may examine church records (including books of account and other records) or religious activities to determine tax-exempt status or church tax liability only after the regional commissioner sends a notice of intent to examine church records to the IRS regional counsel. This notice to the regional counsel must be provided at least 15 days after the general commencement of investigation notice (discussed above) is provided to the church. The regional counsel is then allowed 15 days from issuance of the notice to him in which to file an advisory objection to the examination. During this period, the IRS may not begin examination of church records. The committee intends that the regional commissioner will take any objection by the regional counsel into account when determining whether to proceed with the examination of church books and records.

Additional notice and offer of IRS conference

At the same time that the regional counsel is notified of a proposed examination, the regional commissioner is required to send a second notice (in addition to the commencement of investigation notice) to the organization whose records are to be examined. This second notice is required to include (1) a restatement of the information contained in the commencement of investigation notice (discussed above), adjusted for any change in the relevant facts and cirumstances during the intervening period, (2) a description of all church records and activities which the IRS seeks to examine, and (3) an offer of an opportunity to request copies of any relevant materials in the possession of the IRS under the Freedom of Information Act. The committee intends that this offer will describe the type of materials available under the Freedom of Information Act in sufficient detail to enable the church to frame a reasonable request for information. Any request for such materials will be subject to the general rules (including rules regarding payment of costs) applicable under the Freedom of Information Act. The types of materials to which an organization is entitled under the Freedom of Information Act is not intended to limit the scope of any IRS investigation (or the scope of church records which may be examined by the IRS).

The regional commissioner is further required, as part of the second notice, to offer the organization an opportunity to meet with an IRS official to discuss the concerns which gave rise to the investigation and the general subject matter of the investigation. The organization will have 15 days after the second notice is sent in which to request such a meeting, during which time the IRS is prohibited from examining church records. This 15-day period runs concurrently with the period during which IRS regional counsel may object to a proposed examination. If an organization requests a meeting, the IRS is required to schedule a meeting and may proceed to examine church records only following the meeting. If an organization makes a properly filed Freedom of Information Act request, the IRS is also prohibited from examining church records until the appeal is granted or a final administrative denial of the appeal is made.

For example, if notice of commencement of an investigation is sent to a church on day 1, notice of a proposed examination may be sent to the church and the IRS regional counsel no earlier than day 15, and no examination of church records may be made prior to day 30. If an organization does not request a meeting or make a Freedom of Information Act request by day 30, the IRS may proceed to examine church records.

The purpose of a meeting between the church and the IRS is to discuss the relevant issues that may arise as part of the investigation, in an effort to resolve the issues of tax-exemption or liability without the necessity of an examination of church books and records. The committee therefore intends that the church and the IRS will make a reasonable effort to resolve outstanding issues at the meeting. To avoid misunderstandings, the committee intends that the IRS will remind the church at the meeting, in general terms, of its rights under the audit process as described above (including the right to make an appropriate request under the Freedom of Information Act). However, the IRS will not be required to reveal information at the meeting of a type properly excludable from a written notice (including information regarding the identity of third-party witnesses or evidence provided by such witnesses).

Definition of church records

Church records include all regularly kept church corporate and financial records, including (but not limited to) corporate minute books, contributor or membership lists, and any materials which qualify as church books of account under present law. The committee further intends that church records will include private correspondence between a church and its members that is in the possession of the church. Church records protected by the bill do not include records previously filed with a public official or, as under present law, newspapers or newsletters distributed generally to the church members.

Records held by third parties (e.g., cancelled checks or other records in the possession of a bank) are not considered church records for purposes of the bill. Thus, subject to the general provisions regarding third party summonses, the IRS is permitted access to such records without regard to the requirements of the bill (sec. 7609). As under present law, either the IRS or a third party recordkeeper generally is required, however, to inform a church of any IRS requests for materials.

The bill provides that the IRS may not proceed to revoke a church's tax-exemption or assess any tax for unrelated business income unless the Service follows the church audit procedures as described under the bill. Thus, the IRS may not revoke an exemption or assess tax against a church solely on the basis of third party records, without complying with these procedures. The committee further intends that the IRS will be prohibited from using information obtained from third party bank records in any attempt to avoid the purposes of the bill by harassing individual members of a church. (See, e.g., *Powell* v. *Commissioner*, 379 U.S. 48 (1964).)

The notice requirements before examining church records do not apply to criminal investigations.

Scope of examination

The bill provides that church records may be examined only to the extent necessary to determine tax.

The bill retains the present-law rule that the religious activities of any organization claiming to be a church (including a convention or association of churches) may be examined only to the extent necessary to determine whether the organization actually is a church.

Requirement of IRS determination within two years

Under the bill, if any investigation or proceeding is commenced against a church, the IRS will be required to make a determination within two years after notifying the church of the commencement of the investigation. Running of this two-year period is suspended for (1) any period during which any judicial proceeding initiated by the church or its agents challenging the IRS investigation, examination, or proceeding is pending, (2) any period in which the IRS is unable to make a determination because of the refusal of the church or its agents to comply with reasonable and lawful requests for information or materials necessary for the conduct of the investigation, or (3) any period during which any stay of a suit involving access to third-party records is in effect (sec. 7609). Additionally, running of the two-year period is suspended for any period during which the IRS is responding to a properly filed request from the church under the Freedom of Information Act. Running of the two-year period will resume at any point at which the IRS exceeds the statutory time limit for responding to a request (or the appeal of a denial of a request) under the Freedom of Information Act or when any of the suspension periods discussed above expire.

The bill allows the two-year determination period to be extended by mutual agreement of the church and the IRS.

Statute of limitations

The bill requires the IRS to assess any tax against a church (including a convention or association of churches) within three years after the relevant tax return is due. The IRS also is prohibited from bringing a court proceeding for collection without assessment more than three years after the tax was due. These limitations apply regardless of whether the church actually filed a return for the taxable year in question. No limitation applies in cases of fraud or willful tax evasion or in cases of knowing failure to file a return which should have been filed.

Under the bill, running of the three-year limitation period is suspended during any time period when the special two-year limit on IRS determinations of church tax liability is suspended under the rules described above (i.e., the two-year period beginning on commencement of the IRS investigation). This is in addition to the general statutory criteria for suspending the running of the period of limitations for assessment or collection of tax.

The three-year limitation period may be extended by mutual agreement between the church and the IRS.

Declaratory judgments

Under the bill, once the IRS issues a revenue agent's final report ("30-day letter") to a church which proposes to revoke the organization's tax-exempt status as a church, the organization will be deemed to have exhausted its administrative remedies for purposes of the declaratory judgment provision of the Code (sec. 7428). The organization thus will be entitled to bring a declaratory judgment action to preserve its tax-exempt status without awaiting further IRS action.

The bill does not affect the present law rule which generally prohibits injunctions against assessment or collection of tax (sec. 7421).

Further requirements

The bill requires the IRS regional counsel to approve in writing the issuance to a church of any statutory notice of deficiency or adverse determination letter.

To prevent unwarranted repeated audits, the IRS regional commissioner is required to obtain written approval from the Assistant Commissioner (Employee Plans/Exempt Organizations) for any second audit of a church arising from the same activities as were examined previously where a first audit of that church resulted in neither (1) revocation of tax-exemption or a change in tax liability of a church for one or more years, nor (2) a request by the IRS for any significant changes in church operational practices (including the church's method of keeping records).

The bill specifies that failure by the IRS to follow proper audit procedures as provided by the bill (including a failure to make a determination within two years) may be raised as a defense (but not an absolute defense) in a proceeding to gain access to church records. Once this defense is raised in such a proceeding, the IRS has the burden of establishing that correct procedures have been followed. As under present law, the IRS will be permitted to correct any violations of proper administrative procedures before continuing an investigation.

Scope of legislation

The committee intends that the church audit procedures provided by this bill will apply when an investigation relates directly to the tax status or liability of a church itself, as opposed to that of any individual. The church audit procedures are not intended to apply to investigations of any individual who has made a gift or other contribution to a church, or to investigations of any tax-exempt organization other than an organization claiming to be a church. This is true although issues regarding a church's tax status may arise in such proceedings as part of a determination of another individual's or organization's tax liability. The procedures also are not intended to apply to routine IRS inquiries to a church, including inquiries with respect to income tax withholding for church employees, social security taxes, and similar matters. However, repeated failure by a church or its agents to respond to IRS inquiries (including inquiries relating to investigations of other taxpayers or routine inquiries described above) may provide a reasonable basis for commencement of an investigation of the church under the applicable church audit procedures.

Effective Date

This provision is effective for investigations, examinations, and other proceedings commencing after the date of enactment of the bill.

Revenue Effect

This provision has a negligible effect upon revenues.

15. Employee Tips (sec. 876 of the bill and sec. 6053 of the Code)

Present Law

The Tax Equity and Fiscal Responsibility Act of 1982 (TEFRA) established rules that impose reporting requirements that, under certain circumstances, require an informational report of an allocation of tips in large food or beverage establishments (defined generally to include those establishments that normally employ more than 10 employees). If tipped employees of large food or beverage establishments report tips aggregating 8 percent or more of gross receipts of the establishment, then no reporting of a tip allocation is required. However, if this 8-percent reporting threshold is not met, the employer must allocate (as tips for information reporting purposes only) an amount equal to the difference between 8 percent of gross receipts and the aggregate amount reported by employees. This allocation may be made pursuant to an agreement between the employer and employees or, in the absence of such an agreement, according to Treasury regulations. The Secretary has the authority to reduce the 8-percent threshold down to 5 percent upon petition by the employer.

Under pre-TEFRA law, tipped employees are required to maintain records that establish the amount of tip income received by them during the taxable year.

Reasons for Change

The committee believes that a majority of the employees of an establishment, in addition to the employer, should be able to petition the Secretary to reduce the percentage of gross receipts required to be allocated, and that, at least in certain instances, the current minimum percentage of gross receipts required to be allocated (5 percent) may be too high. Finally, the committee has been made aware of the fact that, at least in certain cases, the definition of large food or beverage establishments may be too stringent.

Explanation of Provision

The bill provides that either the employer or the majority of employees of the employer may petition the Secretary to reduce the percentage of gross receipts required to be allocated. In the case of an employee-originated petition, to the extent the employees possess relevant information needed by the IRS, the burden of supplying that information will fall upon the employees. To the extent that other information is required from the employer in order to support the employees' petition, that information will be treated as tax return information when provided to the IRS and will not be available to employees.

The bill also reduces the minimum percentage of gross receipts required to be allocated from 5 percent (under present law) to 2 percent. The committee recognizes that, ordinarily, an establishment will be unable to prove down to the 2 percent rate. The bill requires that the Secretary prescribe by regulations or rulings the applicable recordkeeping requirements for tipped employees.

Finally, the committee directs the Treasury and the IRS to continue to monitor whether the tip reporting rules enacted by TEFRA affect small food or beverage establishments that were not intended to be covered by the new law. Treasury may wish to consider whether the 10-employee cut-off provided by law is too low, or whether liberalized reporting and recordkeeping requirements can be prescribed for the smaller establishments that are subject to the new law. The committee expects that Treasury will include consideration of these issues in the report it will submit to Congress on the tip reporting rules.

Effective Dates

The petition and reduction of percentage provisions are effective on the date of enactment. The Secretary is required to issue the required regulations or rulings within one year after the date of enactment.

16. Extension of Moratorium on Application of Research and Experimental Expense Allocation Regulation (sec. 873 of the bill)

Present Law

Foreign tax credit and sourcing rules

All income has either a U.S. source or a foreign source. The foreign tax credit can offset tax on foreign-source taxable income, but not U.S.-source taxable income. (This is known as the foreign tax credit limitation.) A shift in the source of income from foreign to U.S. may increase U.S. tax by reducing the amount of foreign tax that a taxpayer may credit.

In determining foreign-source taxable income for purposes of computing the foreign tax credit limitation, and for other tax purposes, Code sections 861–863 require taxpayers to allocate or apportion expenses between foreign-source income and U.S.-source income. A shift in the allocation of expenses from U.S.- to foreign-source gross income decreases foreign-source taxable income. This decrease may increase U.S. tax by reducing the amount of foreign tax that a taxpayer may credit.

Research and experimental expense allocation regulation

Treasury regulation sec. 1.861–8 (published in 1977) sets forth detailed rules for allocating and apportioning several categories of expenses, including deductible research and experimental expenditures ("research expenses"). The regulation provides that research expenses are 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 expenses are not traced solely to the income generated by the particular product which benefited from the research activity. Instead these expenses are associated with all the income within the SIC product group in which the product is classified.

Research expenses identified with an SIC product group are generally apportioned to foreign-source income based on the ratio of total foreign-source sales receipts (or, at the taxpayer's option and subject to certain conditions, total foreign-source gross income) within the SIC product group to the taxpayer's total worldwide sales receipts (or gross income) within the SIC product group. However, research expenses incurred to meet legal requirements imposed with respect to improvement or marketing of specific products or processes are allocable entirely to one geographic source if the research and development cannot reasonably be expected to generate income (beyond de minimis amounts) outside that geographic source. In addition, the regulation provides that 30 percent of research expense is apportioned to the geographic source where over half of the taxpayer's research and development is performed. A taxpayer can choose to apportion to the geographic source where research and development is performed a percentage of research expense significantly greater than 30 percent if he 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. Treas. Reg. sec. 1.861-8 generally requires a smaller allocation of research expense to foreign-source income than a predecessor regulation proposed in 1973 would have required.[1]

Temporary moratorium and Treasury study

The Economic Recovery Tax Act of 1981 (ERTA) provides that, for a taxpayer's first two taxable years beginning after the date of its enactment (August 13, 1981), all research and experimental expenditures (within the meaning of Code sec. 174) which are paid or incurred in those taxable years for research activities conducted in the United States are to be allocated or apportioned to sources within the United States (sec. 223 of ERTA). The two-year moratorium on the application of the research and experimental expense allocation rules of Treas. Reg. sec. 1.861-8 does not apply to taxable years following the taxpayer's second taxable year commencing after August 13, 1981.

One reason Congress cited for enacting the 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 results in unduly high foreign taxes and that, absent changes in the foreign tax credit limitation, U.S. taxpayers would lose foreign tax credits. Because those taxpayers could take their deductions if the research occurs in the foreign country, taxpayers argued that there was 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 expenditures incurred locally.

Accordingly, Congress concluded that the Treasury Department should study the impact of the allocation of research expenses under Treas. Reg. sec. 1.861-8 on U.S.-based research activities and on the availability of the foreign tax credit. While that study was being conducted by the Treasury and considered by Congress, Congress concluded that expenses should be charged to the cost of generating U.S.-source income, whether or not such research is a direct or indirect cost of producing foreign-source income.

In June 1983 the Secretary of the Treasury submitted its report on the mandated study to the Senate Committee on Finance and the House Committee on Ways and Means.[2] In summary, the Treasury report concludes that:

- Had Treas. Reg. sec. 1.861-8 fully been in effect in 1982, the $37 billion in privately financed domestic research and de-

[1] *See* 38 Fed. Reg. 15,840 (1973).

[2] *See* Department of the Treasury, *The Impact of the Section 861-8 Regulation on U.S. Research and Development* (June 1983).

velopment spending in 1982 would have been reduced by approximately $40 million to $260 million. Most of the reduction would have represented a net reduction in overall research and development undertaken by U.S. corporations and their foreign affiliates, rather than a transfer of research and development abroad.

- The moratorium reduces U.S. tax liabilities. If the research and development rules of Treas. Reg. sec. 1.861-8 had been in effect in 1982, U.S. tax liabilities of U.S. firms would have been $100 million to $240 million higher.
- The moratorium reduces the tax liabilities only of firms with excess foreign tax credits. Whether or not a firm has excess foreign tax credits does not seem to be closely related to the level of its research and development efforts.
- The moratorium has its most significant effect on large, mature multinationals as opposed to small, relatively young high-technology companies. Of the $100 million to $240 million estimated increase in U.S. tax liabilities for calendar 1982 that would have occurred had Treas. Reg. sec. 1.861-8 been fully in effect, about 85 percent is estimated to be accounted for by 24 U.S. firms on the list of the 100 largest U.S. industrial corporations compiled by *Fortune Magazine.*
- An allocation of research and development expense to foreign income may increase a taxpayer's worldwide tax liability if the foreign government does not allow the apportioned expense as a deduction. Some allocation to foreign income, however, is appropriate on tax policy grounds when domestic research and development is exploited in a foreign market and generates foreign income. If an allocation is not made, foreign-source taxable income will be too high and the higher limitation may allow the credit for foreign tax to reduce U.S. tax on domestic-source income.
- The research and development rules of Treas. Reg. sec. 1.861-8 reflect significant modifications of the 1973 proposed version of the regulation in response to taxpayer comments. Compared to the 1973 version of the regulations, these modifications allow less research and development expense to be allocated to foreign income and recognize that research and development conducted in the United States may be most valuable in the domestic market.

On the ground that a reduction in research and development may adversely affect the competitive position of the United States, the Treasury report recommends a two-year extension of the moratorium to provide Congress with an opportunity to consider the report's findings while it works with the Administration to develop a coherent national program of research and development incentives.

Reasons for Change

The committee believes that it is appropriate to require the allocation of deductible expenses between U.S. and foreign-source income. At the same time, the committee believes that the Federal tax laws should generally encourage U.S.-based research activity. The committee is concerned that the research and experimental expense allocation rules of Treas. Reg. sec. 1.861-8 may, if implemented, result in reducing domestic research and experimental expenditures and may cause the performance of some research overseas that would otherwise be performed in the United States.

The committee also recognizes that tax incentives for research frequently increase Federal budget deficits and that some tax incentives for research may be more equitable or efficient than others. In light of present fiscal restraints, the committee considers it important that the relative equity and efficiency of the moratorium on the application of the Treas. Reg. sec. 1.861-8 research expense rules, compared to alternative tax incentives, be fully analyzed before any particular tax incentive is permanently adopted.

The committee, therefore, believes that a two-year extension of the present temporary moratorium is warranted. The extension will allow Congress to consider further the results of the Treasury study on the Treasury research expense allocation rules. It will give Congress and the Treasury an opportunity to assess more fully the impact of Treas. Reg. sec. 1.861-8 on U.S.-based research activity and to analyze more thoroughly the merits of the moratorium as a research incentive.

Explanation of Provision

The bill effectively extends for two years the moratorium on the application of the research and experimental expense allocation rules of Treas. Reg. sec. 1.861-8. Under the bill, for taxable years beginning on or before August 13, 1985, all of a taxpayer's research and experimental expenditures (within the meaning of Code sec. 174) attributable to research activities conducted in the United States will be allocated to sources within the United States for purposes of computing taxable income from U.S. sources and from sources partly within and partly without the United States.

This special allocation rule will 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 bill does not affect allocations of expense to DISC income.

Effective Date

This provision will be effective on the date of enactment.

Revenue Effect

This provision will reduce fiscal year budget receipts by $61 million in 1984, $127 million in 1985, and $66 million in 1986.

17. Exclusion from Gross Income for Cancellation of Certain Student Loans (sec. 874 of the bill and sec. 2117 of the Tax Reform Act of 1976)

Present Law

Under present law, gross income means all income from whatever source derived, including income from discharge of indebtedness (Code sec. 61(a)(12)). However, subject to certain limitations, gross income does not include any amount received as a scholarship or a fellowship grant (sec. 117(a)). With the exception of certain Federal grants for tuition, an amount paid to an individual to enable him or her to pursue studies or research does not qualify as a scholarship or fellowship grant if the amount represents compensation for past, present, or future employment services or if the studies or research are primarily for the benefit of the grantor (Treas. Reg. sec. 1.117-4(c)).

Under certain student loan programs established by the United States and by State and local governments, all or a portion of the indebtedness may be forgiven if the student performs certain services for a period of time in certain geographical areas pursuant to conditions in the loan agreement. In 1973, the Internal Revenue Service ruled on a State medical education loan scholarship program under which part of the loan was forgiven if the recipient practiced medicine in a rural area of the State. The Service determined that amounts received under the program were included in the recipient's gross income to the extent that repayment of the loan was no longer required (Rev. Rul. 73-256, 1973-1 C.B. 56).

Section 2117 of the Tax Reform Act of 1976 (P.L. 94-455) provided that, in the case of loans forgiven prior to 1979, no amount was to be included in gross income by reason of the discharge of all or part of the indebtedness of the individual under certain student loan programs. The exclusion applied to a discharge pursuant to a provision of indebtedness which is to be discharged if the individual works for a certain period of time in certain professions in certain geographical areas or for certain classes of employers. The exclusion applied only to loans made by the United States or an instrumentality or agency thereof or by a State or local government, either directly or pursuant to an agreement with the educational institution. The primary purpose of the exclusion was to assist those States and cities that have experienced difficulties in attracting doctors, nurses, and teachers to serve in certain rural and low-income urban areas.

The Revenue Act of 1978 extended the exclusion for certain student loan cancellations to loans forgiven prior to January 1, 1983.

Reasons for Change

The committee believes that the exclusion for income for cancellation of certain student loans serves an important purpose in encouraging doctors, nurses, and teachers to serve in rural and low-income areas and therefore should be made permanent. At the same time, the committee believes that the requirements for the exclusion should be conformed to those applicable under a similar provision included in the bill as part of the tax incentives relating to research and experimentation. The committee further believes that the exclusion should be broadened to include loans made by a public benefit hospital corporation which is treated as a public entity under applicable State law.

Explanation of Provision

The bill provides a permanent exclusion from income for cancellation of certain student loans similar to that provided by the Tax Reform Act of 1976 and previously extended by the Revenue Act of 1978.[1] The bill provides that the exclusion is to apply where an individual works for a certain period of time in certain professions for any of a broad class of employers. (Thus, a requirement that an individual perform services in a certain geographical area, without specifying for what broad class of employers such services are to be performed, does not qualify for the exclusion under the bill.) The bill also broadens the exclusion provided by the 1976 Act to include loans made by a tax-exempt (sec. 501(c)(3)) public benefit hospital corporation which has assumed control over a State, county, or municipal hospital and whose employees have been deemed to be public employees under State law (including loans made directly by such corporation or pursuant to an agreement with the educational institution).

Effective Date

The provision is effective for discharges of indebtedness on or after January 1, 1983.

Revenue Effect

This provision is estimated to reduce budget receipts by less than $5 million per year.

[1] An extension of this exclusion for two years (through 1984) was contained in S. 2062, as reported by the Senate Committee on the Budget, on November 4, 1983. This provision makes the exclusion, as modified by the bill, permanent.

18. Transitional Rule for Safe-Harbor Leasing (sec. 875 of the bill and sec. 280(d) of the Tax Equity and Fiscal Responsibility Act of 1982)

Present Law

The Tax Equity and Fiscal Responsibility Act of 1982 (TEFRA) generally reduced the tax benefits of safe-harbor leasing between July 1, 1982, and January 1, 1984, and repealed safe-harbor leasing for agreements entered into after December 31, 1983. However, these modifications do not apply to transitional safe-harbor lease property, which generally is property placed in service before January 1, 1983, provided that certain additional requirements are met.

Reason for Change

The committee believes that the long construction period associated with coal gasification facilities should be taken into account in determining equitable safe-harbor leasing transition rules.

Explanation of Provision

The bill generally provides that transitional safe-harbor lease property will include certain coal gasification facilities that would meet the requirements of the general transitional rule in TEFRA if July 1, 1984, were substituted for the January 1, 1983, placed-in-service date. The provision will apply only to the lease of an undivided interest in the facility in an amount which does not exceed the lesser of $67.5 million or 50 percent of the cost basis of the entire facility.

Except for the above provision, the bill does not change any requirement under TEFRA regarding the applicability of the safe-harbor leasing rules to transitional safe-harbor lease property.

Effective Date

The provision will take effect as if included in TEFRA.

Revenue Effect

The provision will reduce fiscal year budget receipts by $3 million in 1984, $5 million in 1985, $4 million in both 1986 and 1987, and $6 million in both 1988 and 1989.

19. Treatment of Indian Tribal Governments as State Governments for Tax Purposes (sec. 877 of the bill and sec. 7871 of the Code)

Present Law

Present law generally treats Indian tribal governments as State governments for tax purposes. For example, tribal governments are treated as State governments for the following purposes:

(1) The exclusion from income of interest on certain obligations of State governments (except as explained below);

(2) The income tax deduction for taxes paid to State and local governments;

(3) The income, estate, and gift tax deductions for charitable contributions;

(4) The tax on unrelated business income of certain types of organizations;

(5) The tax imposed on certain prohibited transactions by public charities and private foundations;

(6) The income tax credit for individuals who receive retirement income from public retirement systems;

(7) Eligibility for certain tax-deferred annuities;

(8) The income tax credit for political campaign contributions; and

(9) The exclusion of certain scholarships and fellowships awarded to students who are not candidates for a degree.

With respect to tax-exempt bonds, Indian tribal governments are permitted to issue only bonds to finance traditional public activities (e.g., schools, streets, and sewers). Additionally, the proceeds of these bonds must be used in an "essential governmental function." Tribal governments are not permitted to issue private activity bonds (i.e., industrial development bonds, student loan bonds, and mortgage subsidy bonds).

Additionally, exemptions from Federal excise taxes provided for State governments, apply to articles sold to the Indian tribal governments only if the articles are sold for the tribal government's exclusive use in carrying out an essential governmental function.

This provision is scheduled to expire on December 31, 1984.

Reasons for Change

Indian tribal governments perform many of the functions of State governments. The committee believes, therefore, that the provisions pursuant to which tribal governments are treated as State governments for tax purposes should be made permanent, subject to the restrictions included when the provisions were enacted originally.

Explanation of Provision

The bill makes permanent the provisions of present law pursuant to which Indian tribal governments are treated as State governments under the Internal Revenue Code.

Effective Date

This provision is effective on the date of enactment.

Revenue Effect

This provision will reduce fiscal year budget receipts by less than $5 million annually.

20. Amortization of Expenditures to Rehabilitate Low-Income Rental Housing (sec. 878 of the bill and sec. 167(k) of the Code)

Present Law

Under present law, cost recovery deductions with respect to low-income rental housing generally are determined using the regular ACRS percentages and a 15-year recovery period (unless a longer recovery period is elected as provided under sec. 168). Cost recovery deductions with respect to expenditures for the rehabilitation of low-income rental housing are determined using the same methods and recovery periods as provided for such real property generally.

In general, rehabilitation expenditures incurred before January 1, 1984, with respect to low-income rental housing, could be amortized in equal amounts over 60 months (sec. 167(k)). The aggregate amount of rehabilitation expenditures eligible for this special treatment could not exceed $20,000 with respect to any dwelling unit. A special exception permitted qualification of up to $40,000 of expenditure per dwelling unit if the rehabilitation was conducted pursuant to a program certified by the Secretary of Housing and Urban Development (or by a State or local government) and certain other requirements were satisfied. Under section 167(k), the term low-income rental housing was defined as buildings held for rental occupancy by families and individuals of low or moderate income, determined under rules similar to those under section 8 of the Housing Act of 1937.

Reasons for Change

The committee believes that special tax incentives continue to be needed to ensure that affordable housing is available to individuals of limited means. Therefore, the committee determined that the special 60-month amortization provision of prior law should be reenacted; however, because the committee believes generally that special tax incentives such as this amortization provision should be the subject of ongoing review as economic conditions change, the provision is reenacted for three years only, through December 31, 1986.

Explanation of Provision

The bill reenacts for three years the provision of prior law (sec. 167(k)) permitting amortization over 60 months of certain rehabilitation expenditures incurred with respect to low-income rental housing.

Effective Date

This provision of the bill generally is effective with respect to rehabilitation expenditures incurred after December 31, 1983, and before January 1, 1987.

Under an extension of the affirmative commitment rule presently included in the provision (sec. 167(k)(3)(D)), the provision also applies to rehabilitation expenditures incurred after December 31, 1986, which are incurred pursuant to a binding contract entered into before January 1, 1987, which contract is binding at all times on and after that date, and to rehabilitation expenditures incurred with respect to low-income rental housing, the rehabilitation of which begins before January 1, 1987.

Whether or not an arrangement constitutes a contract is to be determined under the applicable local law. A binding contract is not considered to exist before January 1, 1987, however, unless the property to be acquired or the services to be rendered are specifically identified or described before that date.

A binding contract for purposes of this provision exists only with respect to property or services which the taxpayer is obligated to pay for under the contract. In addition, where a contract obligates a taxpayer to purchase a specified number of items or services and also grants him an option to purchase additional items, the contract is binding on the taxpayer only to the extent of the items or services he must purchase.

A contract may be considered binding on the taxpayer even though (1) the price of the item to be acquired or the services to be rendered under the contract is to be determined at a later date, (2) the contract contains conditions the occurrence of which are under the control of a person not a party to the contract, or (3) the taxpayer has the right under the contract to make minor modifications as to the details of the subject matter of the contract.

On the other hand, a contract that is binding on a taxpayer before January 1, 1987, will not be considered binding at all times on and after that date if it is modified substantially after that date. Additionally, a contract under which the taxpayer has an option to acquire property is not a contract that is binding on the taxpayer for purposes of this exception unless the amount paid for the option is forfeitable and is more than a nominal amount.

Additionally, under the affirmative commitment rule, a rehabilitation is considered to have begun before January 1, 1987, only if actual physical work on the rehabilitation was begun before that date. Under this rule, a rehabilitation is not deemed to have begun unless the physical work which is begun before January 1, 1987, is significant when viewed in light of the entire rehabilitation project.

Revenue Effect

This provision will decrease fiscal year budget receipts by $2 million in 1984, $7 million in 1985, $18 million in 1986, $32 million in 1987, $43 million in 1988, and $34 million in 1989.

21. Reenactment of Denial of Deductions for Costs of Demolishing Certified Historic Structures (sec. 879 of the bill and sec. 280B of the Code)

Present Law

Present law generally allows a current deduction for costs of, and other losses incurred in connection with, the demolition of any real property structure, provided the structure and land on which it is located are not acquired with an intent to demolish the structure. If demolition is anticipated when a structure is acquired, the costs of demolition and any associated loss, including the basis of the structure, generally must be treated as an adjustment to the basis of the land on which the demolished structure was located.

After June 30, 1976, and before January 1, 1984, all costs of, or other losses incurred in connection with, the demolition of a certified historic structure could not be deducted (regardless of whether the demolition was anticipated when the structure was acquired). Rather, these amounts were required to be treated as adjustments to the basis of the land on which the demolished historic structure was located.

A certified historic structure is a building listed in the National Register of Historic Places or located in an historic district that (1) is listed in the National Register or (2) is designated under certain State or local statutes and is certified by the Secretary of the Interior as substantially satisfying the requirements of the National Register for the listing of districts. In the case of a building located in an historic district, the building generally will not be considered a certified historic structure if the Secretary of the Interior certifies that the building is not of historic significance to the district.

Reasons for Change

The committee believes that preservation of certified historic buildings is an important national objective and that the tax law should not provide an incentive for demolition of these buildings. Accordingly, the committee determined that the prior-law denial of deductions for costs of, and other losses incurred in connection with, the demolition of certified historic structures should be reenacted and made permanent.

Explanation of Provision

The bill reenacts and makes permanent the denial of deductions for costs of, and other losses incurred in connection with, the demolition of certified historic structures.

Effective Date

This provision is effective with respect to demolitions commencing after December 31, 1983.

Revenue Effect

This provision will increase fiscal year budget receipts by less than $5 million annually.

22. Reinstatement of Deduction for Elimination of Certain Barriers to the Handicapped and the Elderly (sec. 880 of the bill and sec. 190 of the Code)

Prior Law

Section 190 of the Code, which provided a tax incentive for the removal of architectural and transportation barriers to the handicapped and the elderly, terminated effective with taxable years beginning on or after January 1, 1983. Under section 190 prior to its termination, an electing taxpayer could treat certain expenses for the removal of architectural and transportation barriers as deductible expenses in the year paid or incurred. Absent such an election, the taxpayer would be required to capitalize the expenses.

Section 190 applied to expenses paid or incurred in order to make more accessible to, and usable by, the handicapped and elderly any facility or public transportation vehicle owned or leased by the taxpayer for use in the taxpayer's trade or business. The maximum deduction allowed under prior law to a taxpayer (including a controlled group of corporations filing a consolidated return) for any taxable year was $25,000.

Section 190 allowed the deduction only if it was established to the satisfaction of the Treasury that the barrier removal met standards set by the Treasury with the concurrence of the Architectural and Transportation Barriers Compliance Board. Under section 190, the definition of an elderly person was a person age 65 or over, and handicapped individuals included the blind and the deaf.

Reasons for Change

The committee believes that it is desirable to encourage the removal of architectural and transportation barriers to the handicapped and the elderly through reinstating the deduction for certain expenses incurred in the removal of such barriers, and increasing the maximum deduction to $35,000.

Explanation of Provision

Under the bill, section 190 is reinstated and made applicable to expenses incurred in taxable years beginning after December 31, 1983, and before January 1, 1986. The maximum deduction allowed to a taxpayer (including a controlled group of corporations) is increased to $35,000.

Effective Date

The provision is effective on the date of enactment.

Revenue Effect

This provision will decrease fiscal year budget receipts by $8 million in 1984, $16 million in 1985, and $7 million in 1986.

23. Tax Treatment of Certain Nonprofit Child Care Organizations (sec. 881 of the bill and secs. 170, 2055, and 2522 of the Code)

Present Law

Under present law, nonprofit organizations which are organized and operated exclusively for religious, charitable, educational, or certain other purposes, and which meet certain other requirements, are exempt from Federal income tax (sec. 501(c)(3)). Contributions to such organizations are deductible for income, gift, and estate tax purposes (secs. 170, 2055, 2522).

The Internal Revenue Service has recognized that nonprofit day care centers may be eligible for tax exemption and tax-deductible contributions where enrollment is based on financial need of the family and the need of the child for the program, or where the center provides pre-school age children of working parents with an educational program through a professional staff of qualified teachers (Rev. Rul. 68-166, 1968-1 C.B. 223; Rev. Rul. 70-533, 1970-2 C.B. 112). Under the facts involved in these rulings, the IRS concluded that any private benefits derived by the parents of enrolled children or the employer of the parents were merely incidental to the public benefits resulting from the center's operation, and hence were not inconsistent with tax exemption. Similarly, the Tax Court has upheld the tax-exempt status of child care centers in circumstances where the custodial services of the center were incidental to its educational activities,[1] but not where the center's operations do not serve the community as a whole.[2]

Reasons for Change

The committee understands that definitional difficulties have arisen with respect to whether certain nonprofit day care organizations which provide after-school care to children or care for infants or toddlers meet the present law requirements for tax-exempt status and eligibility for tax-deductible contributions as educational or charitable organizations. Accordingly, the committee believes that certain nonprofit day care organizations which make their services available to the general public should be considered to have educational purposes without regard to the present-law interpretation of that term as applied to such day care organizations.

Explanation of Provision

The bill provides that the term "educational purposes," as used for purposes of tax-exempt status under section 501(c)(3) and eligibility for tax-deductible contributions under sections 170, 2055, and

[1] *San Francisco Infant School, Inc.* v. *Comm'r*, 69 T.C. 957 (1978), acq. 1978-2 C.B. 2.

[2] *Balt. Regional Joint Board Health and Welfare Fund* v. *Comm'r*, 69 T.C. 554 (1978).

2522, includes the providing of care of children (away from their homes) if both (1) substantially all of the child care provided by the organization is for the purposes of enabling individuals to be gainfully employed, and (2) the services provided by the organization are available to the general public. This provision is not intended to affect the meaning of the terms "educational" or "charitable" for any purpose other than considering the child care organizations described in the provision as having educational purposes.

Effective Date

The amendment made by this provision of the bill is effective for taxable years beginning after the date of enactment.

Revenue Effect

The provision is estimated to reduce budget receipts by less than $5 million annually.

24. Incentives for Research and Experimentation and for Vocational Education

a. Extension of credit for increased research expenditures; modification of definition of credit-eligible research expenditures; changes in trade or business requirement (sec. 882 of the bill and sec. 44F* of the Code)

Present Law

Current deduction for certain research expenditures

General rule.—As a general rule, business expenditures to develop or create an asset which has a useful life that extends beyond the taxable year, such as expenditures to develop a new product or improve a production process, must be capitalized. However, Code section 174 permits a taxpayer to elect to deduct currently the amount of "research or experimental expenditures" incurred in connection with the taxpayer's trade or business. For example, a taxpayer may elect to deduct currently the costs of wages paid for services performed in qualifying research activities, and of supplies and materials used in such activities, even though these research costs otherwise would have to be capitalized.

The section 174 election does not apply to expenditures for the acquisition or improvement of depreciable property, or land, to be used in connection with research.[1] Thus, for example, the total cost of a research building or of equipment used for research cannot be currently deducted under 174 in the year of acquisition. However, the amount of depreciation (cost recovery) allowance for a year with respect to depreciable property used for research may be deducted in that year under the election. Under ACRS, machinery and equipment used in connection with research and experimentation are classified as three-year recovery property and are eligible for a six-percent regular investment tax credit.

Qualifying expenditures.—The Code does not specifically define "research or experimental expenditures" eligible for the section 174 deduction election (except to exclude certain costs). Treasury regulations (sec. 1.174-2(a)) define this term to mean "research and development costs in the experimental or laboratory sense." This includes generally "all such costs incident to the development of an experimental or pilot model, a plant process, a product, a formula, an invention, or similar property", and also the costs of obtaining a patent on such property.

*The tax credit simplification provisions of the bill will renumber section 44F.

[1] Also, the statute excludes expenditures to ascertain the existence, location, extent, or quality of mineral deposits, including oil and gas, from eligibility for section 174 elections (sec. 174(d)). However, expenses of developing new and innovative methods of extracting minerals from the ground may be eligible for sec. 174 elections (Rev. Rul. 74-67, 1974-1 C.B. 63). Also, certain expenses for development of a mine or other natural deposit (other than an oil or gas well) may be deductible under sec. 616.

The present regulations provide that qualifying research expenditures do not include expenditures "such as those for the ordinary testing or inspection of materials or products for quality control or those for efficiency surveys, management studies, consumer surveys, advertising, or promotions." Also, the section 174 election cannot be applied to costs of acquiring another person's patent, model, production, or process or to research expenditures incurred in connection with literary, historical, or similar projects (Reg. sec. 1.174-2(a)).

Credit for increasing certain research expenditures

Overview

General rule.—An income tax credit is allowed for certain qualified research expenditures paid or incurred by a taxpayer during the taxable year in carrying on a trade or business of the taxpayer (Code sec. 44F, enacted in the Economic Recovery Tax Act of 1981). The credit applies only to the extent that the taxpayer's qualified research expenditures for the taxable year exceed the average amount of the taxpayer's yearly qualified research expenditures in the specified base period (generally, the preceding three taxable years). The rate of the credit is 25 percent of the incremental research expenditure amount.

Under present law, the section 44F credit applies to qualified research expenditures paid or incurred after June 30, 1981 and before January 1, 1986.

Qualifying expenditures.—For purposes of the section 44F credit, the definition of research is the same as that used for purposes of the special deduction rules under section 174, but subject to certain exclusions. A taxpayer's research expenditures eligible for the section 44F incremental credit consist of (1) "in-house" expenditures by the taxpayer for research wages and supplies used in research, plus certain amounts paid for research use of laboratory equipment, computers, or other personal property; (2) 65 percent of amounts paid by the taxpayer for contract research conducted on the taxpayer's behalf; and (3) if the taxpayer is a corporation, 65 percent of the taxpayer's expenditures (including grants or contributions) pursuant to a written research agreement for basic research to be performed by universities or certain scientific research organizations.

Trade or business limitations

Under present law, the section 44F credit is available only for research expenditures paid or incurred in carrying on a trade or business of the taxpayer. With one exception, the trade or business test for purposes of the credit is the same as for purposes of the business deduction provisions of section 162. Thus, for example, the credit generally is not available to a limited partnership (or to any partners in such partnership, including a general partner which is an operating company) for partnership expenditures for "outside" or contract research intended to be transferred by the partnership to another (such as to the general partner) in return for license or royalty payments. Under the trade or business test, research expenditures of a taxpayer are eligible for the credit only if paid or incurred in a particular trade or business already being carried on by the taxpayer.

As the only exception to the rule that the trade or business test for purposes of section 44F is the same as for purposes of section 162, the Treasury Department is to issue regulations, for credit purposes only, which are to allow the credit in the case of a research joint venture between taxpayers which both (1) themselves satisfy the carrying on test (e.g., the research must be in a particular trade or business already being carried on by the taxpayer) and also (2) themselves are entitled to the research results.

Explanation of incremental credit

Definition of qualified research

Subject to certain exclusions, the credit provision adopts the definition of research as used in section 174. Thus under present law, the term "qualified research" for purposes of section 44F has the same meaning, subject to the specified exclusions, as has the term "research or experimental" under section 174.

The section 44F credit is not available for expenditures such as the costs of routine or ordinary testing or inspection of materials or products for quality control; of efficiency surveys or management studies; of consumer surveys (including market research), advertising, or promotions (including market testing or development activities); or of routine data collection. Also, costs incurred in connection with routine, periodic, or cosmetic alterations or improvements (such as seasonal design or style changes) to existing products, to production lines, or to other ongoing operations, or in connection with routine design of tools, jigs, molds, and dies, do not qualify as research expenditures under the credit.[2]

Exclusions

There are three express exclusions from the definition of qualified research for purposes of the section 44F credit.

First, expenditures for research which is conducted outside the United States do not enter into the credit computation.

Second, the credit is not available for research in the social sciences or humanities (including the arts), such as research on psychological or sociological topics or management feasibility studies.

Third, the credit is not available for research to the extent funded by any grant, contract, or otherwise by another person (or any governmental entity).

Contract research expenditures

In addition to the categories of in-house research expenditures, 65 percent of amounts paid by the taxpayer for qualified research performed on behalf of the taxpayer enters into the incremental credit computation. The research firm, university, or other person

[2] The credit is not available for such expenditures as the costs of construction of copies of prototypes after construction and testing of the original model(s) have been completed; of pre-production planning and trial production runs; of engineering follow-through or troubleshooting during production; or of adaptation of an existing capability to a particular requirement or customer's need as part of a continuing commercial activity. For example, the costs of adapting existing computer software programs to specific customer needs or uses, as well as other modifications of previously developed programs, are not eligible for the credit.

which conducts the research on behalf of the taxpayer cannot claim any amount of the credit for its expenditures in performing the contract.

If any contract research amount paid or incurred during a taxable year is attributable to qualified research to be conducted after the close of that taxable year, that amount is treated, pursuant to a prepayment limitation, as paid or incurred during the period during which the qualified research is actually conducted.[3]

Expenditures for university basic research

A special rule treats as qualified research expenditures 65 percent of certain corporate expenditures (including grants or charitable contributions) for basic research to be performed at a college, university, or other qualified organization pursuant to a written research agreement. Under this rule, a corporate taxpayer takes into account, for purposes of computing the incremental credit, 65 percent of qualifying basic research expenditures, subject to the contract research prepayment limitation.

Computation of allowable credit

General rule

As a general rule, the section 44F credit applies to the amount of qualified research expenditures for the current taxable year which exceeds the average of the yearly qualified research expenditures in the preceding three taxable years. The base period amount is not adjusted for inflation.

New businesses

For a base period year during which it was not in existence, a new business is treated as having research expenditures of zero in such year, for purposes of computing average annual research expenditures during the base period. However, the taxpayer may be deemed to have expenditures in such a base period year pursuant to the 50-percent limitation rule (described below).

50-percent limitation rule

Base period research expenditures are treated as at least equal to 50 percent of qualified research expenditures for the current year.[4] This 50-percent limitation applies both in the case of existing businesses and in the case of newly organized businesses.

[3] For example, if on December 1, 1983, a calendar-year taxpayer paid $100,000 to a research firm pursuant to a contract for qualified research to be performed on behalf of the taxpayer, and if the research firm conducts all of such qualified research during 1984, no amount is eligible for a credit for 1983, and $65,000 (65 percent of the total contract price) is treated as research expenditures of the taxpayer paid during 1984.

Amounts which are treated as contract research expenditures during a particular taxable year pursuant to the prepayment limitation rule, and hence which count as expenditures for such year entering into the credit computation for such taxable year, also are treated as having been made during that same taxable year for purposes of determining average yearly base period expenditures in later year credit computations. Thus, in the example given above, $65,000 enters into the taxpayer's 1984 credit base.

[4] For example, assume that a calendar-year taxpayer is organized on January 1, 1983; makes qualified research expenditures of $100,000 for 1983; and makes qualified research expenditures of $260,000 for 1984. The new-business rule provides that the taxpayer is deemed to have base period expenditures of zero for pre-1983 years. Without regard to the 50-percent limitation, the taxpayer's base period expenditures for purposes of determining any credit for 1984 would be

Continued

Aggregation rules

To ensure that the section 44F credit will be allowed only for actual increases in research expenditures, special rules apply under which research expenditures of the taxpayer are aggregated with research expenditures of certain related persons for purposes of computing any allowable credit. These rules are intended to prevent artificial increases in research expenditures by shifting expenditures among commonly controlled or otherwise related persons.

Changes in business ownership

Special rules apply for computing the credit where a business changes hands, under which qualified research expenditures for periods prior to the change of ownership generally, are treated as transferred with the trade or business which gave rise to those expenditures. These rules are intended to facilitate an accurate computation of base period expenditures and the credit by attributing research expenditures to the appropriate taxpayer.

Limitations and carryover

In the case of an individual who owns an interest in an unincorporated trade or business, who is a beneficiary of a trust or estate, who is a partner in a partnership or who is a shareholder in an S corporation, the amount of credit that can be used in a particular year also cannot exceed an amount (separately computed with respect to the person's interest in the trade or business or entity) equal to the amount of tax attributable to that portion of the person's taxable income which is allocable or apportionable to such interest.[5]

If the amount of credit otherwise allowable exceeds the applicable limitation, the excess amount of credit can be carried back three years (including carrybacks to years before enactment of the credit) and carried forward 15 years, beginning with the earliest year.

Effective date

Under present law, the section 44F credit applies to qualified research expenditures paid or incurred after June 30, 1981 and before January 1, 1986.

the average of its expenditures for 1981 (deemed to be zero), 1982 (deemed to be zero), and 1983 ($100,000), or $33,333. However, by virtue of the 50-percent limitation, the taxpayer's average base period expenditures are deemed to be no less than 50 percent of its current year expenditures ($260,000), or $130,000. Accordingly, the amount of 1984 qualified research expenditures to which the credit applies is limited to $130,000, and the amount of the taxpayer's credit for 1984 is $32,500.

[5] For example, if in a particular year an individual partner derives no taxable income from a partnership which had made incremental qualified research expenditures, the individual may not use in that year any tax credit resulting from incremental qualified research expenditures of such partnership which otherwise would have been properly allowable to the partner (e.g., where the partnership had paid such research expenditures in carrying on a trade or business of the partnership and where any credit allowable to the partnership with respect to such expenditures had been properly allocated among the partners pursuant to Treasury regulations). If in this example the partner had derived taxable income allocable or apportionable to his or her partnership interest, then the amount of credit which may be used in that year by the individual partner may not exceed the lesser of the general limitation amount or the separately computed additional limitation amount applicable to individuals.

Reasons for Change

Overview.—When the section 44F credit was enacted in 1981, the Congress expressed serious concern about the then substantial relative decline in total U.S. expenditures for research and experimentation. The purpose of the credit was to encourage business firms to perform the research necessary to increase the innovative qualities and efficiency of the U.S. economy. An expiration date for the credit was deemed desirable in order to enable the Congress to evaluate the experience with the credit and its operation, and to determine whether it should be extended and what modifications would be necessary to make the credit more effective.

Permanent extension of credit.—Experience to date with the credit has indicated that several of its provisions require immediate modification. Action has been sought at this time because the start of new projects in late 1984 or 1985 might be delayed until there would be assurance that the credit would continue to be available after 1985. This effect of a termination date for the credit on the start of new projects also explains why the committee chose to make the credit a permanent provision of the Code.

Definition of research and experimentation.—After reviewing information on the actual use of the credit, the committee is concerned that the category of qualifying research expenditures has not been defined adequately for the purposes of the credit provision, which under present law cross-references to the definition employed for the special deduction rules in section 174. As a result, the definition has been applied too broadly in practice, and some taxpayers have claimed the credit for virtually all preproduction expenses. According to Treasury data, many of these taxpayers are in industries that do not involve high technology or its application in developing technologically new and improved products or methods of production. The committee believes that it is desirable to target the credit, as originally intended, to research and experimental activities designed to produce a technologically new or improved business component where the new or improved characteristics are functional rather than stylistic or cosmetic.

The process of experimentation involved in qualified research needed clarification because some taxpayers took the view that virtually any trial and error procedure, however rudimentary, would satisfy the requirement of experimentation even though there might be little doubt about the outcome of the procedure. The committee believes that the research credit should be limited to experimentation activities that involve functional changes in product or process and also involve a serious degree of uncertainty as to whether the desired result will be achieved.

The committee is also concerned that some taxpayers take the position that virtually any software development costs should be eligible for the credit, including routine data-processing development costs, adaptations of existing software to meet customer needs, merely duplicative activities, etc. The varieties of software range from software that creates new hardware, such as the development and applications of artificial intelligence, to at least one new word processing software for each and every version of a business or personal computer. To resolve definitional difficulties and to carry out the original intended objectives of the credit, a targeted definition has been set forth with respect to internal-use software developed by a taxpayer.

In administering the section 44F credit, questions may arise in determining whether particular expenditures made by the taxpayer appropriately involve the experimental part of a business research project or include a broader range of expenditures that relate to the overall project but not directly to the experimental phase. The committee decided, therefore, that the statute should provide a more specific set of rules to guide taxpayers and the IRS in determining the limits of qualified research eligible for the credit. Generally, if the scope of qualifying experimentation relates to less than the whole product or process, qualified research expenditures will be defined in terms of the most significant set of elements of the product or process that involves technologically new or improved functional characteristics.

Trade or business test.—Present law provides that research and experimentation expenses are eligible for the credit only if incurred by the taxpayer in carrying on a trade or business within the meaning of section 162. This prerequisite for qualifying for the research credit was enacted principally to preclude use of the tax credit in tax shelters. Experience since enactment indicates that this requirement serves its intended purposes and should be retained, but that the modifications made by the bill are desirable.

Explanation of Provisions

Extension of incremental credit

The bill provides a permanent tax credit for increased research expenditures.

Modification of definition of credit-eligible research expenditures

General rule

Present law defines qualified research for purposes of the section 44F credit principally by a cross-reference to the definition of research developed in Treasury regulations under section 174, which allows a current deduction for certain "research or experimental expenditures." The bill instead provides a separate statutory definition of qualified research for purposes of the credit, effective for post-1984 taxable years. This definition will not affect the category of research expenditures qualifying for the section 174 deduction.

Under the bill, a taxpayer's qualified expenditures (such as inhouse wages) in developing or improving a product, process, etc. are eligible for the section 44F credit only to the extent that (1) such expenditures are incurred in qualified research, (2) the objectives of the qualified research are technologically new or improved characteristics developed through a process of experimentation relating to functional characteristics, (3) the product, process, etc. sought to be developed or improved constitutes a business component, and (4) none of the exclusions set forth in the bill are applicable.

Qualified research

Under the bill, qualified research is defined as either (1) a planned search or systematic investigation (including basic research) undertaken for the purpose of discovering information which may be useful in the development of a technologically new or improved business component of the taxpayer, or (2) application of the results obtained from such research activity, or other knowledge, to develop a technologically new or improved business component of the taxpayer.

The term research includes the conceptual formulation, design, and testing of business component alternatives. Also, research includes the design, construction, and testing of models or prototypes, whether one or several prototypes are made and whether they are made simultaneously or consecutively, but only up to the point at which any necessary modifications to the prototype(s) have been made and testing has been completed. After completion of testing on an original prototype, or a sale or similar disposition of one prototype, the construction of additional copies of the prototype does not constitute research.

The bill also provides that research includes the design, construction, and testing of a pilot plant. The latter term refers to a plant which is constructed for and used for purposes of experimentation and which is not of such a size that it can be used for normal commercial production. If a plant initially qualifies as a pilot plant, but at a later date is used to produce output for sale or other commercial disposition, no activities qualify as research after use of the plant for output purposes (or, if earlier, after the taxpayer commences conversion of the plant from a research facility to an output facility).

Technological improvements

General rule

Development of a business component sought to be developed through such qualified research is treated as technologically new or improved only if both of the following requirements are met—(1) the new or improved characteristics of the component are technological in nature, and (2) substantially all of the activities undertaken by the taxpayer in developing or improving the component constitute elements of a process of qualified experimentation.

Technological characteristics

The determination of whether new or improved characteristics of a component are technological in nature depends on whether the process of experimentation to develop or improve such characteristics fundamentally relies on principles of the physical or biological sciences, engineering, or computer science—in which case the characteristics are deemed technological—or on other principles, such as those of economics—in which case the characteristics are not to be treated as technological. For example, new or improved characteristics of financial services products (such as new types of variable annuities) or advertising could not qualify as technological in nature.

Qualified experimentation

For purposes of the "technologically new or improved" requirement, the term "process of experimentation" means a process, in a field of science or technology, of design and testing involving all of the following steps: (1) formulating detailed technological objectives and specifications for a technologically new or improved business component and designing alternatives to achieve these objectives because of uncertainty as to whether a particular alternative will achieve the desired result; (2) rigorously testing and analyzing these alternatives to determine their respective abilities to fulfill the desired objectives, including testing and analyzing by means of modeling and simulation; and (3) refining and ultimately choosing[6] among alternatives based on the knowledge derived from the tests and analyses and documenting[7] such technological knowledge as to function and specifications. Thus, for example, the costs of developing a new or improved component do not qualify for the credit if the method of reaching the desired objective (the new or improved product characteristics) is readily discernible and applicable as of the beginning of the research activities, so that true experimentation in the scientific or laboratory sense would not have to be undertaken to develop, test, and choose among viable alternatives. Mere trial and error techniques employed to develop or improve a business component will not satisfy this standard of experimentation.

Experimentation is considered qualified only if it relates to such factors as new or improved function, performance, reliability, quality, or significantly reduced cost, rather than to style, taste, cosmetic, or seasonal factors. Activities undertaken to assure achievement of the intended function, performance, quality, reliability, or cost of the business component after the beginning of commercial production of the component do not constitute qualified experimentation. Thus, for example, activities undertaken as part of model-year changes to insure that a product performs as originally intended do not constitute qualified experimentation.

Substantially all test

In determining whether the substantially all test is met, the extent of qualified experimentation in developing or improving a business component is to be compared to the extent of all activities (research and nonresearch) in developing or improving the component, other than duplication,[8] including qualified experimentation,

[6] For this purpose, refining and choosing among alternatives includes only decisions made on the basis of the scientific and technological results of the experimentation. The process of experimentation does not include, for example, management-level decisions among the alternatives on the basis of nonscientific or nontechnological factors such as market risk or customer preference.

[7] Such documentation of research results constitutes qualified experimentation only where done as an integral part of the qualified research for purposes of recording the research results, but not (for example) if done for any other descriptive purpose or if done as part of postproduction, sales, or marketing activities.

[8] For purposes of determining whether the substantially all test is met, any activities relating to the duplication (as defined in the bill) by the taxpayer of a business component of the taxpayer or of another taxpayer are not treated as an activity undertaken in developing or improving the component, and hence do not enter into the comparison of activities for purposes of that test.

other experimentation (such as experimentation relating to style changes), adaptation, other nonresearch activities, post-research activities, etc. If the activities constituting experimentation relate to style, taste, cosmetic, or seasonal design factors as well as to functional or significantly reduced cost factors, then such activities are to be treated as meeting that requirement only if the stylistic, etc. features sought to be developed or improved are merely incidental to the functional, etc., features sought to be developed or improved.

Business component

The bill defines business component to mean a product, process, computer software, technique, formula, or invention to be offered for sale, lease, or license, or used by the taxpayer in a trade or business. However, if all aspects of the "technologically new or improved" requirement described above are not met with respect to a product, etc. but are met with respect to one or more elements thereof, the term business component means the most significant set of elements of such product, etc. with respect to which all aspects of the requirement are met.

Thus, the "technologically new or improved" requirement is applied first at the level of the entire product, etc. to be offered for sale, etc. by the taxpayer. If all aspects of that requirement are not met at that level, the test applies at the most significant subset of elements of the product, etc. This "shrinking back" of the product is to continue until either a subset of elements of the product that satisfies the requirement is reached, or the most basic element of the product is reached and such element fails to satisfy the test.

For example, the stylistic characteristics of the exterior of a product often are of such magnitude in the context of the product as a whole that substantially all of the activities to develop the product do not relate to new or improved functional characteristics. Accordingly, the relevant business component will not be the product as a whole. The "technologically new or improved" test then is reapplied at the next most significant subset of elements of the product, which might be a group of related internal parts. If at this second level the functional character of the first subset of elements, which are technological in nature, predominates, then the business component for purposes of this rule is the set of all internal parts, taken as a whole, of the product.

By way of illustration, assume that installing a technologically new carburetor in an automobile engine requires changes to the engine design. The engine will be the business component only if the engine changes require sufficient experimentation that the substantially all test is met for the engine and carburetor activities together; otherwise the "technologically new or improved" test will be applied to the carburetor.[9]

Computer software

Under a special rule in the bill, computer software that is separately developed by or for the benefit of the taxpayer specifically

[9] Within one product, two or more components which are not parts of the same system may meet the test. For example, within a car, both the carburetor and the braking system could independently satisfy the "technologically new or improved" test.

for the taxpayer's own internal use qualifies as a business component (and hence the development costs of such software may be eligible for the credit) only if the software is used in (1) qualified research (as defined in sec. 44F(d)) undertaken by the taxpayer or (2) a production process that contains a component which qualifies for the credit (e.g., software for robotics used in operating an assembly line), or only to the extent allowed by Treasury regulations.

Accordingly, the costs of developed software are not eligible for the credit where the software is used internally, for example, in general and administrative functions (payroll, bookkeeping, personnel management, etc.) or in providing noncomputer services (such as accounting, consulting, or banking services), except to the extent permitted by Treasury regulations. The committee intends and expects that these regulations will make the costs of technologically new or improved internal-use software eligible for the credit only where such software surmounts a high threshold of innovation as well as satisfying the general requirements for credit eligibility set forth in the bill.

In the case of computer software costs which are not disqualified under the special rule in the bill, the eligibility of such costs for the section 44F credit is to be determined in the same manner as the eligibility of hardware product costs.

Nonresearch activities

The bill specifies that expenditures incurred in certain research-related or nonresearch activities are excluded from eligibility for the credit, without reference to the "technologically new or improved" test.

Duplication

The costs of development or improvement of a business component which otherwise would be qualified research are not eligible for the credit if the predominant portion of the activity related to such development or improvement (which, but for the duplication exclusion, would constitute qualified research) constitutes duplication. The bill defines duplication as any activity related to the reproduction of an existing business component of another person from a physical examination of the component itself or from plans, buleprints, detailed specifications, or publicly available informataion with respect to such component. While such "reverse engineering" activities thus are not eligible for the credit, the exclusion for duplication does not apply merely because the taxpayer initially examines a competitor's product in developing its own component through a process of otherwise qualified experimentation requiring the testing of viable alternatives and based on the knowledge gained from such tests.

Adaptation

Also, qualified research does not include adaptation of an existing business component to a particular requirement or customer's need as part of a continuing commercial activity. Thus, for example, the costs of modifying an existing business component for a particular customer are not eligible for the credit. However the mere fact that a component is intended for a specific customer does not disqualify otherwise qualified research costs of the component (assuming that the research is not funded by the customer).

Post-research activities, etc.

Under the bill, qualified research does not include any activity with respect to a business component after the beginning of commercial production. Thus, no expenditures relating to a business component are eligible for the credit after the business component has been developed to the point where it constitutes a finished business component which either meets the basic functional and economic requirements of the taxpayer for such component, or is ready for commercial sale or use. For example, activities after development of a prototype will not constitute qualified research except to the extent that functional developments must take place to transform the prototype to a finished business component. Under this exclusion, the credit is not available for such expenditures as the costs of preproduction planning for a finished business component, "tooling-up" for production, trial production runs, "trouble-shooting" involving detecting faults in production equipment or processes, accumulation of data relating to production processes, and the cost of "debugging" product flaws (including debugging flaws from an existing model as part of routine model-year changes).

The bill also provides that the costs of any development of plant processes, machinery, or techniques for commercial production of a business component do not constitute qualified research. However, qualified research to develop a technologically new or improved manufacturing process, etc., may qualify for the credit.

Additional exclusions

The bill excludes from eligibility for the credit expenditures for research (1) which is conducted outside the United States; (2) in the social sciences (including economics, business management, and behavioral sciences), arts, or humanities; or (3) to the extent funded by any grant, contract, or otherwise by any person (or any governmental entity). Also, the costs of ascertaining the existence, location, extent, or quality of any deposit of ore or other mineral (including oil and gas) are not eligible for the credit.[10] The credit is not available for the costs of efficiency surveys, management studies, management techniques, market research, market testing and development (such as advertising or promotions), routine data collections, or routine or ordinary testing or inspection of materials or business components for quality control. The exclusion for management techniques applies to such items as development of a manual accounting system, preparation of financial data and analysis, development of employee training programs and management organization plans, and management-based changes in production processes (such as rearranging work stations on an assembly line).

[10] See note 1, *supra*.

Modification of trade or business limitation

Under the bill, all otherwise qualifying in-house and contract research expenses paid or incurred by a regular corporation [11] are treated as qualified research expenses for credit purposes without regard to the trade or business test of present law if, at the time such research expenses are paid or incurred, the principal purpose of such corporation is to use the results of the research in the active conduct of a present or future trade or business and not to license or otherwise transfer such research results to unrelated persons (e.g., persons other than members of a controlled group of corporations, as defined in sec. 1563(a), which includes the taxpayer). Thus, the research expenditures of a start-up corporation whose activities have not yet reached the level of constituting a trade or business (as defined for purposes of sec. 162) will be eligible for the credit.[12] Also, the bill makes the credit available for corporate expenditures for new research endeavors that are not part of any of the corporation's existing trades or businesses.

With respect to in-house and contract research expenses paid or incurred by a partnership, the bill provides that, as a general rule, the trade or business test is to be applied at the partnership level without regard to the trade or business of any partner. If at the partnership level the test is met, any available credit is to be apportioned among the partners in accordance with any safe harbor rule that the Treasury will provide for allocations of credits (other than investment tax credits) under regulations promulgated under section 704(b).

Under the bill, in two cases in-house or contract research expenses paid or incurred by a partnership other than in carrying on a trade or business of the partnership could nonetheless constitute qualified research expenses. These special rules will apply if each partner is a corporation,[13] or if all of the in-house or contract research expenses paid or incurred by a partnership (all of whose partners are not regular corporations) would have satisfied the trade or business requirement as applied to each of the partners had each of the partners directly conducted the research. In these cases, instead of computing the credit at the partner's level, the trade or business requirement will be deemed to be met at the partnership level (due to the partners' activities), and the credit will be determined at the partnership level. In either of these two cases, the qualified research expenses are to be apportioned among the partners in accordance with the partnership allocation rules described above.

The bill does not modify the present-law limitation in section 44F(g)(1)(B), described above, applicable to an individual who is a partner in a partnership.

[11] For this purpose, the term regular corporation does not include an S corporation (sec. 1361(a)), a service organization (sec. 414(m)(3)), and, except to the extent as may otherwise be provided in regulations, a personal holding company (sec. 542).

[12] See discussion under present law as to computation rules applicable to new businesses, including the 50-percent limitation rule.

[13] See note 11, *supra*.

Effective Date

These provisions are effective for taxable years beginning after 1984.[14]

[14] In computing the section 44F credit for a post-1984 year, base period expenditures for a pre-1985 year are to be determined under the credit definition which was applicable in that year and are not to be redetermined under the definition in the bill.

b. Increased credit for corporate support of basic research at universities (sec. 882 of the bill and Code sec. 44F(e))

Present Law

General rule

Under present law, a corporation[14a] may take into account, for purposes of computing the section 44F credit for a taxable year, 65 percent of qualifying basic research expenditures for that year (subject to the contract research prepayment limitation).[15] Similarly, this percentage is treated as research expenditures in a base period year when calculating the credit in subsequent years.

The special rule for basic research applies only to expenditures paid or incurred pursuant to a written research agreement between the taxpayer corporation and a college or university, certain tax-exempt scientific research organizations, and certain qualified funds (organized exclusively to make basic research grants to colleges and universities).

For purposes of this special rule, the term "basic research" means any original investigation for the advancement of scientific knowledge not having a specific commercial objective. However, the term basic research does not include expenditures for any activity excluded from the section 44F definition of qualified research, e.g., expenditures for basic research in the social sciences or humanities (including the arts).

Illustration of computation

Assume that a corporation makes qualified in-house research expenditures totaling $120 million in each of the years 1980, 1981, and 1982. In addition, in 1981 the corporation makes a $6 million grant to a university for qualifying basic research; all of this amount is expended by the university in that year. In 1983, the corporation makes qualified in-house research expenditures totaling $130 million and also contributes $3 million to a university for basic research pursuant to a written research agreement. The university expends 50 percent of the 1983 contribution funds during 1983 and the rest during 1984.

Under these facts, the corporation's qualified research expenditures for 1983 would equal $130 million *plus* 65 percent of $1.5 million ($975,000). The corporation's base period expenditures with respect to 1983 would be the average of its qualified research expenditures for 1980, 1981, and 1982, or $121,300,000. Accordingly, the 25-

[14a] For this purpose, the term corporation does not include S corporations (sec. 1361(a)), personal holding companies (sec. 542), or service organizations (sec. 414(m)(3)).

[15] If any contract research amount paid or incurred during a taxable year is attributable to qualified research to be conducted after the close of that taxable year, that amount is treated as paid or incurred in the year or years during which the qualified research is actually conducted. See note 3, *supra*.

percent credit for 1983 would apply to the excess of total current-year expenditures ($130,975,000) over the base period average ($121,300,000), or $9,675,000.

Assume further that in 1984 the total of the corporation's qualified in-house research expenditures increases to $135 million, and that the corporation makes no new basic research expenditures. The corporation is treated as having qualifying basic research expenditures in 1984 equal to 65 percent of $1.5 million, or $975,000. The corporation's base period expenditures with respect to 1984 would be the average of qualified research expenditures for 1981 ($123,900,000), 1982 ($120 million), and 1983 ($130,975,000). Accordingly, under present law the 25-percent credit for 1984 would apply to the excess of current-year expenditures ($135,975,000) over the base period average ($124,958,333), or $11,016,667.

Reasons for Change

The committee believes it is desirable to provide increased tax incentives for corporate cash expenditures for university basic research where such expenditures do not merely represent a switching of donations from general university giving and where certain other maintenance-of-effort levels are exceeded.

Explanation of Provision

Overview

Under present law, research expenditures entering into the computation of the section 44F incremental credit include 65 percent of a corporation's expenditures (including grants or contributions) pursuant to a written research agreement for basic research to be performed by universities or certain scientific research organizations. Under the bill, a 25-percent tax credit applies to the excess of (1) 65 percent of corporate cash expenditures for university basic research over (2) the sum of the greater of two fixed research floors (the average yearly amount of the corporation's credit-eligible university basic research expenditures for 1981–1983 taxable years or one percent of the average yearly amount of all the corporation's credit-eligible research expenditures for those years) plus an amount reflecting any decrease in nonresearch giving to universities by the corporation during a moving base period.

The excess credit-eligible expenditures to which the new credit applies will not also enter into the computation of the present-law incremental credit under section 44F. The remaining amount of credit-eligible basic research expenditures will continue to be eligible for the present-law incremental credit under section 44F.

In addition, the bill makes other modifications to the present-law university basic research provision.

Qualifying expenditures

For purposes of the new credit and the incremental credit, qualifying university basic research expenditures will be expenditures paid or incurred pursuant to a written agreement between the taxpayer corporation[16] and a university or certain other qualified organizations for basic research to be performed by the qualified organization (or by universities receiving funds through the initial recipient qualified organizations). Such corporate expenditures for university basic research will be deemed to satisfy the trade or business test (described above), whether or not the basic research is in the same field as the trade or business of the corporation.

Under the bill, qualifying expenditures include both grants or contributions by the corporation which constitute charitable contributions under section 170, and also payments for contract research to be performed by the university on behalf of the corporation. The bill makes inapplicable to university basic research expenditures the prepayment limitation of present law, under which corporate expenditures for university basic research enter into the incremental credit computation only when the university actually expends the funds for basic research.

The bill also provides that only cash expenditures may qualify under the university basic research provision. No amount (basis or value) on account of contributions or transfers of property constitutes university basic research expenditure for purposes of the incremental credit or the new credit, whether or not such property constitutes scientific equipment eligible for an augmented charitable deduction under the bill.

As under present law, the term "basic research" is defined as any original investigation for the advancement of scientific knowledge not having a specific commercial objective, other than basic research in the social sciences, arts, or humanities or basic research conducted outside the United States.

Qualified organizations

To be eligible for a credit, the corporate expenditures must be for basic research to be conducted by a qualified organization. For this purpose, the term qualified organization generally includes colleges or universities, tax-exempt scientific research organizations, and certain qualified funds which are treated as qualified organizations under present law.

The first category of qualified organizations consists of educational organizations that both are described in section 170(b)(1)(A)(ii)[17] and constitute institutions of higher education as defined in the bill.[18] Scientific organizations that qualify are tax-exempt organizations that (1) are organized and operated primarily to conduct

[16] The new basic research credit is not available with respect to university basic research expenditures by corporations that are S corporations (sec. 1361(a)), personal holding companies (sec. 542), or service organizations (sec. 414(m)(3)).

[17] An educational organization is described in sec. 170(b)(1)(A)(ii) "if its primary function is the presentation of formal instruction and it normally maintains a regular faculty and curriculum and normally has a regularly enrolled body of pupils or students in attendance at the place where its educational activities are regularly carried on. The term includes institutions such as primary, secondary, preparatory, or high schools, and colleges and universities", and includes both public and private schools (Treas. Reg. sec. 1.170A-9(b)(1)).

[18] The bill defines "institution of higher education" as an educational institution which (1) admits as regular students only individuals having a certificate of graduation from a high school, or the recognized equivalent of such a certificate; (2) is legally authorized to provide a program of education beyond high school; (3) provides an educational program for it which awards a bachelor's or higher degree, or provides a program which is acceptable for full credit toward such a degree, or offers a program of training to prepare students for gainful employment in a recognized occupation; and (4) is a public or other nonprofit institution.

scientific research, (2) are described in section 501(c)(3) (relating to exclusively charitable, educational, scientific, etc., organizations), and (3) are not private foundations. Also, certain tax-exempt funds which qualify under present law would continue to qualify under the bill.

In addition, the bill would treat as qualified any tax-exempt organization which is organized primarily to promote scientific research by colleges or universities pursuant to written research agreements, which expends on a current basis substantially all its funds through grants and contracts for basic research by colleges and universities and which is either (a) described in section 501(c)(3) and is not a private foundation or (b) described in section 501(c)(6) (trade associations).

Computation rules for new credit

The new 25-percent credit applies to the *excess* of (1) 65 percent of corporate cash expenditures for university basic research *over* (2) the sum of the minimum university basic research amount plus the maintenance-of-effort amount.

The minimum university basic research amount is the *greater* of two fixed floors—

(A) the average of all credit-eligible basic research expenditures under Code section 44F(e)(1) for each of the three taxable years immediately preceding the taxable year beginning after December 31, 1983; *or*

(B) one percent of the average of the sum of all in-house research expenses, contract research expenses, and credit-eligible basic research expenditures under Code section 44F(e)(1) for each of the three taxable years immediately preceding the taxable year beginning after December 31, 1983.

The maintenance-of-effort amount is the excess of the average of the undesignated donations paid or incurred by the taxpayer during the immediately preceding three taxable years over the amount of undesignated donations paid or incurred by the taxpayer in the taxable year. The term "undesignated donations" means the amount paid or incurred by the taxpayer to all institutions of higher education (as defined in sec. 3304(f)) that are described in section 170(b)(1)(A)(ii) for which a charitable deduction was allowable and which were not designated by the taxpayer for use for basic research. If the amount of the taxpayer's undesignated donations for a base period year is less than the corresponding amount for the preceding taxable year, and if the amount of the taxpayer's credit-eligible university basic research expenditures in the base period year is greater than the amount of such expenditures for the preceding taxable year, then for purposes of determining the average of the taxpayer's undesignated donations during the base period, the amount of the taxpayer's undesignated donations for the base period year is increased by the lesser of the increase in the amount of credit-eligible university basic research expenditures paid or incurred by the taxpayer from the preceding taxable year, or the reduction in the amount of undesignated donations from the preceding taxable year.

The amount of credit-eligible university basic research expenditures to which the new credit applies does not enter into the computation of the present-law incremental credit under section 44F. The remaining amount of credit-eligible university basic research expenditures, to which the new credit does not apply, enters into the incremental credit computation under section 44F (and in subsequent years enters into the base period amounts for purposes of computing the incremental credit).

The bill repeals the prepayment limitation of present law as applied to university basic research expenditures. Thus, for example, amounts transferred to a university in December, 1985 for research to be performed over 1986-87 which otherwise are eligible for the new credit are eligible in full for the new 25-percent credit in 1985, rather than in the years the university actually performs the research. However, the prepayment limitation remains in effect for other contract research expenditures.

Effective Date

This provision applies to taxable years beginning after 1984. The modifications made by the bill to the university basic research provision are not to apply in determining base period expenditures for taxable years beginning before 1985.

c. Augmented charitable deduction for donations to universities of scientific equipment for certain purposes (sec. 883 of the bill and new Code sec. 170(j))

Present Law

General rule for donations of property

In general, the amount of charitable deduction otherwise allowable for donated property must be reduced by the amount of any ordinary gain which the taxpayer would have realized had the property been sold for its fair market value at the date of the contribution (Code sec. 170(e)).

Thus, a donor of inventory or other ordinary-income property (property the sale of which would not give rise to long-term capital gain) generally may deduct only the donor's basis in the property, rather than its full fair market value. In the case of property used in the taxpayer's trade or business (sec. 1231), the charitable deduction must be reduced by the amount of depreciation recapture which would be recognized on sale of the donated property.

Special rule for certain research equipment donations

Under a special rule, corporations are allowed an augmented charitable deduction for donations of newly manufactured scientific equipment or apparatus to a college or university for research use in the physcial or biological sciences (sec. 170(e)(4), added by ERTA).[19]

This increased deduction is generally for the sum of (1) the corporation's basis in the donated property and (2) one-half of the unrealized appreciation (i.e., one-half of the difference between the property's fair market value determinated at the time of the contribution and the donor's basis in the property). However, in no event is the deduction under the special rule allowed for an amount which exceeds twice the basis of the property.

To qualify for this special deduction rule, a corporate contribution of scientific equipment to a college or university must satisfy the following requirements:

(1) The property contributed was constructed by the corporate donor;

(2) The contribution is made within two years of substantial completion of construction of the property;

(3) The original use of the property is by the college or university;

(4) Substantially all (at least 80 percent) of the use of the scientific equipment or apparatus by the college or university is

[19] Under a special rule enacted in 1976, an augmented charitable deduction also is allowed for corporate contributions of certain types of ordinary income property donated for the care of the needy, the ill, or infants (sec. 170(e)(3)).

for research (within the meaning of sec. 174), or for research training, in the United States in the physical or biological sciences;[20]

(5) The property is not transferred by the donee in exchange for money, other property, or services; and

(6) The taxpayer receives the donee's written statement representing that the use and disposition of the property contributed will be in accordance with the last two requirements.

For purposes of the first requirement listed above, property is treated as constructed by the taxpayer only if the cost of parts (other than parts manufactured by the taxpayer or a related person) used in construction does not exceed 50 percent of the taxpayer's basis in the property.

Reasons for Change

The committee believes that the present-law provisions concerning donations of newly manufactured scientific equipment to universities for research use should be expanded in certain respects. The committee is concerned about the obsolescence and inadequacy of much research equipment at universities, particularly because universities carry out more than one-half the basic research done in this country.

Explanation of Provision

General rule

Under the bill, an augmented charitable deduction applies to a charitable contribution by a corporation[21] of tangible personal property that is inventory (sec. 1221(1)), of tangible personal property used in the transferor's business (sec. 1231(b)), or of certain new computer software, if all of the following requirements are met.

(1) Qualified scientific property

The transferred property must be scientific or technological equipment or apparatus, replacement parts for such equipment, or computer software. In the case of transferred inventory, the equipment must be manufactured, produced, or assembled by the taxpayer, and the taxpayer must be regularly engaged in the business of manufacturing, producing, or assembling, and selling or leasing, such equipment. Computer software is eligible for an augmented deduction only if contributed within six months after substantial completion of its production and only if the original use is by the donee.

Substantially all (at least 80 percent) the use of the transferred property must be in the United States directly for research (within the meaning of sec. 174), for research training, for educational use in a scientific or engineering laboratory, or for educational use if the activity involving the equipment is a direct substitute for scien-

[20] For purposes of this limitation on research use, and on research training use, the physical sciences include physics, chemistry, astronomy, mathematics, and engineering, and the biological sciences include biology and medicine.

[21] For this purpose, the term corporation does not include S corporations (sec. 1361(a)), personal holding companies (sec. 542), or service organizations (sec. 414(m)(3)).

tific or engineering laboratory activities.[22] In the case of any such research or educational use, the property must be directly used in mathematics, the physical or biological sciences, or engineering.

Except for replacement parts, or computer software, only single units of qualified scientific property having a fair market value in excess of $250 can qualify for the augmented deduction. To qualify, the property (whether new or used) must be functional and usable as transferred, without need of any repair, reconditioning, or other similar investment by the donee. All transferred property must be accompanied by the same warranties as are normally provided by the manufacturer in connection with a sale of the transferred property.

(2) Eligible recipients

The qualified scientific property must be donated to—

(a) an educational organization (within the meaning of sec. 170(b)(1)(A)(ii))[23] which is an institution of higher education [24]; or

(b) a tax-exempt association at least 80 percent of whose members are such institutions of higher education, that is described in section 501(c)(3), and that is not a private foundation.

In either case, the transfer must be made through the recipient's governing body.

(3) Time of donation/original use

In the case of inventory property, and computer software, the contribution must be made within six months after substantial completion of assembly or production of the property. Also, the original use of the equipment or software must be by the donee. In the case of equipment which has been used in the transferor's business, the contribution must be made within three years after the property has been first placed in service.

(4) Restriction on donees

The bill provides that the transferred property may not be retransferred by the donee, in exchange for money, other property, or services, within five years after receipt.

The transferor must obtain a written statement from the donee's governing body, executed under penalties of perjury, representing that the latter's use and disposition of the property will be in accordance with the requirements for the augmented deduction and that the property is functional and usable without need of any repair, reconditioning, or other investment.

[22] Under this provision, donated computers or software to be used by students in basic mathematics, physics, or other undergraduate courses generally will not qualify for the augmented deduction because such property would be used for general problem-solving and not for research or research training, in a scientific laboratory, or as a direct substitute for scientific or engineering laboratory activities. On the other hand, gifts of microscopes or other equipment to be used in a scientific or engineering laboratory generally will qualify for the augmented deduction, as will donated computers or new computer software used for engineering design simulation as a direct substitute for engineering laboratory activities.

[23] See note 17, *supra.*

[24] See note 18, *supra.*

Allowable deduction

The amount of deduction allowed for contributions of qualified scientific property meeting the requirements of the bill will be as follows:

(a) *Tangible inventory property or computer software.*—Fair market value, but limited to the *lesser* of (a) twice the taxpayer's basis in the property *or* (b) the sum of the taxpayer's basis in the property plus one-half of the unrealized appreciation (i.e., one-half of the difference between the property's fair market value determined at the time of the donation and the basis in the property).

(b) *Tangible property used in the transferor's business.*—The *lesser* of (a) 150 percent of the taxpayer's basis in the property (computed without regard to sec. 1016 depreciation adjustments), less accumulated depreciation (sec. 1016(a)), *or* (b) fair market value.

Special limitations

Under the bill, the augmented deduction is not allowed for contributions of qualified scientific property (other than used equipment) if, determined on a product-by-product basis, the total of contributions in the taxable year by the taxpayer of such property exceeds 20 percent of the number of units of such item sold by the taxpayer in the ordinary course of its business in that taxable year.

Effective Date

This provision will be effective for taxable years beginning after 1984.

d. Tax treatment of payments and loan forgiveness received by certain graduate science students (sec. 884 of the bill and new sec. 117A of the Code)

Present Law

In general

Subject to several limitations, gross income does not include amounts received as a scholarship at an educational institution or as a fellowship grant (Code sec. 117). In general, a degree candidate may exclude the entire amount of the scholarship or fellowship grant, except for any portion which is regarded as payment for services in the nature of part-time employment. An individual who is not a candidate for a degree is limited to an exclusion of $300 per month for a period of 36 months.

Future services as compensation

In general, scholarships or fellowship grants are not excludable from gross income if they constitute compensation for past, present, or future employment services or for services subject to the direction or supervision of the grantor, or if the funded studies or research are primarily for the benefit of the grantor (Treas. Regs. sec. 1.117-4(c)). However, amounts received under Federal programs that are used for qualified tuition and related expenses are not disqualified from the exclusion merely because the recipient agrees to perform future services as a Federal employee or in a health manpower shortage area (sec. 117(c)).

In 1977, the Internal Revenue Service ruled that awards made under the provisions of the National Research Service Awards Act to individuals who, in return for receiving the awards, must subsequently engage in health research or teaching or some equivalent service (and must allow the government to make royalty-free use of any copyrighted materials produced as a result of the research) are not excludable as scholarships or fellowship grants (Rev. Rul. 77-319, 1977-2 C.B. 48). However, this ruling was overturned by the Revenue Act of 1978 for awards made during calendar years 1974-1979, and by subsequent legislation for awards made through 1983.

Income from debt cancellation

As a general rule, income is realized when indebtedness is forgiven or cancelled (sec. 61(a)(12)). In the case of discharge from debt when the taxpayer is in bankruptcy or is insolvent or the discharge of qualified business indebtedness, the discharge amount instead may be applied to reduce tax attributes of the debtor (or in certain circumstances, may be excluded from income) (secs. 108, 1017).

The Tax Reform Act of 1976 provided a special income exclusion rule for cancellation of certain student loans. The exclusion under that rule applied to debt discharges (prior to 1979) pursuant to a loan agreement under which the indebtedness would be discharged if the individual worked for a period of time in specified professions in certain geographical areas or for certain classes of employers. This rule applied to student loans made to an individual to assist in attending an educational institution only if the loan was made by a government unit or agency. The rule was exended by the Revenue Act of 1978 to such discharges occurring through 1982.[25]

Reasons for Change

The committee believes that present-law income tax provisions relating to the exclusion from income of scholarships, grants, and forgiveness of student loans should be modified in ways that support national policy to improve training and education in scientific fields where shortages of teachers are evident. Present law, therefore, is amended to provide such exclusions in cases where certain graduate science students are to perform future teaching services for any of a broad class of qualified educational institutions.

Explanation of Provision

In general

The bill provides a new Code section 117A, under which gross income does not include amounts received by certain graduate science students as a scholarship, fellowship grant, or qualified student loan forgiveness, including situations where the recipient is required as a condition of receiving such amounts to perform future teaching services for any of a broad class of qualified educational organizations.

Qualified recipients

Under the bill, the new provision applies to a student who has a bachelor's degree or its equivalent and who is engaged in postgraduate study as a degree candidate in mathematics, engineering, the physical or biological sciences, or computer science at a qualified educational organization. The latter term means an educational institution that is described in section 170(b)(1)(A)(ii),[26] admits as regular students only individuals having a certificate of graduation from a high school (or the recognized equivalent of such certificate), is legally authorized to provide an educational program beyond high school, and provides an educational program for which it awards a bachelor's or higher degree.

Qualified student loan forgiveness is defined as forgiveness of a loan received by a qualified student for the purpose of financing postgraduate study in mathematics, engineering, the physical or biological sciences, or computer science, but only to the extent that the loan was actually spent for qualified tuition and related expenses (as defined below), and where the student is required to perform teaching services for any of a broad class of qualified educational organizations on completion of the postgraduate course of

[25] Section 874 of the bill makes permanent this rule, as modified by that section.
[26] See note 17, *supra*.

study, under the terms of a written loan agreement and as a condition of receiving loan forgiveness.

Limitations on exclusion

The exclusion from gross income under the bills does not extend to amounts received as payment for teaching, research, or other services as part-time employment required during the period of postgraduate study as a condition to receiving the scholarship, fellowship grant, or qualified student loan. However, teaching, research, or other services are not regarded as such part-time employment if such activities are required of all candidates (whether or not recipients of scholarships, fellowship grants, or qualified student loans) for a particular degree as a condition to receiving the degree.

The bill provides that amounts otherwise qualifying for exclusion from gross income as a scholarship or fellowship grant under new Code section 117A are not includible in gross income merely because of a requirement for performance of teaching services, after completion of the postgraduate course of study, for any of a broad class of qualified educational organizations. For this rule to apply, the recipient also must establish that the amount of the award or grant was used for qualified tuition and related expenses, defined in the bill as tuition and fees required for enrollment or attendance, and fees, books, supplies, and equipment required for courses at the educational institution.

Effective Date

This provision of the bill applies to taxable years beginning after December 31, 1984.

e. Tax incentives for vocational education programs

(1) Augmented deduction for certain equipment contributions (sec. 810 of the bill and sec. 170 of the Code)

Present Law

In general, the amount of charitable deduction otherwise allowable for donated property must be reduced by the amount of any ordinary gain which the taxpayer would have realized had the property been sold for its fair market value on the date of the donation (Code sec. 170(e)).

Thus, a donor of inventory or other ordinary-income property (property the sale of which would not give rise to long-term capital gain) generally may deduct only the donor's basis in the property, rather than its full fair market value. In the case of property used in the taxpayer's trade or business (sec. 1231 property), the charitable deduction must be reduced by the amount of depreciation recapture which would be recognized on sale of the donated property.

Under a special rule, corporations are allowed an augmented charitable deduction for donations of newly manufactured scientific equipment or apparatus to a college or university for research use in the physical or biological sciences (sec. 170(e)(4), enacted in the Economic Recovery Tax Act of 1981).[27] The augmented deduction is generally for the sum of (1) the corporation's basis in the donated property and (2) one-half of the unrealized appreciation (i.e., one-half of the difference between the property's fair market value determined at the time of the contribution and the donor's basis in the property). However, in no event is the deduction under the special rule allowed for an amount which exceeds twice the basis of the property.

Reasons for Change

The committee believes that it is desirable to provide an augmented deduction for certain contributions of newly manufactured scientific or technical equipment, for vocational education use, to assist public community colleges and public technical institutes in providing individuals with the scientific and technological skills needed in the economy.

Explanation of Provision

General rule

The bill provides an augmented charitable deduction for corporate donations of certain newly manufactured tangible personal

[27] Under a special rule enacted in 1976, an augmented charitable deduction also is allowed for corporate contributions of certain types of ordinary income property donated for the care of the needy, the ill, or infants (sec. 170(e)(3)).

property to a public community college or public technical institute (within the meaning of sec. 742(b) of the Higher Education Act of 1965),[28] if the donated property generally is used for training students enrolled in a postsecondary vocational education program.[29] The contribution must be made through the governing body of the donee.

Requirements for favorable treatment

To qualify, a donation of equipment must satisfy all of the following requirements:

(1) The property is scientific or technical equipment or apparatus;

(2) The property was manufactured, produced, or assembled by the taxpayer, and is property described in Code section 1221(1), and the taxpayer is in the business of manufacturing, etc., and selling or leasing such property;

(3) The contribution of the equipment is made within six months after the date the construction or assembly of the property is substantially completed;

(4) The fair market value of the donated item exceeds $250;

(5) The original use of the donated property is by the donee;

(6) Substantially all of the use of the property by the donee is for training students enrolled in a postsecondary vocational education program offered by the donee;

(7) The donor transfers with the property the same warranties normally provided by the manufacturer in connection with a sale of such property;

(8) The property as transferred is usable and functional without need of any repair, reconditioning, or similar investment by the donee;

(9) The donated property must not be transferred by the donee in exchange for money, other property, or services within five years after receipt; and

(10) The taxpayer receives from the governing body of the donee a written statement, signed under penalties of perjury, representing that the use, condition, and disposition of the donated property are in accordance with these requirements (6), (8), and (9).

The augmented deduction does not apply to contributions of computer software, a microcomputer, or any other computer designed generally for use in the home or other personal use.

[28] Section 742(b) of the Higher Education Act of 1965, as amended, defines a public community college or public technical institute as an institution of higher education which is under public supervision and control, and is organized and administered principally to provide a two-year program which is acceptable for full credit toward a bachelor's degree, or a two-year program in engineering, mathematics, or the physical or biological sciences which is designed to prepare the student to work as a technician and at a semiprofessional level in engineering, scientific, or other technological fields which require the understanding and application of basic engineering, scientific, or mathematical principles or knowledge; and the term includes a branch of an institution of higher education offering four or more years of higher education which is located in a community different from that in which its parent institution is located (20 U.S.C. sec. 1132e-1).

[29] For this purpose, the term corporation does not include S corporations (sec. 1361(a)), personal holding companies (sec. 542), or service organizations (sec. 414(m)(3)).

Allowable deduction

If all these requirements are satisfied, the augmented charitable deduction allowed for the donation of equipment generally is the sum of (1) the taxpayer's basis in the donated property and (2) one-half of the unrealized appreciation (i.e., one-half of the difference between the property's fair market value determined at the time of the contribution and the donor's basis in the property). However, in no event is a deduction allowed for any amount which exceeds twice the basis of the property, or any amount in excess of fair market value.

Effective Date

This provision is effective for contributions made after December 31, 1984.

(2) Vocational education instruction tax credit (sec. 811 of the bill)

Present Law

In general, employers may deduct as an ordinary and necessary business expense a reasonable allowance for salaries or other compensation for personal services actually rendered (sec. 162). Thus, a manufacturer generally may deduct reasonable compensation paid to an employee who, while regularly employed by the manufacturer in a nonteaching capacity, teaches vocational education courses part-time at a teaching institution, with or without compensation. In addition, a manufacturer generally may deduct reasonable compensation paid to a vocational education teacher regularly employed by a teaching institution who works temporarily for the manufacturer to upgrade his or her skills.

Under present law, a targeted jobs tax credit is also available, on an elective basis, to employers who hire individuals from one or more of nine target groups (sec. 51). One such group consists of youths between the ages of 16 and 20 from economically disadvantaged families who receive instruction in and otherwise actively participate in certain cooperative vocational education programs. The targeted jobs credit is not available with respect to individuals who teach vocational education courses.

Reasons for Change

The committee believes that it is desirable to provide a new tax credit relating to postsecondary vocational education instruction, in order to facilitate the training of skilled workers in scientific and technological fields and closer links between such education and the private sector.

Explanation of Provision

General rule

The bill provides a new tax credit to corporations[30] with respect to (1) postsecondary vocational education courses taught by quali-

[30] See note 29, *supra*.

fied teaching employees of the taxpayer and (2) qualified vocational education instructors temporarily employed by the taxpayer.

The amount of the credit generally is $100 for each postsecondary vocational education course taught by qualified teaching employees of the taxpayer during the taxable year (not to exceed five courses per employee per taxable year), plus $100 for each qualified vocational education instructor temporarily employed by the taxpayer during the taxable year. The total of such credits allowed to a taxpayer (or to a controlled group of corporations) for a taxable year is $20,000.

Definitions

A postsecondary vocational education course is defined as any course of instruction which (1) is offered by an institution of higher education (within the meaning of sec. 1201(a) of the Higher Education Act of 1965)[31] as part of an organized education program; (2) is in the physical, biological, computer, or engineering technologies, or electronic and automated industrial, medical, and agricultural equipment and instrumentation operation: (3) consists of a period of instruction which is at least equivalent to a course of instruction that provides three hours of instruction per week during an academic semester; and (4) has been completed before the close of the taxable year.

A qualified teaching employee is defined as any individual employed full time by the taxpayer for the entire taxable year who taught at least one postsecondary vocational education course part-time at an institution of higher education,[32] does not receive any compensation from the institution of higher education, and was not a qualified vocational education instructor at any time during the taxable year.

A vocational education instructor is defined as any individual who (1) was employed full time by the taxpayer for at least three months but not more than 12 months during the two-year period ending at the close of the taxable year; (2) prior to this employment, taught postsecondary vocational education courses full-time

[31] Section 1201(a) of the Higher Education Act of 1965, as amended, defines an institution of higher education as an educational institution in any State which (1) admits as regular students only persons having a certificate of graduation from a school providing secondary education, or the recognized equivalent of such a certificate; (2) is legally authorized within such State to provide a program of education beyond secondary education; (3) provides an educational program for which it awards a bachelor's degree or provides not less than a two-year program which is acceptable for full credit toward such a degree; (4) is a public or other nonprofit institution; and (5) is accredited by a nationally recognized accrediting agency or association or, if not so accredited, (A) is an institution with respect to which the Secretary [of Education] has determined that there is satisfactory assurance, considering the resources available to the institution, the period of time, if any, during which it has operated, the effort it is making to meet accredited standards, and the purpose for which this determination is being made, that the institution will meet the accreditation standards of such an agency or association within a reasonable time, or (B) is an institution whose credits are accepted, on transfer, by not less than three instituions which are so accredited, for credit on the same basis as if transferred from an institution so accredited. Such term also includes any school which provides not less than a one-year program of training to prepare students for gainful employment in a recognized occupation and which meets the provisions of clauses (1), (2), (4) and (5). For purposes of this subsection, the Secretary [of Education] shall publish a list of nationally recognized accrediting agencies or associations which he determines to be reliable authority as to the quality of training offered. Such term also includes a public or nonprofit private educational institution in any State which, in lieu of the requirement in clause (1), admits as regular students persons who are beyond the age of compulsory school attendance in the State in which the institution is located who have the ability to benefit from the training offered by the institution (20 U.S.C. Sec. 1141).

[32] See note 31, *supra.*

at an institution of higher education[33]; (3) is teaching such courses full-time at an institution of higher education at the close of the taxable year; and (4) is not employed by the taxpayer at the close of the taxable year.

Double benefit

Any credit allowed under the bill with respect to an employee is in addition to any allowable deduction for compensation paid to the employee by the taxpayer.

Effective Date

This provision is effective for taxable years beginning after December 31, 1984.

f. Revenue effect

The amendments made by the provisions of the bill described above relating to incentives for research and experimentation and for vocational education are estimated to reduce fiscal year budget receipts by $77 million in 1985, $722 million in 1986, $1,347 million in 1987, $1,803 million in 1988, and $2,026 million in 1989.

[33] See noie 31, *supra*.

25. Percentage Depletion for Secondary and Tertiary Production after 1983 (sec. 885 of the bill and sec. 613A(c) of the Code)

Present Law

In the Tax Reduction Act of 1975, Congress retained the percentage depletion allowance for limited quantities of oil and gas production. For oil production, effective January 1, 1984, the rate has declined to a permanent level of 15 percent and is limited to 1,000 barrels per day.

The 1975 amendment continued this percentage depletion allowance for secondary and tertiary production at a 22-percent rate but (because of an error that all parties agree was not intended) only through 1983. Also, a special rule reduces the depletable oil amount by any secondary or tertiary production. Therefore, a producer's depletable quantity of primary production will be reduced by any secondary or tertiary production even though percentage depletion is not available for such production.

Under the 1975 amendments, if an interest in any proven oil or gas property is transferred to another owner after 1974, no percentage depletion allowance applies to the property after the transfer unless one of the exceptions provided for in section 613A(c) (9) or (10) applies. The proposed Treasury regulations, published in 1977, stated that the transfer restrictions would not apply to percentage depletion for secondary and tertiary production. This exception to the transfer rule resulted from the same 1975 drafting error that caused termination of that percentage depletion after 1983.

Reasons for Change

The committee wishes to correct the technical errors made in the Tax Reform Act of 1975.

Explanation of Provision

The bill corrects the technical errors that occurred in the Tax Reform Act of 1975 with respect to depletion on secondary and tertiary depletion. The bill eliminates the distinction between primary and secondary or tertiary production after 1983. Thus, independent producers may claim percentage depletion in 1984 at a rate of 15 percent on up to 1,000 barrels of all their production. In addition, starting in 1984, percentage depletion on secondary and tertiary production will not be available after 1983 for production from proven properties transferred since 1974 unless one of the exceptions provided for in sections 613A(c) (9) and (10) applies to the transfer.

Revenue Effect

The provision has no effect on revenues.

26. Study of Alternative Tax Systems (sec. 886 of the bill)

Present Law

Studies of particular parts of the Internal Revenue Code or of alternative tax mechanisms are not mandated in present law. However, one of the duties of the Joint Committee on Taxation is to investigate the operation and effects of the Federal system of internal revenue taxes, including measures and methods for the simplification of such taxes (sec. 8022). The Joint Committee published a report on income tax simplification in 1977 in response to the requirement for the study in the Tax Reform Act of 1976 (sec. 507; P.L. 94-455).[1]

Reasons for Change

The committee believes that the current system of income taxation is unduly complex. The large number of tax preferences and special deductions, credits and exclusions increase compliance and administration costs, and undermine the taxpayers' confidence in the fairness of the Internal Revenue Code. Non-uniform taxation distorts individual and corporate economic decisions, thereby lowering economic efficiency. For these reasons, it is desirable to study the effects of a more comprehensive tax base. Broadening the base also would allow a reduction in marginal rates, which would increase the incentive to work and invest. The committee believes that alternatives which increase the simplicity, efficiency and fairness of the tax system should be carefully studied.

Explanation of Provision

The bill requires the Secretary of the Treasury to conduct a study of the advisability of replacing (1) only the Federal individual income tax and (2) both the Federal individual income tax and the Federal corporate income tax with an alternative tax system. For this purpose, the Secretary is required to study (1) a simplified income tax based on gross income, (2) a percentage tax on consumption, (3) the broadening of the base and lowering the rates of the current income tax system, (4) a national sales tax, and (5) a value-added tax.

The study is to consider the administrative complexity of the existing Federal income tax system and to address the ramifications of replacing the existing system with an alternative system. The Treasury would be required to submit a report to the Senate Committee on Finance and the House Committee on Ways and Means not later than 6 months after enactment of the bill.

[1] "Issues in Simplification of the Income Tax Laws." JCS-57-77, September 19, 1977.

27. Migratory Bird Hunting and Conservation Stamp (Duck Stamp) (sec. 887 of the bill and 18 U.S.C. 504)

Present Law

Federal anticounterfeiting laws forbid any reproduction of duck stamps because they are considered a type of Federal obligation, like a postage stamp. There is a provision of current law which permits limited reproduction of U.S. revenue stamps, but those reproductions are permitted for philatelic, numismatic, educational, historical or newsworthy purposes, and only black and white illustrations are permitted.

Reasons for Change

A number of businesses would like to use color and black and white reproductions of duck stamps on commercial products, such as on placemats and shotguns. There is particular interest in such reproductions this year because it is the 50th anniversary of duck stamps. Such controlled use of duck stamp reproductions would provide an additional source of funds for migratory bird conservation activities.

Explanation of Provision

The bill would authorize the Secretary of the Interior, with the concurrence of the Secretary of the Treasury, to license color and black and white reproductions of migratory bird hunting stamps for commercial purposes. The reproductions would have to be of a size of less than three-fourths, or more than one and one-half of the size of the original stamp. The proceeds from such licensed reproductions would be placed in the Migratory Bird Conservation Fund.

Effectivε Date

The provision will become effective on the date of enactment.

Revenue Effect

This provision is estimated to increase revenues by a negligible amount.

28. Treasury Study on Foreign Taxation of Certain U.S. Services (sec. 889 of the bill)

Present Law

U.S. treatment of foreign taxes—in general

U.S. persons [1] are taxable on their worldwide income, including their foreign income. However, the foreign tax credit allows U.S. taxpayers to offset the U.S. tax on their foreign income by the income taxes paid to a foreign country.

The foreign tax credit was enacted to prevent U.S. taxpayers from being taxed twice on their foreign income—once by the foreign country where the income is earned and again by the United States as part of the taxpayer's worldwide income. The foreign tax credit system embodies the principle that the country in which a business activity is conducted (or in which any income is earned) has the first right to tax any or all of the income arising from activities in that country, even though the activities are conducted by corporations or individuals resident in other countries. Under this principle, the home country of the individual or corporation has a residual right to tax income arising from these activities, but recognizes the obligation to prevent double taxation.

Foreign tax credit limitation

A fundamental premise of the foreign tax credit is that it should not offset the U.S. tax on U.S. source income. Accordingly, a statutory formula limits the foreign tax credit to insure that the credit will offset only the U.S. tax on the taxpayer's foreign income. Under the formula, the larger the proportion of a taxpayer's worldwide income in a given year that is treated as from U.S. sources, the less foreign taxes the taxpayer may be able to credit in that year.

The foreign tax credit limitation tends both (1) to prevent other countries from taxing the U.S. tax base, and (2) to discourage U.S. taxpayers from operating in countries that tax the U.S. tax base. Without the limitation, U.S. taxpayers who paid enough high foreign taxes might operate tax-free in the United States. U.S. taxpayers would tend to become indifferent to high foreign tax rates, because the U.S. Treasury would absorb the foreign tax burden.

Source of income—U.S. or foreign

For the foreign tax credit mechanism to function, every item of income must have a source, that is, it must arise either within the United States or outside the United States.

[1] U.S. persons are U.S. citizens, U.S. residents, U.S. partnerships, U.S. corporations, and, generally, U.S. trusts and estates (Code sec. 7701(a)(30)).

The United States treats compensation for personal services performed in the United States as U.S.-source income (sec. 861(a)(3)). This income is U.S.-source income even though the person paying for the services resides in a foreign country and uses the services in a foreign country. For example, payments for a blueprint drawn in the United States for use in a foreign country are U.S.-source income.

The United States Model Income Tax Treaty (which represents the U.S. income tax treaty negotiating position) and the Model Treaty of the Organization for Economic Cooperation and Development adopt the U.S. statutory rule that only the country where the services are performed may tax this income (Article 7 (Business Profits), Article 14 (Dependent Personal Services)). Most developed countries use this rule.

Some foreign countries, especially developing countries, have a tax source rule different from the U.S. rule, however. They treat income from personal services as having its source in the country where the services are used. Generally, in a developing country, the total value of services used is greater than the total value of services performed. A place-of-use source rule therefore gives a developing country a broader tax base than a place-of-performance source rule. Like the United States, these countries will insist on taxing income they consider from sources within their borders. Therefore, these countries and the United States insist on taxing the same income. Double taxation arises. Taxes imposed by these countries on income from services performed in the U.S. may not be usable as foreign tax credits in the year paid because the income, being U.S.-source income under U.S. tax law, does not increase the foreign tax credit limitation.

The United States has few treaties with developing countries. However, under the income tax treaty between the United States and Morocco, payments from the Government of Morocco to a U.S. person for technical and economic studies have their source in Morocco (Articles 5(3) and 12(3)(c)). Payments from the private sector to U.S. persons for U.S.-performed services for use in Morocco still have their source in the United States.

Foreign taxation of payments for technical assistance

Many countries impose gross withholding taxes on payments for technical services (such as engineering services, architectural services, and other construction contract services) that a U.S. taxpayer performs in the United States for use within their borders. Some countries waive or reduce these taxes in negotiations with foreign taxpayers on a case-by-case basis. Others reduce them through tax treaties.

Reasons for Change

The committee is concerned that the treatment of income from services performed in the United States by U.S. persons for foreign persons for use abroad, as foreign income, and its taxation as such by foreign countries, may subject U.S. persons to double taxation. The committee believes that the sourcing of income from personal services based on where the services are used, rather than performed, may be undertaken by some foreign countries to broaden artificially their tax bases at the expense of countries such as the United States that apply the generally-accepted place-of-performance sourcing rule. The committee is uncertain, however, how the United States should best address this problem. Accordingly, the committee believes that the Treasury Department should study the problem and report back to the committee.

Explanation of Provision

The bill directs the Treasury Department to study the practices of foreign countries that impose taxes on the basis of services that are performed in the United States, including the status of treaty negotiations with such countries, and options to alleviate the resulting double tax burden on U.S. taxpayers. The Treasury Department is to report on the results of its study to the Senate Committee on Finance and the House Committee on Ways and Means no later than August 31, 1984.

Effective Date

This provision of the bill will be effective on the date of enactment.

Revenue Effect

This provision will not have a revenue effect.

29. Boundary Waters Canoe Act Payments (sec. 888 of the bill and new sec. 132 of the Code)

Present Law

The Boundary Waters Canoe Area Wilderness Act of 1978 designated sites in the Boundary Waters Canoe area to be developed for recreational purposes within limits consistent with the expressed policy to protect the special qualities of the area as a natural forest-lakeland wilderness ecosystem of major recreational and educational value. Statutory limits were imposed on various activities in the area, including motorboating. The size of motors usable on certain lakes is limited to 25 horsepower or 10 horsepower. On other lakes, only canoes are allowed on the waters. In all of these areas, resort operators have had to adjust their mode of operation, and some motorboat outfitters have had to dispose of entire inventories of motorboats and replace them with canoes.

The Act also authorized the appropriation of funds that would enable the Secretary of Agriculture, operating through the U.S. Forest Service to develop technical and financial assistance programs to help qualified resort operators and commercial outfitters who had operated in certain of the areas. The assistance program was developed with two parts. The first part provided $2,500 to be used for conversion from powerboat to canoe operations, trading down to smaller boats, improving resort areas, and other similar uses. The second part involves equity-grants awards limited to 25 percent of an applicant's projected costs to upgrade resort and outfitting businesses, not exceeding $50,000. The equity-grants awards are to be accompanied by loans for the remaining portion of projected costs, and the loans were to be secured from government and private sources. All qualified applicants were expected to have had an opportunity to apply for assistance by the end of fiscal year 1982. In the event that a recipient of an equity-grant award sold the business, the terms of the grant required repayment of the grant in three parts.

Reasons for Change

Because of the wilderness designation, resort operators have been forced to change their mode of operation and to dispose of certain equipment. Thus, this designation has had an economic effect similar to an involuntary conversion, and the committee believes that the affected taxpayers should receive tax treatment similar to that accorded an involuntary conversion.

Explanation of Provision

In general, the bill permits resort operators and boat outfitters to make tax-free reinvestments of equity-grants provided under the

Boundary Waters Canoe Wilderness Act in depreciable property for use in activities allowed within the Boundary Waters Canoe Areas. The taxpayer's basis in the property is to be reduced by the amount of the equity grant. The property to which payments are allocated must be placed in service before the later of two years after the date of enactment or two years after the payment is received.

Under new section 132, the taxpayer may elect to exclude from gross income the excludable portion of payments received from the U.S. Forest Service under the programs developed following the imposition of restrictions on motorized traffic in the Boundary Waters Canoe Area. The excludable portion is defined in the statute as that portion (or all) of a payment made to the taxpayer during the period between December 31, 1979, and two years after the later of the date of enactment or the date of the payment, which is reinvested during that period in depreciable assets used in the taxpayer's business or trade as authorized in the Boundary Waters Canoe Area Wilderness Act.

When making an election with resiect to the excludable portion of payments, the taxpayer will identıfy the assets for which the payment has been allocated. The basis of any asset to which the taxpayer elects to allocate any portion of a payment will be reduced by the amount of the payment. The basis of any such asset will be increased by the amount of any repayments to the U.S. Forest Service on the sale of the asset. No deduction under ACRS or credit will be allowed with respect to the portion of expenditure for property that has been funded by any amount excluded from gross income under the provisions of this section.

An election may be made at any time before the expiration of the period for making a claim for credit or refund for the taxable year in which the reinvestment occurred. The Secretary shall prescribe the manner in which the election may be made in regulations.

Effective Date

The amendments made by this section will apply to payments made in taxable years beginning after December 31, 1979.

Notwithstanding any other provisions in the Internal Revenue Code that relate to a period of limitation or lapse of time, a claim for credit or refund of overpayment of tax, with respect to payments described in this section which were made after December 31, 1979, may be filed by the taxpayer with the allocation election within one year after the date of enactment.

Revenue Effect

This provision is estimated to affect revenues by a negligible amount in fiscal years 1984 and 1985.

TITLE IX—SPENDING REDUCTION PROVISIONS

A. Medicare, Medicaid, and Other Health Provisions

1. Part B Premium (sec. 901 of the bill)

Present Law

By law, the Secretary of Health and Human Services has been required to calculate each December the increase in premiums of those who elect to enroll in the Supplementary Medical Insurance (or part B) portion of the Medicare program. The new premium rates have been effective on July 1 of the year following the year in which the calculation was made. Ordinarily, the new premium rate is the lower of: (1) an amount sufficient to cover one-half of the costs of the program for aged beneficiaries or (2) the current premium amount increased by the percentage by which cash benefits increased under the cost-of-living adjustment (COLA) provisions of the Social Security program. Premium income, which originally financed half of the costs of part B, had declined—as the result of this formula—to less than 25 percent of total program costs. The "Tax Equity and Fiscal Responsibility Act of 1982" (TEFRA) temporarily suspended the COLA limitation for two one-year periods, beginning on July 1, 1983. During these periods, enrollee premiums would be allowed to increase to amounts necessary to produce premium income equal to 25 percent of program costs for elderly enrollees. The limitation would again apply with respect to periods beginning July 1, 1985 and thereafter.

The "Social Security Amendments of 1983" (Public Law 98-21) postponed the scheduled July 1, 1983 increase to January 1, 1984 to coincide with the delay in the cost-of-living increase in social security cash benefit payments. Further increases will occur in January of each year based on calculations made the previous September. Public Law 98-21 further provided that the suspension of limitations as authorized by TEFRA is to apply for the two-year period beginning January 1, 1984, and ending December 31, 1985.

S. 2062

S. 2062 would extend for one year the existing temporary provision which fixes the proportion of the part B Medicare costs financed by enrollees at 25 percent of program costs for aged beneficiaries.

Modified Provision

The provision would permanently establish the premium rate at 25 percent of program costs for aged beneficiaries.

Effective Date

January 1, 1985.

Estimated Savings

Fiscal years:	*Millions*
1984	0
1985	0
1986	$384
1987	884
4-year total	$1,268

2. One-Month Delay In Medicare Entitlement (sec. 902 of the bill)

Present Law

Under current law, eligibility for Medicare begins on the first day of the month in which an individual reaches age 65. As a result, Medicare often pays benefits for services that were provided before an individual reaches his 65th birthday.

Explanation of Provision

The provision defers eligibility for parts A and B of Medicare until the first day of the month following the month the individual attains age 65.

The Committee believes that current private health benefits coverage can be extended to protect the large majority of people during the month in which they reach age 65. The Committee is concerned however that some people could find themselves with gaps in protection as a result of the provision. The Committee believes that State insurance authorities, which are the responsible governmental authorities for regulating private insurance contract provisions, will take such steps as may be necessary to assure that private policies wil! be amended or adjusted to assure continuity of coverage under such plans until Medicare coverage begins. The Committee also notes that Medicaid coverage will continue to be a available to needy aged individuals during the month before their Medicare coverage will begin.

The Committee directs the Secretary of HHS to make all reasonable efforts to inform individuals in advance of the date their Medicare coverage begins, and, to the extent feasible, make sure that these people do not suffer undue hardships as a result of the deferral of Medicare eligibility.

Effective Date

January 1, 1985.

Estimated Savings

Fiscal years:	*Millions*
1984	0
1985	$145
1986	230
1987	255
4-year total	$630

3. Modification of Working Aged Provision (sec. 903 of the bill)

Present Law

The Tax Equity and Fiscal Responsibility Act of 1982 (TEFRA) changed the Medicare benefits for the working aged. As of January 1, 1983, if the beneficiary so elects, Medicare benefits became secondary to benefits under an employer group health plan for employed individuals between the ages of 65 and 69. This provision applies to spouses only when both the employee and spouse are covered by an employer group health plan and both are between the ages of 65 and 69.

TEFRA does not allow Medicare to be the secondary payer if a beneficiary age 65 through 69 has a spouse under age 65 who is working and has an employer group health plan.

Explanation of Provision

The provision would modify both title XVIII and the Age Discrimination in Employment Act (ADEA) so as to eliminate the lower age limit for the working spouse. Under the provision a nonworking spouse aged 65 to 69 may elect primary coverage under the working spouse's employer group health plan even though the working spouse is not yet 65 years of age. If such an election is made, Medicare would become the secondary payer.

As modified the ADEA would require that any employer must provide that any employee's spouse aged 65 through 69 shall be entitled to coverage under any group health plan offered to such employee under the same conditions as any employee and the spouse of such employee under age 65.

Effective Date

January 1, 1985.

Estimated Savings

Fiscal years:	*Millions*
1984	0
1985	$260
1986	380
1987	415
4-year total	$1,055

4. Limitation on Physician Fee Prevailing and Customary Charge Levels; Participating Physician Incentives (sec. 904 of the bill)

Present Law

Under current law, Medicare pays for physician services on the basis of Medicare-determined "reasonable charges." "Reasonable charges" are the lesser of: a physician's actual charges, the customary charges made by an individual physician for specific services, or the prevailing level of charges made by other physicians for specific services in a geographic area. The amounts recognized by Medicare as customary and prevailing charges are updated annually (on July 1) to reflect changes in physician charging practices. Increases in prevailing charge levels are limited by an economic index which reflects changes in the operating expenses of physicians and earnings levels in general. The economic index limit promulgated for the period July 1, 1983 through June 30, 1984 represents an increase of 5.85 percent over the index utilized for the previous 12-month period.

S. 2062

The bill provided that the prevailing charge level which was in effect prior to the annual updating which occurred on July 1, 1983 would be utilized for the December 1, 1983-June 30, 1984 period. Thus, for this seven month period until July 1, 1984, prevailing charge limits for all physician service would have reverted to the levels applicable during the July 1, 1982-June 30, 1983 fee screen year. Physicians' customary charge screens would not have been affected by the rollback.

Modified Provision

The provision would freeze all customary and prevailing fees for physician services one year beginning July 1, 1984. The freeze would be continued for an additional year for the prevailing fees of physicians who are not willing to accept assignment on all Medicare claims. No catch-up would be permitted for fees which were frozen.

In conjunction with the freeze, a voluntary participating system would be established for Medicare, similar to the participation physician agreements successfully used by some Blue Shield plans in their private business. Under a physician participating system, physicians would sign an agreement indicating their willingness to accept assignment for all services provided to all Medicare patients for the following fee screen year (July 1, 1985 to June 30, 1986). By agreeing to accept assignment in advance for all services for all Medicare patients, the physician would agree to accept the Medicare determined allowance as payment in full except for cost-sharing amounts. The physician would bill the carrier directly and receive payment from the carrier.

The current assignment system would remain for physicians who did not voluntarily sign a participation agreement, i.e., nonparticipating physicians could continue to accept assignment on a claim-by-claim basis. As under the current system, assignment must be accepted for joint Medicaid-Medicare eligibles.

A voluntary participation physician system would allow Medicare beneficiaries to better predict out-of-pocket expenses since, as noted below, they would know in advance which physicians participate (i.e., always accept assignment). A voluntary system would not compel any physician to participate and the current claim-by-claim assignment system would be preserved for non-participating physicians.

Several incentives would be used to encourage physician participation. These include:

(1) Physician and Supplier List.—Similar to the provision already agreed to by the Committee, one incentive would require that lists of physicians and suppliers be published containing the name, ad-

dress, phone number, specialty and an indication of volume of assigned versus total Medicare claims or reimbursements in the previous year for each physician and supplier. Low-volume physicians or supplies could be excluded from the list. In the case of physicians who practice solely as staff members of a health maintenance organization or other similar associations, the Secretary may choose to list the name of the organization and its Medicare assignment data information.

These lists would be published annually with carrier discretion as to the appropriate geographic level to make them most meaningful for beneficiary use. A check stuffer would be sent to all Medicare beneficiaries notifying them about the availability of the lists. The lists would be provided to senior citizen groups and would be made available for beneficiaries to review at both carrier and Social Security District and Branch offices. The Secretary would be directed to make arrangements to make such lists available for purchase by organizations and individuals. In addition to this list there would also be prepared a directory containing the names of only those physicians and suppliers who agree to be "participating" physicians and suppliers.

(2) Toll-free hot lines.—The system of toll-free hot-lines already in place at the carriers would be expanded. Carriers would hire additional staff to (a) provide names, addresses, phone numbers and specialties of participating physicians and suppliers, and (b) confirm whether specified physicians participated.

(3) Electronic Billing Transmission Lines.—Currently about 13 percent of Medicare claims are transmitted to carriers by a variety of electronic/automatic mechanisms, including tape-to-tape, floppy disks, etc. As an incentive to become a participating physician, carriers could establish direct lines for the electronic receipt of claims from participating physicians. Non-participating physicians would be permitted to continue to transmit claims electronically.

(4) For beneficiaries with approved Medigap coverage, or with group health insurance plans which serve as Medigap policies, two simplified billing/payment arrangements would be available. Carriers could use either or both.

(a) Piggyback Billing.—Under this arrrangement, the physician or supplier submits one bill to the carrier. The carrier pays the physician or supplier the Medicare reimbursement and then sends willing Medigap insurors information on the amount paid. The Medigap insuror would automatically pay the physician or supplier for the beneficiary's cost-sharing liabilities. The physician or supplier would not need to submit a separate bill to the beneficiary or the Medigap plan for the cost-sharing and the beneficiary would be removed from the paperwork payment process. In order to avail itself of this option, the supplemental plan would have had to provide its eligibility file to the carrier. To the extent feasible, Medicaid could also make use of piggyback billing.

(b) Payment to organizations.—Under this arrangement, the participating physician or supplier would submit one bill to the Medigap insuror. The Medigap insuror would pay the physician or supplier an amount which the physician or supplier accepts as payment-in-full, including cost-sharing liabilities. (The Medigap plan may pay the physician or supplier more than the Medicare reasonable charge.) The Medigap plan would then collect the reasonable charge from Medicare. Only one bill would be submitted by the physician or supplier and one check would be paid to the physician or supplier. The beneficiary would not be responsible for paying the physician or supplier or collecting from the Medicare carrier or the Medigap plan.

Effective Date

July 1, 1984.

Estimated Savings

Fiscal years:	*Millions*
1984	$40
1985	750
1986	910
1987	1,070
4-year total	$2,770

5. Limitation on Increase in Hospital Costs per Case (sec. 905 of the bill)

Present Law

The "Tax Equity and Fiscal Responsibility Act of 1982" (Public Law 97-248, commonly referred to as TEFRA) expanded previously existing limits on Medicare costs effective October 1, 1982. Among other things, it established a 3-year target rate reimbursement system which in effect limited allowable rates of increase in Medicare payments per case over the fiscal year 1983-1985 period. The target rate is equal to the previous year's allowable operating costs per case (or after the first year, the previous year's target amount) increased by the percentage increase in the hospital wage and price index (market basket) plus one percentage point. Penalties and bonuses were established for hospitals, with costs above and below the target.

The "Social Security Amendments of 1983" (Public Law 98-21) provides for the establishment of a prospective payment system for hospitals to be phased-in over a 3-year period. During the transitional period a portion of a hospital's payments will be based on prospective rates and a portion on each hospital's own cost base. The cost-based portion of the payment will be calculated on the basis of reasonable costs, subject to the existing rate of increase limits, without the penalties and bonuses established under TEFRA.

In addition, under current law the rates for each DRG, like the cost-based costs per case, are derived from historical Medicare cost data for each hospital. For fiscal years 1984 and 1985, payment amounts from the previous fiscal years would be increased by the market basket, plus one percentage point. For fiscal years beginning on or after October 1, 1986, the rate of increase is left to the discretion of the Secretary.

Explanation of Provision

The provision would, for two years, (fiscal years 1985 and 1986), limit the rate of increase in the hospital cost portion of the payment amounts to the market basket minus one-half percentage point. The rate of increase in the DRG portion of the payment amounts would be limited during the same two years to the market basket plus one-half percentage point. Exempted hospitals and hospital units would be subject to similar rate of increase limitations applicable to their costs . . . (MB−½ and MB+½) in the same proportion as hospitals under the prospective payment system with the same accounting years. This would result in a rate of increase for exempted hospitals of MB in the first year and MB +¼ in the second year.

Effective Date

Accounting years beginning on or after October 1, 1984 and before October 1, 1986.

Estimated Savings

Fiscal year:	*Millions*
1984	0
1985	$190
1986	430
1987	460
4-year total	$1,080

6. Fee Schedule for Clinical Laboratory Services (sec. 906 of the bill)

Under current law, outpatient diagnostic laboratory services are reimbursed on the basis of reasonable charges when furnished by an independent laboratory or by a physician. Payment for such services to hospital outpatients is on the basis of reasonable cost. These laboratory services are covered under part B of the Medicare program; thus, the beneficiary is subject to the part B deductible and coinsurance requirements.

S. 2062

The bill would establish fee schedules for all laboratory services other than hospital-based laboratory services. Payments would be based on a fee schedule unless the actual charge is lower. The schedule would be established for two years for areas to be designated by the Secretary.

The initial payment level for each fee schedule would have been established at 65% of prevailing charges in the area for the fee screen year beginning July 1, 1983. The Secretary would be required to adjust the fee schedules annually to reflect changes in the Consumer Price Index for all Urban Consumers (U.S. city average).

All clinical laboratories would have been required to bill the Medicare program or beneficiaries directly, for the tests they perform rather than billing the physician who ordered the tests (laboratories performing tests "under arrangement" with a hospital could continue to bill the hospital for hospital outpatients). Physicians would be permitted to bill for clinical laboratory services only when the physician directly provides, or supervises the provision of, clinical laboratory services.

The bill provided that acceptance of assignment for the performance of laboratory services is optional for both clinical laboratories and physicians. Where either accepts assignment, reimbursement would be made at 100 percent of the fee schedule amount (or, if lower, the billed charge), with the deductible and coinsurance waived.

Laboratories and physicians not accepting assignment would have continued to be reimbursed at 80 percent of the fee schedule amount or if lower, 80 percent of the billed charge; applicable deductible and coinsurance amounts would continue to apply.

The bill directed the Secretary to simplify current billing requirements for laboratory services.

The bill further required the Secretary to report to the Congress by June 30, 1985 on the appropriate treatment of hospital-based laboratories, direct payment of all lab fees to physicians, the basis for the formulation of a nationwide fee schedule, and an appropriate indexing mechanism for such a schedule.

Modified Provision

The provision requires the establishment of a fee schedule for all noninpatient laboratory services, including those furnished by hospital outpatient departments. The level of payment would be set at 60 percent of the prevailing charge levels (applicable during the fee screen year beginning July 1, 1983) for services provided by independent labs and in physicians' offices. The level of payment for hospital-based labs would be set at 62 percent of these prevailing charge levels.

These fee schedules would be in effect from May 1, 1984 until September 30, 1987.

Under the provision, the Secretary may make adjustments or exceptions to the fee schedule to assure adequate reimbursement of: (1) emergency laboratory tests needed for the provision of bona fide emergency services in a hospital emergency room; and (2) certain low volume high-cost tests where highly sophisticated equipment and extremely skilled personnel are necessary to assure quality.

The other provisions previously contained in S. 2062 relating to assignment and billing requirements would be retained as would the requirement that the Secretary report to the Congress. However, the provision makes permanent the requirement that only those actually performing the tests or supervising the tests bill the program. In the case of an unassigned claim the beneficiary may continue to submit the bill.

Effective Date

May 1, 1984.

Estimated Savings

Fiscal year:	*Millions*
1984	$70
1985	255

1986	320
1987	400
4-year total	$1,045

7. Revaluation of Assets (sec. 907 of the bill)

Present Law

Medicare currently reimburses hospitals for their capital-related costs, including depreciation costs and interest. Investor-owned hospitals also receive a return on equity.

When hospitals are sold, their assets are often revalued, thereby increasing reimbursement for these capital-related costs.

Explanation of Provision

The provision would limit any increase in capital-related cost reimbursement to a new owner that would result from the revaluation of hospital assets acquired in fiscal year 1985 and thereafter. The capital-related cost of the new owner would be based on the acquisition cost of the asset as entered on the books of the prior owner less any depreciation taken on the asset by the prior owner. In addition, the new owner's capital-related costs must be determined using the same useful life and method of depreciation as used by the prior owner for reimbursement under the Medicare program.

Effective Date

Acquisitions made on or after October 1, 1984.

Estimated Savings

Fiscal year:	*Millions*
1984	0
1985	$50
1986	110
1987	170
4-year total	$330

8. Repeal of Preadmission Diagnostic Testing Provision (sec. 908 of the bill)

Present Law

The Omnibus Reconciliation Act of 1980 (Section 932 and 942) authorized 100 percent Part B reimbursement (on a reasonable cost or charge basis) for preadmission diagnostic testing, either in a hospital's outpatient department or in a physician's office, within seven days prior to a hospital admission. This provision was intended to encourage preadmission testing and shorten hospital stays, thus decreasing overall Medicare payments.

The final regulation implementing 100 percent reimbursement for preadmission testing in hospital outpatient departments was not published because of subsequent hospital reimbursement changes in the Social Security Amendments of 1983. (The regulation covering physician's offices has not been developed.)

Explanation of Provision

The provision would repeal the provision providing for 100 percent reimbursement and simply pay for these services on the same basis as all other services under part B (80 percent).

The Committee believes that given the incentives created by the new prospective payment system, hospitals already have every reason to do their testing on an outpatient basis.

Effective Date

Enactment.

9. Skilled Nursing Facility Reimbursement (sec. 909 of the bill)

Present Law

The Tax Equity and Fiscal Responsibility Act of 1982 (P.L. 97-248) required the Secretary to establish a single payment limit for both freestanding and hospital-based skilled nursing facilities (SNFs), effective October 1, 1982. Prior to that time, separate limits were established for these two types of facilities in recognition of the fact that the operating costs of hospital-based facilities were typically much higher than those of the freestanding facilities.

In the Social Security Amendments of 1983 (P.L. 98-21), the effective date of the single-limit requirement was postponed for one year. In addition, the Congress required the Secretary to report by December 31, 1983 on the effect of the implementation of the TEFRA single-rate provision on hospital-based SNFs, given the difference (if any) in the patient populations served by such facilities and by freestanding SNFs. Further, the Secretary was required to report by the end of 1983 on the impact of hospital prospective payment on SNFs.

S. 2062

The bill postponed implementation of the single rate for SNFs until April 1, 1984. The Committee believed it prudent to wait until the Secretary completed the report on hospital-based SNFs before implementing the single-rate provision.

Modified Provision

(1) For fiscal year 1983 and until July 1, 1984, hospital based facilities and freestanding facilities would be paid on the basis of the policy for calculating reimbursement limits that had been in effect prior to the passage of TEFRA. Under this system, the limits for freestanding facilities would be set at 112 percent of the average per diem operating costs for urban and rural facilities, respectively. The limits for hospital-based facilities would similarly be set at 112 percent of the average per diem operating cost for urban and rural hospital based facilities, respectively.

(2) Effective July 1, 1984 and thereafter, the Secretary would establish dual limits for hospital-based and freestanding SNFs on a

somewhat different basis. Separate limits would continue to be established for freestanding facilities in urban and rural areas at 112 percent of the mean operating costs of urban and rural freestanding facilities, respectively. However, limits for urban or rural hospital-based facilities would be set at the appropriate freestanding facility limit plus 50 percent of the difference between the freestanding facility limit and 112 percent of mean operating costs for hospital-based facilities. Cost differences between hospital-based and free-standing facilities attributable to excess overhead allocations resulting from medicare reimbursement principles shall be recognized as an add-on to the limit. Adjustments would be made to take account of differences in wage levels prevailing in a facilities area.

Under this provision, both hospital-based and freestanding facilities could continue to apply for and receive exceptions from the cost limits in circumstances where high costs result from more severe than average case mix or circumstances beyond the control of the facility. Indicators of more severe casemix include a comparatively high proportion of Medicare days to total patient days, comparatively high ancillary costs, or relatively low average length of stay for all patients (an indicator of the rehabilitative orientation of the facility). Facilities eligible for exceptions could receive, where justified, up to all of their reasonable costs.

(3) The Secretary shall forward to the Congress, no later than April 15, 1984, the final report on skilled nursing facilities as required by TEFRA.

(4) The Secretary shall submit, no later than December 1, 1984, a proposal for implementation of a prospective payment system for skilled nursing care under Part A. Such payment system shall take into account case mix differences between providers. Such a system should also be designed so as to permit the inclusion of payments into the payments currently made to hospitals under the DRG system. The proposal shall be drafted so as to be implementable as of October 1, 1985.

Effective Date

October 1, 1983.

Estimated Cost

Fiscal year:	*Millions*
1984	$20
1985	30
1986	35
1987	40
4-year total	$125

10. Rounding of Part B Payments (sec. 910 of the bill)

Present Law

The Omnibus Budget Reconciliation Act of 1981 authorized the Social Security Administration (SSA) to round to the next lower whole dollar payments made after July 31, 1981 to beneficiaries of Title II of the Social Security Act (Federal Old Age, Survivors and Disability Insurance).

The Tax Equity and Fiscal Responsibility Act of 1982 (TEFRA) expanded the use of the "round-down" concept to two other programs administered by SSA. Under the Aid to Families with Dependent Children (AFDC) program, States are required to round both their AFDC need standard and actual monthly benefit amounts to the next lower whole dollar. Under the Supplemental Security Income (SSI) program, both the monthly benefit and income eligibility amounts are to be rounded to the next lower whole dollar.

Neither the Omnibus Budget Reconciliation Act nor TEFRA incorporated the "round-down" concept into Medicare reimbursement. Medicare carriers continue to compute payments to physicians and suppliers, or beneficiaries in the case of unassigned claims, to the nearest penny.

Explanation of Provision

The provision would require Medicare part B charge based payments on claims that are not whole dollar amounts to be rounded down to the next lower dollar. Physicians and suppliers accepting assignment could not bill the beneficiary for amounts lost through rounding.

Effective Date

July 1, 1984.

Estimated Savings

Fiscal year:	*Millions*
1984	$15
1985	65
1986	70
1987	75
4-year total	$225

11. Agreements for Medicare Claims Processing (sec. 911 of the bill)

Present Law

Under current law, Medicare contracts with intermediaries and carriers to perform the day-to-day operational work of the program including reviewing claims and making program payments.

Explanation of Provision

The provision would increase the Secretary's discretion in entering into agreements for Medicare claims processing by (1) eliminating the right of providers of services to nominate intermediaries, (2) permitting the Secretary to enter into various kinds of agreements, not solely those based on cost, and (3) broadening the Secretary's authority to experiment with different kinds of contracts by including contracts other than fixed price or performance incentive contracts and by permitting waiver of competitive bidding requirements. The provision also allows the Secretary to provide for publication of the standards for contractors through normal administrative issuances rather than through the regulatory process.

Effective Date

October 1, 1984.

Estimated Savings

Fiscal year:	*Millions*
1984	0
1985	$15
1986	25
1987	35
4-year total	$75

12. Lesser of Cost or Charges (sec. 912 of the bill)

Present Law

Current law includes provisions for Medicare to pay providers the lesser of costs or charges (LCC). These provisions were adopted (before hospital prospective payment) to assure that Medicare would not pay providers more than the amounts paid by the general public. HCFA regulations allow hospitals to calculate the amount of their costs and charges in the aggregate for inpatient and outpatient services. This policy has the effect of permitting hospitals with low outpatient charges to nevertheless receive their full costs from Medicare by adding in their typically above-cost inpatient charges.

Explanation of Provision

The provision would require the Secretary to issue regulations to isolate the calculation of the lesser of costs or charges for outpatient services from the calculation for inpatient services.

Effective Date

Accounting periods beginning on or after October 1, 1984.

Estimated Savings

Fiscal year:	*Millions*
1984	0
1985	$80
1986	90
1987	105
4-year total	$275

13. Hepatitis B Vaccine (sec. 913 of the bill)

(Contained in S. 2062 as originally reported)

Present Law

Present law precludes Medicare coverage of immunizations and vaccines with the exception of the pneumococcal vaccine. Therefore, the program does not cover immunizations against viral hepatitis, and infectious disease that produces acute and chronic inflamation of the liver which may lead to serious illness or death.

End stage renal disease (ESRD) patients are currently monitored by monthly testing for the virus, and these tests are covered and paid for under Medicare.

Explanation of Provision

The provision covers Hepatitis B vaccine under Medicare for ESRD hemodialysis patients.

The Committee has given the Secretary the flexibility to develop a payment method that may be different from the usual Medicare reimbursement rules. In developing such a payment system, the Committee believes that any payment system should provide a payment amount which reasonably reflects the cost of efficiently providing and administering the vaccine. We would also recommend that the Secretary revise coverage guidelines with respect to the frequency of Hepatitis B testing for successfully immunized patients.

Effective Date

July 1, 1984.

Estimated Savings

Fiscal year:	*Millions*
1984	−$3
1985	1
1986	2
1987	2
4-year total	$2

14. Limitation on Certain Foot Care Services (sec. 914 of the bill)

(Contained in S. 2062 as originally reported)

Present Law

Routine foot care is not covered under the Medicare program; however, Medicare does allow reimbursement to physicians for debridement of mycotic toenails (toenails with fungal infection) which should not be performed by a nonprofessional.

There has been considerable concern regarding the frequency with which this procedure is taking place. The Health and Human Services Inspector General conducted a review in Virginia and concluded that this benefit was being abused because the procedure was being performed more frequently than necessary and was being performed on patients (particularly nursing home patients) who did not require professional care.

Explanation of Provision

The provision would require the Secretary to issue regulations establishing coverage guidelines under the Medicare program for debridement of mycotic toenails. Unless the Secretary determines otherwise, no payment would be made for such services where performed more frequently than once every 60 days. Exceptions could be authorized if medical necessity were documented by the physician.

Effective Date

Services furnished on or after enactment.

Estimated Savings

Fiscal year:	Millions
1984	$5
1985	11
1986	11
1987	12
4-year total	$39

15. Coverage of Hemophilia Clotting Factor (sec. 915 of the bill)

(Contained in S. 2062 as originally reported)

Present Law

Present law excludes coverage of drugs and biologicals unless they are of the type that cannot be self-administered and are commonly furnished incident to physicians services.

Hemophilia is a life-long disease in which a patient whose blood lacks a clotting factor is subject to spontaneous hemorrhages. In the past 13 years hemophilia patients have had the benefit of a human blood derived concentrate which, when infused, induces the blood to clot, and when appropriately given in advance may prevent bleeding.

The hemophilia clotting factor is considered to be a biological under Medicare and is covered when provided by a physician to a patient, on either an inpatient or outpatient basis.

Explanation of Provision

The provision would permit Medicare coverage for the supplies and products necessary for the self-administration of the clotting factor, subject to utilization controls deemed necessary by the Secretary for the efficient use of the factors.

Effective Date

Items and services purchased on or after enactment.

Estimated Savings

Negligible.

16. Indexing of Part B Deductible (sec. 916 of the bill)

(Contained in S. 2062 as originally reported)

Present Law

Under present law, enrollees in the Supplementary Medical Insurance (or Part B) portion of Medicare must pay the first $75 of covered expenses (known as the deductible) each year before any benefits are paid. The amount of this deductible is fixed by law.

Explanation of Provision

The provision would index the amount of the Part B deductible for 3 years beginning in calendar year 1985, by the percentage by which the Medicare economic index increases each year. The Medicare economic index is the index used to limit increases in the prevailing level of physician fees reimbursable under the Part B program. It is estimated that the deductible would increase to $78 in calendar year 1985, $82 in calendar year 1986, and $86 in calendar year 1987, and then remain at that level.

Effective Date

January 1, 1985.

Estimated Savings

Fiscal year:	*Millions*
1984	0
1985	$35
1986	90
1987	100
4-year total	$225

17. Cost Sharing for Durable Medical Equipment Furnished as a Home Health Benefit (sec. 917 of the bill)

(Contained in S. 2062 as originally reported)

Present Law

Under present law, when covered durable medical equipment (DME) is furnished to an outpatient by a supplier of services or by an institutional provider, payment is made under the Part B program on the basis of 80 percent of the reasonable charges or 80 percent of the reasonable costs, with one exception. If the equipment is furnished by a home health agency, payment is made on the basis of 100 percent of the reasonable cost.

Explanation of Provision

The provision would reimburse home health agencies for durable medical equipment at 80 percent of reasonable cost and as in the case of other providers and suppliers, permit the agencies to bill beneficiaries for the remaining 20 percent.

Effective Date

Items or services furnished on or after enactment.

Estimated Savings

Fiscal year:	*Millions*
1984	$10
1985	20
1986	25
1987	25
4-year total	$80

18. Extension of Medicaid Payment Reductions and Offsets (sec. 921 of the bill)

Present Law

Public Law 97-35 provided that whatever Federal matching payments a State is otherwise entitled to are to be reduced by 3 percent in fiscal year 1982, 4 percent in fiscal year 1983, and 4.5 percent in fiscal year 1984. A State may qualify for a percentage point offset to these reductions of up to 3 percent if it has a qualified hospital cost review program, an unemployment rate which exceeds 150 percent of the national average, or fraud and abuse recoveries greater than one percent of Federal expenditures. In addition States may earn back part or all of the reductions if expenditures remain below specific target amounts.

Explanation of Provision

This provision would extend the existing reduction and offset provisions for 3 years. The reduction rate would be 3 percent for fiscal years 1985, 1986 and 1987. Moreover, for the purpose of determining the amount of payments under subsection 1903(s)(1)(A) that a State is otherwise entitled to receive for a given fiscal year, interest paid under subsections 1903(d)(2) and 1903(d)(5) and adjustments under section 1128A are to be excluded under certain circumstances.

Effective Date

October 1, 1984.

Estimated Savings

Fiscal year:	Millions
1984	0
1985	$562
1986	353
1987	432
4-year total	$1,347

19. Mandatory Assignment of Rights of Payment by Medicaid Recipients (sec. 922 of the bill)

Present Law

States are now permitted to require Medicaid applicants to assign to the State their rights to medical support and third party payments for medical care. Approximately 25 States have taken advantage of this provision.

Explanation of Provision

This provision would mandate that States require Medicaid applicants to assign to the State their rights to third party payments as a condition of eligibility.

Effective Date

October 1, 1984. A later implementation date is permitted when State legislation is required.

Estimated Savings

Fiscal year:	*Millions*
1984	0
1985	$7
1986	7
1987	8
4-year total	$22

20. Increase in Medicaid Ceiling Amount for Puerto Rico, the Virgin Islands, Guam, the Northern Mariana Islands, and American Samoa (sec. 923 of the bill)

(Contained in S. 2062 as originally reported)

Present Law

Current law authorizes participation of Puerto Rico, the Virgin Islands, Guam, the Northern Mariana Islands, and American Samoa in the Medicaid program. It sets the Federal matching rate for these jurisdictions at 50% and provides for annual ceilings on such payments of $45 million for Puerto Rico, $1.5 million for the Virgin Islands, $1.4 million for Guam, $350,000 for the Northern Mariana Islands, and $750,000 for American Samoa.

Explanation of Provision

The provision would increase the annual dollar ceilings on Federal payments to these jurisdictions. The new ceilings would be $63.4 million for Puerto Rico, $2.1 million for the Virgin Islands, $2.0 million for Guam, $550,000 for the Northern Mariana Islands, and $1,150,000 for American Samoa.

Effective Date

October 1, 1983.

Estimated Cost

Fiscal year:	*Millions*
1984	$20
1985	20
1986	20
1987	20
4-year total	$80

21. Increase Authorization for Maternal and Child Health Block Grant Program (sec. 924 of the bill)

(Contained in S. 2062 as originally reported)

Present Law

The present law authorizes $373 million for the Maternal and Child Health (MCH) Block grant program. Congress appropriated an additional $105 million for the program in fiscal year 1983 under Public Law 98-8 and an additional $26 million in fiscal year 1984.

Explanation of Provision

The provision would permanently increase the authorization level for the MCH block grant program. The level would be increased to $452 million in fiscal year 1984, $453 million in fiscal year 1985, and $455 million in fiscal year 1986 and thereafter.

Effective Date

October 1, 1983.

Estimated Cost

Fiscal year:	*Millions*
1984	$33
1985	30
1986	12
1987	−14
4-year total	$61

22. Medicaid Coverage for Pregnant Women (sec. 925 of the bill)

(Contained in S. 2062 as originally reported)

Present Law

Prior to the enactment of the "Omnibus Budget Reconciliation Act of 1981" (Public Law 97-35) States were permitted to allow pregnant women to qualify for AFDC payments on the basis of their unborn children. Pregnant women who are entitled to AFDC cash payments on this basis were also entitled to Medicaid coverage. Public Law 97-35 prohibited States from making AFDC cash payments to a pregnant woman on the basis of her unborn child until the sixth month of pregnancy. However, States are permitted to extend Medicaid eligibility to these women from the time the pregnancy has been medically verified. An estimated 80 percent of the States and jurisdictions have elected to provide Medicaid coverage to a pregnant woman on the basis of her unborn child for either all or a portion of her pregnancy.

Explanation of Provision

The provision would mandate States to provide Medicaid coverage beginning with the medical determination of pregnancy to every woman who would be eligible for AFDC if the child were born.

Effective Date

July 1, 1984. A later implementation date is permitted when State legislation is required.

Estimated Cost

Fiscal year:	*Millions*
1984	$4
1985	11
1986	12
1987	13
4-year total	$40

23. Recertification of SNF/ICF Patients (sec. 926 of the bill)

(Contained in S. 2062 as originally reported)

a. Present Law

Under current Medicaid law, a State's evidence of a satisfactory program of controls over utilization must include evidence that physicians recertify the need for continuing skilled nursing facility (SNF) and intermediate care facility (ICF) services every 60 days. However, there is evidence that less frequent recertification may be more appropriate in the case of long term intermediate care facility stays.

Explanation of Provision

The provision would modify the current physician recertification schedule. For skilled nursing facilities the following schedule would be established:

30 days after initial admittance;
60 days after initial admittance;
90 days after initial admittance;
60-day intervals thereafter.

For intermediate care facilities, the following schedule would be established:

60 days after initial admittance;
120 days after initial admittance;
12 months after initial admittance;
18 months after initial admittance;
24 months after initial admittance;
1-year intervals thereafter.

b. Present Law

Current law requires 100 percent on-time compliance with physician recertification requirements.

Explanation of Provision

The provision permits a ten day grace period if a State demonstrates good cause for physicians not meeting the deadline.

c. *Present Law*

By law, the quarterly Federal penalty imposed on States for failure to have an adequate program of controls over utilization is equal to 33⅓ percent multiplied by a ratio of all Medicaid patients in facilities with one or more surveyed records out of compliance to all Medicaid patients in those types of facilities.

Explanation of Provision

The provision would modify the existing formula by substituting 5 percent for the existing 33⅓ percent figure. Further, the provision would specify that no penalty would be imposed in cases where the total number of patients whose records were surveyed and found out of compliance is less than 3 percent of the total number of patients included in the survey.

Effective Date

Quarters beginning on or after enactment.

Estimated Savings

Fiscal year:	*Millions*
1984	$3
1985	4
1986	0
1987	−1
4-year total	$6

24. Study of Physician Reimbursement for Cognitive Services (sec. 931 of the bill)

(Contained in S. 2062 as originally reported)

Present Law

Medicare payments to physicians are made on the basis of reasonable charges for specific services. There is concern that the existing payment methodology may result in payment imbalances between various physician specialties, types of procedures, and health care settings. The current reimbursement system rewards physicians for their technical skills and for the performance of certain activities such as surgery or diagnostic tests. As a result, there is concern that the system discourages physicians from spending time with patients to counsel or examine them.

Explanation of Provision

The provision directs the Office of Technology Assessment, in consultation with appropriate physician organizations and the Secretary, to conduct a study examining any imbalance in payments to physicians for their cognitive vs. their technical services. It is the desire of the Committee that the OTA study results include specific recommendations on ways to modify the existing system for determining Medicare allowances to eliminate any inequities that exist between reimbursement levels for medical procedures and cognitive services.

OTA is also directed to include specific findings and recommendations on creating a means to adjust allowances to physicians as the costs and risks to physicians, which result from new technologies and procedures, decrease over time. The provision requires submission of the report to Congress by December 31, 1985.

Effective Date

Enactment.

25. Elimination of Part B Deductible for Certain Diagnostic Laboratory Tests (sec. 932 of the bill)

(Contained in S. 2062 as originally reported)

Present Law

Present law authorizes the Secretary to negotiate with a laboratory a payment rate that is considered the full charge for diagnostic tests. The payment, which is made directly to the laboratory, equals 100 percent of the negotiated rate subject to the annual Part B deductible. The beneficiary is not liable for the 20-percent coinsurance payment that usually is applicable.

Explanation of Provision

The provision eliminates application of the annual Part B deductible in the case of diagnostic tests performed in a laboratory which has entered into a negotiated rate agreement with the Secretary. Should the fee schedule provision proposed in a separate section of this bill not be extended beyond September 30, 1987, this provision would then provide an incentive for laboratories to enter into such agreements and thereby reduce costs associated with individual billing of Medicare beneficiaries.

Effective Date

Diagnostic tests performed on or after September 30, 1987.

26. Payment for Services Following Termination of Participation Agreements With Home Health Agencies and Hospices (sec. 933 of the bill)

(Contained in S. 2062 as originally reported)

Present Law

Under current law, if Medicare participation of a home health agency or a hospice is terminated, the Secretary is required to continue to pay for services provided to a beneficiary until the end of the calendar year in which the termination took place. This requirement is only applicable to services provided under an individual plan of care established prior to the termination of the agency.

Explanation of Provision

The provision changes from the end of the calendar year to 30 days after termination, the ending of coverage for services provided under a plan established prior to the termination date of the participation agreement. This provision brings the treatment of home health agencies and hospices into conformity with the treatment of hospitals and skilled nursing facilities.

Effective Date

Enactment.

27. Repeal of Special Tuberculosis Treatment Requirements Under Medicare and Medicaid (sec. 934 of the bill)

(Contained in S. 2062 as originally reported)

Present Law

Present law contains a number of provisions intended to assure that institutional services provided to Medicare and Medicaid patients suffering from tuberculosis are not custodial in nature and that such treatment can reasonably be expected to improve the patient's condition or render the condition noncommunicable.

Explanation of Provision

The provision repeals the special provisions. Advances in the active treatment of tuberculosis make such safeguards against paying for custodial care for tuberculosis patients unnecessary. The provision also eliminates tuberculosis hospitals as a special provider category in the Medicare and Medicaid programs.

Effective Date

Enactment.

28. Medicare Recovery Against Certain Third Parties (sec. 935 of the bill)

(Contained in S. 2062 as originally reported)

Present Law

Under current law, the Medicare program may make payments for services for which other third party insurance programs (e.g., worker's compensation, auto or liability insurance, and employer health plans) are ultimately liable for some or all of the costs. However, the Secretary does not now have the right of subrogation to become a party to claims against other liable parties or to recover directly from such parties.

Explanation of Provision

The provision establishes the statutory right of Medicare to recover directly from a liable third party, on behalf of a beneficiary, if the beneficiary himself does not do so, and to pay the beneficiary or a health care provider or supplier on the beneficiary's behalf, pending recovery where such third party is not expected to pay promptly. These provisions are intended to improve the ability of the Medicare program to obtain reimbursement to which it is entitled by law.

Effective Date

Enactment.

29. Indirect Payment of Supplementary Medical Insurance Benefits (sec. 936 of the bill)

(Contained in S. 2062 as originally reported)

Present Law

Current law does not, in general, permit Medicare Part B payments to be made to anyone other than a beneficiary or an entity providing services.

Explanation of Provision

The provision permits Part B payments to be made to a health benefits plan whose payment, in combination with the Medicare payment, is accepted by the physician or other supplier as payment in full. The purpose of this provision is to enable this indirect payment procedure to be available to non-group as well as group, health benefit plans such as those offered by employers, unions, insurance companies, and other organizations.

Effective Date

Enactment.

30. Elimination of Health Insurance Benefits Advisory Council (sec. 937 of the bill)

(Contained in S. 2062 as originally reported)

Present Law

Section 1867 of the Social Security Act provides for a 19 member panel of health experts (the Health Insurance Benefits Advisory Council or HIBAC) appointed by the Secretary to advise on matters of general policy with respect to the Medicare and Medicaid programs.

Explanation of Provision

The provision repeals Section 1867. HIBAC was very active in the early years of the Medicare program when regulations were first promulgated. As the Federal Government gained experience in administering the Medicare program, the Council's advisory functions with respect to regulations became less important. With passage of the Social Security Amendments of 1972, Public Law 92-603, the Council's authority to review regulations and recommend changes was specifically deleted, and its role limited to advice on matters of "general policy." At that same time its purview was extended to include the Medicaid program. However, HIBAC has not been called upon to advise the Secretary since late in 1976, and there are currently no members.

Effective Date

Enactment.

31. Confidentiality of Accreditation Surveys (sec. 938 of the bill)

(Contained in S. 2062 as originally reported)

Present Law

Current law contains certain disclosure safeguards relating to survey information used by the Secretary in connection with the hospital certification process under Medicare. However, the law only specifically refers to surveys conducted by the Joint Commission on the Accreditation of Hospitals (JCAH).

Explanation of Provision

The provision extends the same disclosure protections given JCAH survey information to similar survey information provided to the Secretary by the American Osteopathic Association or other national accreditation organizations.

Effective Date

Enactment.

32. Flexible Sanctions for Noncompliance With Requirements for End Stage Renal Disease (ESRD) Facilities (sec. 939 of the bill)

(Contained in S. 2062 as originally reported)

Present Law

Current law and regulations provide for decertification of end-stage renal disease (ESRD) facilities that are not in complete compliance with Medicare program requirements.

Explanation of Provision

The provision allows the Secretary to apply intermediate sanctions, such as a graduated reduction of reimbursement, to ESRD facilities whose noncompliance does not jeopardize patient health or safety or justify decertification of such facilities. Noncompliance would, in these cases, deal primarily with administrative requirements. This provision makes the treatment of ESRD facilities comparable to the treatment of nursing homes which are out of compliance.

The Committee intends that the Secretary, in applying the sanctions, should take certain factors into account. When reviewing a facility's compliance with the nurse staffing requirements, consideration should be given to the economic situation of areas with exceedingly high unemployment rates. For example, an area may be unable to recruit nurses because of the difficulty in finding employment for the nurses' spouses. In addition, in the event that a free standing facility functions as a sole community provider for dialysis services, care shall be taken to ensure that Medicare beneficiaries requiring inpatient services continue to have those services available in a reasonably accessible facility.

Effective Date

Enactment.

33. Use of Additional Accrediting Organizations Under Medicare (sec. 940 of the bill)

(Contained in S. 2062 as originally reported)

Present Law

Under current law, the Secretary has authority to rely on certain accrediting organizations in determining whether hospitals, skilled nursing facilities, home health agencies, ambulatory surgical centers and hospice programs meet Medicare requirements.

Explanation of Provision

The provision extends the Secretary's authority to permit reliance on such organizations in determining whether rural health clinics, laboratories, clinics, rehabilitation agencies, including outpatient rehabilitation facilities, and public health agencies meet Medicare requirements (and clarifies the Secretary's authority with respect to ambulatory surgical centers). The standards of an accrediting organization chosen must be at least equivalent to those of the Secretary, and it must have a satisfactory record of application of such standards.

Effcctive Date

Enactment.

34. Repeal of Exclusion of For-Profit Organizations From Research and Demonstration Grants (sec. 941 of the bill)

(Contained in S. 2062 as originally reported)

Present Law

Current law limits the awarding of grants (under sections 1110 of the Social Security Act and section 222(b) of the 1972 Medicare amendments) for the conduct of research and demonstrations to non-profit organizations. However, contracts are permitted to be awarded to both for-profit and non-profit organizations.

Explanation of Provision

The provision extends the research and demonstration grant authority to for-profit organizations.

Effective Date

Enactment.

35. Requirements for Medical Review and Independent Professional Review Under Medicaid (sec. 942 of the bill)

(Contained in S. 2062 as originally reported)

Present Law

Under current law, medical review requirements for skilled nursing facilities (SNFs) and independent professional review for intermediate care facilities (ICFs) under Medicaid both call for teams of physicians, registered nurses and other appropriate personnel to conduct virtually similar kinds of review.

Explanation of Provision

The provision makes the State plan requirements for medical review consistent with the requirements for independent professional review thereby clarifying that there is no substantial statutory difference between review of SNFs and ICFs. The provision also corrects a technical error in present law to assure that Christian Science sanatoria are excluded from the revised medical review/independent professional review requirements.

Effective Date

Enactment.

36. Flexibility in Setting Rates for Hospitals Furnishing Long-Term Care Services Under Medicaid (sec. 943 of the bill)

(Contained in S. 2062 as originally reported)

Present Law

Current law contains special requirements for the establishment of payment rates for hospitals furnishing skilled nursing or intermediate care facility services under Medicaid.

Explanation of Provision

The provision deletes the requirements for setting payment rates for certain hospital-furnished long-term care. Under the provision such rates need only meet the general criteria applicable to rates for similar services provided by long-term care institutions to Medicaid recipients.

Effective Date

Enactment.

37. Authority of the Secretary To Issue and Enforce Subpoenas Under Medicaid (sec. 944 of the bill)

(Contained in S. 2062 as originally reported)

Present Law

Current law authorizes the Secretary to issue and seek enforcement of subpoenas under Medicare to obtain information needed in connection with hearings, investigations and other matters related to program fraud and abuse.

Explanation of Provision

The provision authorizes the Secretary to issue and seek enforcement of subpoenas under Medicaid to the same extent that he has authority under the Medicare program.

Effective Date

Enactment.

38. Repeal of Authority for Payments To Promote Closing and Conversion of Underutilized Hospital Facilities (sec. 945 of the bill)

(Contained in S. 2062 as originally reported)

Present Law

Section 2101 of the "Omnibus Budget Reconciliation Act of 1981" (Public Law 97-35) authorized the Secretary to make Medicare and Medicaid payments to cover capital and increased operating costs associated with the conversion or closing of underutilized hospital facilities. The provision, which has never been implemented, restricts the number of facilities which may receive these funds to no more than 50 prior to January 1, 1984.

Explanation of Provision

The provision repeals this section of current law.

Effective Date

Enactment.

39. Presidential Appointment of and Pay Level for the Administrator of the Health Care Financing Administration (sec. 946 of the bill)

(Contained in S. 2062 as originally reported)

Present Law

By law, the Administrator of the Health Care Financing Administration (HCFA) is in the Senior Executive Service and is appointed by the Secretary of Health and Human Services.

Explanation of Provision

The provision provides for the appointment of the Administrator of HCFA by the President, with the advice and consent of the Senate. The position and pay of the Administrator is increased to Level IV of the Executive Schedule.

Effective Date

Applies to appointments to the position made after enactment.

40. Exclusion of Certain Entities Owned or Controlled by Individuals Convicted of Medicare- or Medicaid-Related Crimes (sec. 947 of the bill)

(Contained in S. 2062 as originally reported)

Present Law

Current law authorizes the Secretary to bar from participation in Medicare (and to direct State agencies to bar from Medicaid) institutional providers in which a significant interest is held by a person convicted of program-related criminal offenses.

Explanation of Provision

The provision extends the Secretary's authority to also exclude from Medicare participation (and to direct State agencies to exclude from Medicaid participation) any entity or supplier of services in which a significant ownership or controlling interest is held by a person convicted of program related criminal offenses.

Effective Date

Enactment.

41. Judicial Review of Provider Reimbursement Review Board Decisions (sec. 948 of the bill)

(Contained in S. 2062 as originally reported)

Present Law

The "Social Security Amendments of 1983" (Public Law 98-21) permits groups of providers to bring action in the judicial district in which the largest number of them are located. Under prior law, group judicial appeals could only be made in the District Court for the District of Columbia. Public Law 98-21 also requires certain appeals by providers which are under common ownership or control to be made as a group.

These provisions were included in a section of Public Law 98-21 entitled "Conforming Amendments" and were not assigned a specific effective date. Therefore, these provisions together with most of the prospective payment provisions were given the following effective date, "apply to items and services furnished by . . . a hospital beginning with its first cost reporting period that begins on or after October 1, 1983."

Explanation of Provision

The provision clarifies the effective date of the judicial review provisions.

Effective Date

Applies to court actions brought on and after the enactment of Public Law 98-21.

42. Access to Home Health Services (sec. 949 of the bill)

(Contained in S. 2062 as originally reported)

(a) Present Law

Current law requires a physician to certify to a patient's health needs and establish a plan of care before the patient can qualify for home health benefits. The Secretary is directed, however, to prescribe regulations to disqualify a physician from carrying out these functions for patients of any agency in which the physician has a significant ownership interest or a significant financial or contractual relationship.

Explanation of Provision

The provision permits a physician who has a financial interest in an agency which is a sole community provider to carry out the certification and plan-of-care functions for patients who will receive services from the agency. Existing regulations, which were intended to prevent potential conflicts of interest, have created a serious problem for the relatively few patients whose physicians have an interest in the only agency in the area. These patients have been unable to qualify for home health benefits unless they switched physicians.

Effective Date

Enactment.

(b) Present Law

Current regulations specifying which physicians are disqualified from carrying out the certification and plan-of-care functions for the patients of a home health agency include physicians who are uncompensated officers or directors of agencies even though they have no financial interest in its operation.

Explanation of Provision

The provision deletes from the list of disqualified physicians uncompensated officers or directors of agencies. These physicians do not stand to gain or lose from referrals to the agency.

Effective Date

Enactment.

43. Provider Representation In Peer Review Organizations (PROs) (sec. 950 of the bill)

(Contained in S. 2062 as originally reported)•

Present Law

Under current law, no health care facility such as a hospital may be a peer review organization although they may perform "delegated review" for a peer review organization. The law specifically prohibits the Secretary of HHS from contracting with an entity which is, or is affiliated with (through management, ownership or common control), a health care facility. The Secretary, by regulation, has interpreted this to mean that a peer review organization (PRO) may not have a governing body which has as a member any individual who is a governing body member, officer, or managing employee of a health care facility.

It is common among professional standards review organizations (PSRO's), which are being phased out and replaced by PRO's, for one or two hospital administrators to sit on the PSRO board. The regulation could have the effect of prohibiting any physician or other person who is on the board of, or has certain administrative responsibilities in, a hospital from serving on the board of a PRO.

Explanation of Provision

The provision provides for limited representation of provider related individuals on PRO's. In the case of a PRO with a governing body of 15 or fewer members, one such member may be a governing body member, officer, or managing employee of a health care facility; and in the case of a PRO with a governing body of more than 15 members, no more than two such members may be a governing body member, officer, or managing employee of a health care facility.

Effective Date

Enactment.

44. Prospective Payment Assessment Commission (sec. 951 of the bill)

Present Law

The "Social Security Amendments of 1983" (P.L 98-21) provided for the implementation of a prospective payment system for hospitals under the Medicare program. The legislation established an independent, legislative-branch commission to assist the Department of Health and Human Services (HHS) and the Congress in dealing with the issues that will arise with respect to the new payment method. This Prospective Payment Assessment Commission is required to make recommendations concerning the annual percentage increase factor for diagnosis related group (DRG) payment rates. The Commission is also required to make recommendations with respect to changes in the DRGs based on its evaluation of scientific evidence.

Explanation of Provision

The provision would make several clarifying changes. It would clarify that the Commission is an independent authority and responsible for requesting appropriations. The Commission would be exempt from competitive public bidding (considered to be too cumbersome for an organization of the Commission's size) and from open-meeting requirements. Further, HHS would be directed to provide the Commission with basic support services and be reimbursed out of funds of the Commission. The provision would also authorize HHS to finance clinical trials under certain conditions. Provision would also be made for the appointment of an executive director. Physicians serving as personnel of the Commission may be provided a physician comparability allowance by the Commission similar to those provided to physicians employed in the Executive Branch.

Effective Date

Enactment.

45. Medicaid Clinic Administration (sec. 952 of the bill)

(Contained in S. 2062 as originally reported)

Present Law

By law, States may cover clinic services under their Medicaid programs. To assure that the clinic services are provided on a safe and appropriate basis, regulations issued by the Department of Health and Human Services limit coverage to situations where services are furnished under the direction of a physician. In certain cases, the physician direction rule has been interpreted as requiring that clinic administrators be physicians.

Explanation of Provision

The provision would direct the Department of Health and Human Services to modify the physician-direction requirement to clarify that the administrator of a clinic need not be a physician.

Effective Date

Enactment.

46. Enrollment and Premium Penalty With Respect to Working Aged Provision (sec. 953 of the bill)

(Contained in S. 2062 as originally reported)

Present Law

The "Tax Equity and Fiscal Responsibility Act" (TEFRA) required employers to offer their employees aged 65 to 69 the same health benefits plan as offered to their younger workers. At the employee's option, Medicare payments may be secondary with respect to himself and to a spouse if age 65-69. Aged employees and spouses who elect enrollment in such employer offered health benefit plans may wish to delay enrollment in Part B because Part B coverage may be duplicative. However, these persons are currently subject to a late enrollment penalty. By law, the monthly Part B premium is increased by 10 percent for each full 12 months that individuals delays enrollment in the program beyond their initial enrollment period.

Explanation of Provision

The provision would waive the Part B delayed enrollment penalty for workers and their spouses aged 65 to 70 who elect private coverage under the provisions of TEFRA and would establish special enrollment periods for such workers. The waiver would apply for the period during which an individual continued to be covered under an employer's group health benefits plan.

Effective Date

Enactment.

47. Emergency Room Services (sec. 954 of the bill)

(Contained in S. 2062 as originally reported)

Present Law

The "Omnibus Budget Reconciliation Act of 1981" (P.L. 97-35) included a provision requiring the Secretary of HHS to place reasonable limits on hospital costs and physician charges for outpatient services. The limits were to be reasonably related to the charges for similar services in physician's offices in the area. The statute specifically exempted from the outpatient limits "bona fide emergency services provided in an emergency room."

The Tax Equity and Fiscal Responsibility Act of 1982 (P.L. 97-248) included a provision to eliminate duplicate overhead payments for outpatient services. The provision added authority for the Secretary to reduce the payment to a physician providing services in an outpatient department by a factor representing the overhead costs already being paid by Medicare through the payment to the hospital.

The Secretary of HHS issued implementing regulations for these provisions on October 1, 1982. The definition of "bona fide emergency services" was limited to services necessary to prevent death or serious impairment. After receiving public comment, the Department of HHS reconsidered the definition. Although the regulations have not yet been reissued, it appears that the Department is prepared to broaden the definition.

Explanation of Provision

The provision would provide for the following statutory definition of "bona fide emergency services":

> Services provided in a hospital emergency room after the sudden onset of a medical condition manifesting itself by symptoms of sufficient severity (including severe pain) that the absence of immediate medical attention could reasonably be expected to result in (a) placing the patient's health in serious jeopardy; (b) serious impairment to bodily functions; or (c) serious dysfunction of any bodily organ or part.

The Committee believes that a statutory definition of "bona fide emergency services" is necessary to express clearly the intent of Congress in this regard.

Effective Date

Services furnished on or after enactment.

48. Nurse Anesthetists (sec. 955 of the bill)

(Contained in S. 2062 as originally reported)

Present Law

Under the new prospective payment system enacted as a part of the Social Security Amendments of 1983 (P.L. 98-21), Medicare's payments to hospitals under Part A will be based on the diagnosis of the patient. Each diagnosis-related group (DRG) payment is intended to cover all the services that hospitals customarily furnish in caring for patients with a specified diagnosis.

Certified registered nurse anesthetists (CRNAs) have a variety of employment arrangements. Nearly 40 percent of all anesthesia services are provided by CRNAs employed by, or under contract with, hospitals. Certified registered nurse anesthetists who are paid by the hospital often assist at operations by anesthetising the patient. A part of each hospital's DRG payment is intended to cover these costs. On the other hand, a physician might provide the anesthetic, and in these cases the physician can bill Medicare separately. Physicians may also employ nurse anesthetists and bill for their services through part B. Since a hospital will be paid the same amount regardless of whether it pays a CRNA to perform the procedure, or a physician or a CRNA whom he employs, gives the anesthetic at no cost to the hospital, there is a clear financial incentive for hospitals to have physicians replace CRNAs employed by the hospital.

Explanation of Provision

The provision provides that the costs a hospital actually incurs in employing CRNAs are to be reimbursed on a reasonable cost basis. Thus, the hospital will have neither a financial incentive or disincentive to employ CRNSs. The costs may not be based on a greater number of CRNAs than were employed by a hospital in 1982, unless the Secretary determines that patient volume, patient mix, or a loss of physicians' services requires otherwise.

The provision further requires the Secretary to conduct a study and report to Congress on an alternative method for reimbursing for these services. Such alternative method should not discourage the use of CRNAs.

Effective Date

Hospital reporting periods beginning on and after October 1, 1984.

49. Prospective Payment Wage Index (sec. 956 of the bill)

(Contained in S. 2062 as originally reported)

Present Law

The "Social Security Amendments of 1983" (P.L. 98-21) provided for the implementation of a prospective payment system for hospitals under the Medicare program. Under the system, payments made to hospitals are adjusted to reflect differences in hospital area wage levels. The wage index is calculated based on wage and employment data maintained by the Bureau of Labor Statistics (BLS) of the Department of Labor. This data is currently the most reliable national data available. However, it is an inadequate measure of wage differences because it fails to accurately reflect the relative use of part time and full time employees in calculating the index.

Explanation of Provision

The provision would direct the Secretary of Health and Human Services to consult with the Secretary of Labor to develop methods of refining and improving the adequacy and equity of the hospital wage index, taking into account wage differences of part time and full time workers. The Secretary of HHS would be required to report to the Congress by May 1, 1984.

The provision would further require the Secretary to adjust, if found appropriate, a hospital's payment to reflect changes made in the index. Such adjustments would be made for reporting periods beginning on or after October 1, 1983. In making any necessary adjustment for the first reporting period beginning on or after October 1, 1984, any overpayment or underpayment that may have occurred in the previous cost reporting period would be taken into account.

Effective Date

Enactment

50. Hospice Contracting for Core Services (sec. 957 of the bill)

(Contained in S. 2062 as originally reported)

Present Law

Public Law 98-248, the "Tax Equity and Fiscal Responsibility Act of 1982", authorized for the period November 1, 1983 to October 1, 1986 Medicare Part A coverage for hospice services provided to terminally ill Medicare beneficiaries with a life expectancy of six months or less. The law specifies that a hospice must routinely provide directly, substantially all of the following "core services": nursing care, medical social services, physician's services, and counseling services. The remaining "non-core services" may be provided either directly by the hospice or under arrangements with others, in which case the hospice must maintain professional management responsibility for all such services furnished to an individual, regardless of the location or facility in which such services are furnished.

Under existing regulations, a hospice may use contracted staff to meet the "core service" needs of its patients but only when necessary to supplement hospice employees during periods of peak patient loads or under extraordinary circumstances.

Explanation of Provision

The provision would permit the Secretary to waive the nursing care "core services" requirements for hospices that are located in rural areas, that were in operation on or before January 1, 1983, and that have demonstrated a good faith effort to hire their own nurses. A waiver request would be granted automatically unless expressly denied by the Secretary within 60 days. The granting of a waiver would not preclude the favorable consideration of a subsequent waiver request should such a request be made.

In providing for this waiver, the Committee emphasizes that it does not support or condone the establishment of hospices which serve only as brokers for services. Hospices which receive core-service waivers would be expected to exert professional management responsibility over the services and would be accountable for assuring that they are rendered consistent with the plan of care.

The provision would also require the Secretary to study the necessity and appropriateness of the core service requirement and report his findings to Congress within 18 months of enactment. The Committee wishes to express its interest in having the Secretary make recommendations for (1) legislative action to further protect hospice patients and the Medicare program from fraud and abuse and (2) standards of quality to be used in connection with hospice services.

Effective Date

Enactment.

51. Exemption of Public Psychiatric Hospitals From Provision Limiting Reimbursement to SNF Rates (sec. 958 of the bill)

(Contained in S. 2062 as originally reported)

Present Law

Under the terms of a reimbursement experimentation contract with the State of New Jersey, Medicaid patients who need skilled nursing or intermediate care facility care, but who are waiting in a hospital for placement in a nursing home, are subject to different reimbursement rules than those who need acute inpatient hospital services. If the Secretary determines that the hospital has no excess beds, and if there are no excess hospital beds in the hospital's service area, the reimbursement for patients awaiting nursing home placement is set at the hospital's acute care rate; otherwise, Medicaid reimbursement must reflect the level of care actually received by the patient. (A similar Medicare statutory provision which would make this policy applicable nationwide has not yet been implemented.)

The application of this policy to public psychiatric hospitals in New Jersey has created a problem for the State and some of its localities. After July 1, 1984, reimbursement for Medicaid patients in these facilities awaiting nursing home placement will no longer be set at the acute care rate, but will be lowered to the skilled nursing facility rate. This will result in a sudden drop in the Medicaid reimbursement rate to the affected facilities by as much as 50 percent.

Explanation of Provision

The provision delays until July 1, 1985, the application of any reimbursement reductions required to be made to public psychiatric hospitals due to the level of care received by Medicaid patients in such hospital. The provision further requires that one-third of the reductions take effect during the year ending June 30, 1986, and that the remaining two-thirds of the reductions take effect during the year ending June 30, 1987.

The Committee believes that a gradual phase-in of the policy under the New Jersey reimbursement experiment would be appropriate.

Estimated Cost

Fiscal year:	*Millions*
1984	$5
1985	10
1986	6
1987	3
4-year total	$24

Effective Date

Enactment.

52. Certification of Psychiatric Hospitals (sec. 959 of the bill)

(Contained in S. 2062 as originally reported)

Present Law

Under present law, psychiatric hospitals must be accredited by the Joint Commission on the Accreditation of Hospitals (JCAH) in order to participate in Medicare and Medicaid. Psychiatric units of general hospitals must also be accredited by the JCAH in order to receive Medicaid payments for the care of children.

Explanation of Provision

The provision permits psychiatric hospitals and psychiatric units of general hospitals to participate in Medicare and Medicaid on the basis of a survey by the Secretary of Health and Human Services or, if found appropriate, accreditation by the American Osteopathic Association or the JCAH.

Effective Date

Enactment.

53. Payments to Teaching Physicians (sec. 960 of the bill)

(Contained in S. 2062 as originally reported)

Present Law

Under a provision of current law, which has not yet been implemented, teaching physicians who practice primarily in teaching hospitals may be paid charges for their services to Medicare patients if charges for their services are also billed to other patients. The level of charges that is to be paid by Medicare under present law is to be based on the amounts charged and collected for non-Medicare patients.

Implementation of this policy could result in large payment reductions, and financial problems, for some teaching hospitals in States which have very low Medicaid payment rates. These rates sometimes represent as little as 25 percent of the area's prevailing charges. Their use in calculating Medicare payment levels would reduce Medicare reimbursement substantially.

Explanation of Provision

The provision provides that the Medicare reasonable charge for a physician's service furnished in a teaching hospital may not be less than 75 percent of the prevailing charge for that service in the locality.

Effective Date

Enactment.

54. Pacemaker Reimbursement Review and Reform (sec. 961 of the bill)

Present Law

Current law provides for the physician services associated with the implantation of cardiac pacemakers and post-implantation monitoring of these devices to be reimbursed under Part B. A number of criticisms have been raised concerning current Medicare policies and practices relating to cardiac pacemakers. The criticisms focus on the frequency of trans-telephonic monitoring of pacemakers and physician fees for the implantation of pacemakers.

S. 2062

The bill would have required the Secretary of Health and Human Services to issue revisions by February 1, 1984 to the current coverage guidelines on the frequency of trans-telephonic monitoring procedures considered to be reasonable and necessary. The Secretary is now reviewing Medicare policies in this area. As a part of this review, the American College of Cardiology, the American Heart Association, the American Medical Association, and other organizations and individuals with expertise in this area will provide materials to the Department. It was anticipated that the February 1, 1984 date provided the Department the necessary time to complete its analysis and issue revised guidelines.

The provision would have required the Secretary to review and report to the Congress on the appropriateness of the current rate of physician reimbursement for services associated with implantation and replacement of pacemakers and pacemaker leads. In conducting this review, the Secretary was to take into account the amounts recognized as reasonable with respect to the procedures and the time and difficulty of the procedures compared to those charged when the rates were first established. The Committee thus intended that the Secretary take into consideration improvements in pacemaker implantation and reductions in the time required for such procedures that have occurred over the past decade.

The provision required the Secretary, through the Commissioner of the Food and Drug Administration (FDA), to provide for a manufacturer-based registry of all cardiac pacemaker devices and leads for which payments may be made under Medicare. The bill required manufacturers to maintain a registry on its devices and leads which includes: model identification, serial number, the name of the recipient, the date and geographic location of the implantation or removal, and the name of the physician, hospital or other provider. The registry would include any express or implied warranties associated with the device and any other information which the Secretary deemed appropriate. The registry would be readily accessible to duly authorized agents of the Food and Drug Administration.

The purpose of the registry was to assist the Secretary in determining when Medicare payments for a replacement pacemaker may properly be made, in determining when inspection by the FDA may be necessary for purposes of review and testing for malfunctions of pacemakers, in tracing the performance of cardiac pacemaker devices and leads, and in carrying out such other studies as the Secretary determined appropriate. The Secretary was specifically prohibited from identifying any recipient of a pacemaker by name.

The Secretary was authorized to require, by regulation, that all patients bearing a device or lead for which Medicare payment was made or requested, be registered with the manufacturer of the device or lead. The Secretary could, also, by regulation, require that any device or lead explanted from any such patient be returned to the manufacturer of same. Failure to return an explanted device or lead could be grounds for the intermediary to deny payment for the replacement of such device or lead.

The Secretary could require the manufacturers to maintain accurate records and report annually to the FDA on the results of all returned product analyses and on such other clinical experiences as are deemed appropriate. In the case of adverse performance, manufacturers would be required to provide prompt notification to the FDA.

The bill authorized the Secretary to require the manufacturer to test or analyze each returned cardiac pacemaker device or lead and provide the test results to the institution or party who returned it to the manufacturer together with information as to whether or not such unit qualifies for any warranty or other credit. In any case where the Secretary has reason to believe that replacement of a pacemaker is related to its malfunction, the Secretary could require that FDA personnel have access to the manufacturers testing records or may verify such testing.

Modified Proposal

This provision would modify the provision previously agreed to by the Committee as part of S. 2062, which directed the Secretary to study the impact technology should have on the costs of physician services, publish guidelines on the frequency and appropriate payment levels for trans-telephonic monitoring, and establish a manufacturer-administered pacemaker registry.

As a result of the modification (1) the Secretary would be required to publish the revisions of the current coverage guidelines by April 1, 1984, (2) the Secretary also would be required to study the reasonableness of Part A payments associated with pacemaker implants and (3) a pacemaker registry provided through the FDA, rather than manufacturer-based, would be required.

Effective Date

Enactment.

55. Open Enrollment Period for Health Maintenance Organizations and Competitive Medical Plans (sec. 962 of the bill)

(Contained in S. 2062 as originally reported)

Present Law

Under current law, health maintenance organizations (HMOs) and competitive medical plans (CMPs) are required to have an open enrollment period of at least 30 days during which time they must accept Medicare beneficiaries up to the limits of their capacity.

Explanation of Provision

The provision requires the Secretary to designate one 30-day period in which all of the CMPs and HMOs in an area participating in Medicare must conduct open enrollment. The CMP or HMO would be permitted, in addition, to provide for open enrollment at other times during the year or hold enrollment open throughout the year. The Secretary would be required to establish annual per capita rates in a manner that assures that the beneficiaries enrolling during the designated 30-day open enrollment period will not have their premiums increased or their benefits decreased for the 12-month enrollment period for which the beneficiary is enrolling.

The Secretary, in establishing the open enrollment period for a geographic area, would be directed to consult with the CMPs or HMOs in the area concerning the timing of the annual 30-day open enrollment period. It is the intent of the Committee that the majority of CMPs or HMOs annual enrollments occur during the coordinated open enrollment period.

The Committee understands that there may be some difficulty in administering this provision and has therefore allowed the Secretary a period of not more than three years to phase in this provision. The Committee intends that the Secretary make every effort to designate open enrollment periods for different areas as soon as possible and not wait until the second or third year of this period before designating open enrollment periods.

Effective Date

Enactment.

56. Waivers for Social Health Maintenance Organizations (sec. 963 of the bill)

Present Law

Present law gives the Secretary general authority to conduct experiments and demonstrations. While the Department has provided start-up funding for four demonstration projects for social HMO's, operational funding has not been provided.

Explanation of Provision

The amendment requires the Secretary to approve certain waivers for a project to demonstrate the concept of a social HMO at four sites within 30 days after submission of a waiver request or within 30 days of enactment, whichever date is earlier.

Effective Date

Enactment.

57. Funding for PSRO Review (sec. 964 of the bill)

Present Law

Since 1982, the PSRO program has been hampered by inadequate and uncertain funding. In order to avoid these problems in the future, legislation was enacted earlier this year (P.L. 98-21) which provides that the soon-to-be-established PRO's to be automatically funded outside the appropriations process.

Under this 1983 legislation, the Secretary of Health and Human Services is directed to pay PRO's amounts determined to be reasonable, but not less than the 1982 funding levels (adjusted for inflation).

Because it was believed that the PRO program would replace PSRO's early in fiscal year 1984, this special authorization was not extended to the expiring PSRO's. However, delays in issuing regulations for the new PRO program have made it necessary to continue funding PSRO's well into fiscal year 1984.

It now appears likely that the PSRO appropriation will not be sufficient to cover the costs of their protracted 1984 operations.

Explanation of Provision

The provision would permit funding of PSRO's out of the part A Trust Fund, making funding no longer subject to the appropriations process. In addition, two dates contained in the PRO legislation would be moved back three months to take into account the delay in implementation.

The date by which hospitals are required to have an agreement with a PRO would be changed from October 1, 1984, to January 1, 1985. The date on which Medicare claims processing organizations can first qualify as PRO's would be similarly changed.

Effective Date

May 1, 1984.

58. Other Considerations

Under a provision of the 1980 amendments, small rural hospitals are allowed to temporarily participate in Medicare under certain circumstances even though they are unable to meet the Medicare requirement that they provide 24-hour nursing. One of the conditions is that the hospital's lack of nursing must be due to a temporary nurse shortage and that the hospital is making a good faith effort to comply with the program's nursing standards.

The Committee believes that in assessing the hospital's effort to attract personnel, consideration should be given to the economic conditions in the area in which the hospital is located and the communities ability to attract and pay skilled hospital staff and provide employment for a spouse. Specifically, factors such as rate of unemployment, relative poverty and hardship resulting from natural disasters or economic dislocation should be identified and given weight.

In the case of a facility which functions as a sole community provider, or where a hospital is located in a geographically remote area, care shall be taken to ensure that hospital emergency services continue to be accessible to area residents.

B. Income Maintenance Provisions

Aid to Families With Dependent Children (AFDC) Provisions

1. Parents and Siblings of Dependent Child Included in AFDC Family (sec. 971 of the bill)

(Contained in S. 2062 as originally reported)

Present Law

There is no requirement in present law that parents and all siblings be included in the AFDC filing unit. Families applying for assistance may exclude from the filing unit certain family members who have income which might reduce the family benefit. For example, a family might choose to exclude a child who is receiving social security or child support payments, if the payments would reduce the family's benefits by an amount greater than the amount payable on behalf of the child. In addition, a mother who is a minor is excluded if she is supported by her parents. However, if she has no income of her own which may be attributed to her child, the child may qualify for assistance as a one-person unit, and receive proportionately more in assistance than it would receive as part of a two-person unit. The income of the parents of the minor parent is not considered in determining the eligibility of the child.

Explanation of Provision

The provision approved by the Committee would require States to include in the filing unit the parents and all dependent minor siblings (except SSI recipients and any stepbrothers and stepsisters) living with a child who applies for or receives AFDC. In addition, if a minor who is living in the same home as his parents applies for aid as the parent of a needy child, the income of the minor's parents would be counted as available to the filing unit. The rules that would be used in determining the amount of available income would be the same as are currently used in counting the income of stepparents.

This change will end the present practice whereby families exclude members with income in order to maximize family benefits, and will ensure that the income of family members who live together and share expenses is recognized and counted as available to the family as a whole. A similar provision was approved by the Committee last year, but was dropped in conference with the House.

Effective Date

April 1, 1984.

Estimated Savings

Fiscal year:	*Millions*
1984	$35
1985	135
1986	140
1987	145
4-year total	$455

2. Households Headed by Minor Parents (sec. 972 of the bill)

(Contained in S. 2062 as originally reported)

Present Law

A minor parent who has a child, and who leaves home, may establish her own household and claim AFDC as a separate family unit. The income of the parents of the minor parent is not automatically counted as available to the minor parent, because they are not sharing the household.

Explanation of Provision

In the case of a minor parent who is not and has never been married, AFDC may be provided only if the minor parent resides with her parent or legal guardian, unless the State agency determines that (1) the minor parent has no parent or legal guardian who is living and whose whereabouts are known, (2) the health and safety of the minor parent or the dependent child would be seriously jeopardized if she lived in the same residence with the parent or legal guardian, or (3) the minor parent has lived apart from the parent or legal guardian for a period of at least one year prior to the birth of the child, or before claiming aid, whichever is later. The State agency would be given authority to make payments to a protective payee with respect to a minor parent affected by the provision, until the individual is no longer considered a minor by the State.

The Committee approved a similar provision last year, but it was dropped in conference with the House.

Effective Date

April 1, 1984.

Estimated Savings

Fiscal year:	*Millions*
1984	$5
1985	20
1986	20
1987	20
4-year total	$65

3. Clarification of Earned Income Provisions (sec. 973 of the bill)

(Contained in S. 2062 as originally reported)

Present Law

The AFDC statute was amended in 1981 to change the way in which earned income is counted for purposes of determining eligibility and benefit amounts. As amended by Public Law 97-35, the law currently requires the States to disregard the following amounts of a family's earned income—

Eligibility Determination: (1) the first $75 of monthly earnings for full time employment; and (2) the cost of care for a child or incapacitated adult, up to $160 per child per month.

Benefit Calculation: (1) the first $75 of monthly earnings for full time employment; (2) child care costs up to $160 per child per month; and (3) $30 plus one-third of earnings not previously disregarded.

The $30 plus one-third disregard is allowed only during the first 4 consecutive months in which a recipient has earnings in excess of the standard work expense and child care disregards.

Courts in several States have been asked to interpret whether the term "earned income" refers to the gross amount earned by an individual before deductons are taken (for income taxes, insurance, FICA, support payments, or other items, regardless of whether the deduction is voluntary or involuntary), or whether the term refers to net income, after such deductions are taken. Regulations issued by the Department of Health and Human Services require that the term be interpreted as referring to gross income. However, courts in two States have ruled that the term must be interpreted as referring to net income.

Explanation of Provision

The statute would be amended to make clear that the term "earned income' means the gross amount of earnings, prior to the taking of payroll or other deductions. The provisions in the AFDC statute which require that specified amounts of earned income be disregarded in determining eligibility and benefits have historically been interpreted as requiring that such amounts be deducted from gross, rather than net, earnings.

The Committee agrees with the Department that there was no intention to change this interpretation when it approved the 1981 AFDC amendments. The Committee notes that when the Congressional Budget Office estimated the savings expected to be derived from the changes in 1981, it followed the interpretation shared by the Department and the Committee that the proposed disregards would apply to gross earnings.

Effective Date

Enactment.

Estimated Savings

Fiscal year:	*Millions*
1984	$8
1985	24
1986	24
1987	24
4-year total	$80

4. CWEP Work for Federal Agencies Permitted (sec. 974 of the bill)

(Contained in S. 2062 as originally reported)

Present Law

The Omnibus Budget Reconciliation Act of 1981 authorized States to conduct community work experience programs "which serve a useful purpose." Employable recipients may be required to participate in these programs as a condition of eligibility for AFDC.

Explanation of Provision

The statute would be amended to make clear that the participation in a CWEP program may include work performed for a Federal office or agency. Such work would not be considered to constitute Federal employment, and the State agency would be required to provide appropriate workers' compensation and tort claims protection to each participant.

Effective Date

Enactment.

Estimated Savings

No budget effect.

5. Earned Income of Full-Time Students (sec. 975 of the bill)

(Contained in S. 2062 as originally reported)

Present Law

The statute provides that eligibility for AFDC benefits is limited to families with gross incomes (income before application of any disregards) at or below 150 percent of the State's standard of need. A provision was included in Public Law 97-377, the Job Training Partnership Act, which amended the gross income limitation to allow States to disregard the income of an AFDC youth which is derived from a program carried out under that Act, in such amounts and for such period of time (not to exceed six months with respect to earned income) as the Secretary of Health and Human Services may provide in regulations.

Explanation of Provision

Under the Committee provision, for purposes of applying the gross income limitation, States would also be allowed to disregard the income of an AFDC child who is a full-time student, under the same limitations with respect to amounts and periods of time as are applied in the case of youths who participate in a program under the Job Training Partnership Act.

Effective Date

Enactment.

Estimated Costs

Negligible.

Supplemental Security Income (SSI) Provisions

1. Adjustments in SSI Benefits on Account of Retroactive Benefits Under Title II (sec. 976 of the bill)

(Contained in S. 2062 as originally reported)

Present Law

Legislation was enacted in 1980 (P.L. 96-265) aimed at ensuring that an individual's entitlement under the Old-Age, Survivors, and Disability Insurance (OASDI) and Supplemental Security Income (SSI) programs would not result in windfall benefits. Under this legislation, OASDI benefits that are paid retroactively following the initial determination of eligibility, are reduced by the amount of any excess SSI benefits that are paid because the OASDI benefits have been received in a lump sum rather than in the months when regularly payable.

Explanation of Provision

The Committee provision would amend the present requirement to allow the adjustment of benefits in additional situations. First, in the case where retroactive OASDI benefits are paid before the SSI benefits, but for the same period, the retroactive SSI amount otherwise payable would be reduced by the amount that would not have been paid had OASDI been paid when regularly due. Second, the provision would allow for an adjustment of SSI and OASDI benefits which result from either an initial determination of eligibility or a resumption of payments following a period of suspension or termination of those benefits. In cases where retroactive OASDI benefits result from posteligibility events, such as earnings recomputations, the Secretary would be authorized to adjust those benefits when it is administratively feasible.

Finally, present law would be amended to coordinate the benefit adjustment provision with the SSI retrospective accounting system. Under present law, it is possible that the two-month lag in counting OASDI income for purposes of determining the SSI benefit amount can result in adjustment for less than the full retroactive period. The proposed change would make it possible to adjust benefits paid for the entire retroactive period.

Effective Date

Applicable to retroactive benefits (either OASDI or SSI) payable beginning 7 months after enactment.

Estimated Savings

Fiscal year:	*Millions*
1984	0
1985	$12
1986	17
1987	18
4-year total	$47

Child Support Enforcement (CSE) Provisions

Regulatory Initiative on Medical Support (sec. 977 of the bill)

(Contained in S. 2062 as originally reported)

Present Law

The Child Support Enforcement (CSE) program is a Federal-State partnership under which States are required to have a program which locates absent parents, establishes paternity and obtains and enforces support orders.

Explanation of Provisions

The provision would require the Secretary to issue regulations which would require State CSE agencies to petition the court to include medical support as part of the child support order whenever health care coverage is available to the absent parent at a reasonable cost. In addition, the regulation would provide for improved information exchange between the CSE and medicaid agencies on the availability of health insurance coverage.

Effective Date

Enactment.

C. Social Security Provisions

1. Special Social Security Treatment for Church Employees (sec. 981 of the bill, secs. 1402, and 3121 of the Code, and secs. 210 and 211 of the Social Security Act)

Present Law

FICA and self-employment taxes

The Federal Insurance Contributions Act (FICA) imposes separate taxes on employers and employees equal to a percentage of wages paid as remuneration for employment, subject to certain exceptions. The 1984 FICA tax rates are 7 percent each for employers and employees (a combined 14 percent rate); a credit against the employee FICA tax of 0.3 percent of 1984 wages is allowed. These rates are scheduled to increase in stages until reaching a maximum of 7.65 percent each for employers and employees (a combined 15.3 percent) in 1990. A ceiling ($37,800 in 1984), adjusted annually for increases in average wages, is imposed on the amount of wages subject to FICA taxes. Both the employee and employer taxes are paid to the Internal Revenue Service by the employer (in the case of employee taxes, after withholding these taxes from the employee's wages) and are deposited in the social security trust funds.

For self-employed individuals, a tax is imposed on self-employment income under the Self-Employment Contributions Act (SECA). This tax equals 14 percent of self-employment income in 1984 and is scheduled to increase to 15.3 percent by 1990, i.e., the rates are equal to the combined employer-employee FICA tax rates. However, for years through 1989, self-employed individuals are allowed a credit against the tax for a portion of self-employment income (2.7 percent in 1984). Thus, the net rate of SECA tax is somewhat lower than the combined FICA rate. Thereafter, self-employed individuals would be permitted special deductions designed to treat them in much the same manner as employees and employers are treated for social security and income tax purposes. The SECA tax does not apply to income which (together with wages) exceeds the FICA tax base; additionally, the tax does not apply if self-employment income for the taxable year is less than $400.

Present law treats certain classes of employees, including employees of foreign governments and international organizations, as self-employed for purposes of social security taxes.

Employees of religious organizations

Prior to the Social Security Amendments of 1983 (P.L. 98-21), employees of nonprofit religious, charitable, educational or other tax-exempt organizations of the type described in section 501(c)(3) of the Code were covered by social security only if the organization waived (or was deemed to have waived) its exemption from social security taxation. Organizations for whom coverage had been in effect for at least 8 years were entitled to terminate coverage upon 2 years' advance notice to the Treasury Department.

The Social Security Amendments of 1983 extend mandatory social security coverage to employees of nonprofit organizations (including religious organizations), effective January 1, 1984. This coverage applies to employees of organizations which previously terminated coverage as well as to employees of organizations which had never been covered by social security. As under prior law, wages of an employee of a tax-exempt organization are excluded from social security for tax and benefit purposes if less than $100 is paid to the employee in a calendar year.

Ministers and certain members of religious orders.—Under present law, employees who are ministers of a church in the exercise of their ministry or members of religious orders (other than members subject to a vow of poverty) in the exercise of duties required by the order are treated as self-employed individuals for purposes of social security taxes. Such individuals who are conscientiously, or because of religious principles, opposed to participation in a public insurance system may elect to be exempt from self-employment taxes and credit under social security (on earnings for services as ministers or members of religious orders) by filing an irrevocable one-time application to that effect within two years of beginning their ministry. The treatment of ministers and members of religious orders not subject to a vow of poverty was not affected by the 1983 amendments.

Reasons for Change

The Committee remains committed to the policy of the 1983 amendments in extending mandatory social security coverage to employees of nonprofit organizations. Such employees are thereby assured protection under the old-age, disability, and hospital insurance programs of social security. In addition, the problem of windfalls accruing to workers with short periods of covered employment will be reduced. The Committee is aware, however, of the special problems which arise when a Federal tax (i.e., the employer's share of FICA taxes) is imposed directly upon a religious organization. Mandatory taxation of a religious organization inevitably raises concerns regarding the separation of church and state. Additionally, the taxation of amounts contributed to a church may suggest the possibility of government interference in the relationship of a church to its members.

The Committee bill attempts to resolve these concerns while maintaining mandatory social security coverage for employees of religious organizations and while continuing to provide equity between employees of religious organizations and other nonprofit organizations. Thus, the bill allows churches and certain church-controlled organizations to make a one-time election to treat their employees similarly to self-employed individuals for purposes of social security taxes. The election is limited to churches and organizations which state that they are opposed for religious reasons to the payment of social security taxes. If a church elects such treatment, its employees will pay tax at a rate equal to or approaching the combined employee-employer FICA rate (that is, at the SECA rate less the credit against SECA taxes), and will be entitled to credit for their earnings equivalent to that received by employees of other nonprofit organizations; however, no social security taxes will be imposed directly upon the church. The Committee believes that this solution will result in equitable treatment for employees of religious organizations without impinging upon the separation of church and state. To ensure compliance with the self-employment tax provisions, the bill provides that the election remains in effect only so long as the organization electing self-employment treatment for its employees provides information to the IRS regarding wages paid to employees.

In addition to church employees, the bill allows an election to treat employees of certain church-controlled tax-exempt organizations similarly to self-employed individuals. However, many church-controlled organizations (including church-controlled universities and religious hospitals) provide services to the general public which are similar in nature to those provided by other, secular institutions. Allowing an election in these cases would result in differing treatment for employees of religious and secular organizations performing essentially similar functions (e.g. nurses in religious hospitals as opposed to nurses in secular facilities). Further, where an organization provides paid services to the general public, concerns regarding the separation of church and state become less pressing.

To meet the concerns above, the Committee bill therefore does not allow an election to church-controlled organizations which offer goods, services or facilities for sale to the general public (other than those offered on an incidental basis or for a nominal charge) and which normally receive more than 25 percent of their support from governmental sources and/or from sales receipts. (Because an election is not allowed with respect to services performed in an unrelated trade or business, these trades or businesses are excluded from the computation.) The Committee believes that these rules provide a fair, objective test for determining those organizations entitled to make an election without questioning the religious connection of any particular organization. However, for purposes of this provision, church-supported elementary and secondary schools are allowed to make an election regardless of the objective tests above.

Explanation of Provision

General rule

The bill allows a church or qualified church-controlled organization to make a one-time election to exclude from the definition of employment, for purposes of FICA taxes, services performed in the employ of the church or organization. This exclusion does not apply to services performed in an unrelated trade or business of the church or organization. This election may be made only if (1) the electing organization states that it is opposed for religious reasons to the payment of social security taxes, and (2) the organization did not have a waiver of exemption from social security coverage in effect on December 31, 1980.

Where an election is made to exclude services for FICA purposes, the employee will be treated similarly to the self-employed with respect to those services. Thus, the employee will be liable for SECA taxes on remuneration for such services. This tax will be imposed at the usual self-employment tax rate under section 1402 of the Code (e.g., 14 percent in 1984), and subject to the general self-employment tax credits for 1984 through 1989 and special deduction provisions thereafter. (The net rate of tax in 1984 is 11.3 percent.)

The bill does not affect the employment tax status of ministers of a church or members of a religious order.

Procedure for making election

An election by existing or newly created organizations to exclude services for FICA purposes must be made prior to the first date, more than 90 days after enactment of the provision, on which a quarterly employment tax return would otherwise be due from the electing organization. The election will apply to all current and future employees of the electing organization for services performed on or after January 1, 1984. The election is to be made in accordance with such procedures as the Treasury Department determines to be appropriate. Once made, an election may not be revoked by the electing organization.

Eligibility to make election

An election may be made by churches or qualified church-controlled organizations. For purposes of this provision, churches include conventions or associations of churches and elementary or secondary schools which are controlled, operated, or principally supported by a church or by a convention or association of churches.

Qualified church-controlled organizations include any church-controlled tax-exempt organization described in section 501(c)(3) of the Code, other than an organization which (1) offers goods, services, or facilities for sale, other than on an incidental basis, to the general public (e.g., to individuals who are not members of the church), other than goods, services, or facilities which are sold at a norminal charge which is substantially less than the cost of providing such goods, services, or facilities, and which (2) normally receives more than 25 percent of its support from either (a) governmental sources or (b) receipts from admissions, sales of merchandise, or furnishing of facilities in activities which are not unrelated trades or businesses, or (a) and (b) combined.

In order to be excluded from the definition of qualified church-controlled organizations, an organization must satisfy both of the tests above. Thus, a seminary, religious retreat center, or burial society would generally qualify to make an election, regardless of its funding sources, because it did not offer goods, services, or facilities for sale to the general public. Conversely, a church-run orphanage or old-age home would qualify, even if it is open to the general public, if not more than 25 percent of its support was derived from the receipts of admissions, sales of merchandise, or furnishing of facilities in other than unrelated trades or businesses from governmental sources. However, where an organization satisfies both tests, the organization would not be eligible to make an election. The Committee specifically intends that church-run universities (other than religious seminaries) and hospitals which satisfy both tests will not be eligible to make an election. Auxiliary organizations of a church (including youth groups, women's auxiliaries, etc.) will generally satisfy neither of the Committee's tests and will thus be eligibile to make an election. Similarly, church pension boards or fund-raising organizations generally would qualify to make an election.

Information reporting requirement

An organization electing to exclude services for FICA purposes nonetheless continues to be required to furnish relevant information required of employers subject to income tax withholding (sec. 6051). This includes information with respect to the identity of employees and the amount of wages paid to each employee. The election will be permanently revoked by the Treasury if the organization fails to provide such information for a period of two years or more and, upon request by the Treasury Department, fails to furnish previously unfurnished information for the period covered by the election. The revocation will apply back to the first year of the two year period for which there was a failure to furnish such information.

Amount of remuneration subject to SECA taxes

The remuneration on which the employee of an electing institution is to be liable for SECA tax generally is to be the same as the amount which would have been subject to FICA tax if that individual had continued to be treated as an employee. Thus, business expenses are not to be subtracted in computing self-employment income (reimbursed business expenses are not to be included in self-employment income, however), the $400 threshold on self-employment-income does not apply, and a $100 threshold is to apply in determining whether this remuneration is subject to SECA tax. However, after 1989 these individuals will be eligible for a deduction, in computing SECA taxes, for the product of net earnings from self-employment and one-half of the SECA rate.

Refunds of taxes previously paid

Where a church or church-controlled organization makes an election with respect to FICA taxes, and the electing organization has paid FICA taxes for services performed after December 31, 1983, which are covered by the election, the Treasury is required to refund such taxes (without interest) to the electing organization. Such refund is to be conditioned upon the electing organization agreeing to pay to each present or former employee that portion of the refund which is attributable to the employee portion of FICA taxes collected by the organization from such employee. The employee will then not be entitled to any other refund for such taxes.

Estimated taxes

Employees of electing institutions generally will be required to make estimated tax payments with respect to their SECA liability.

However, the Committee intends that employees who become liable for SECA taxes for 1984 because of an election by their employer made before the first date, more than 90 days after the date of enactment on which a quarterly employment tax return is generally due, are to be relieved of estimated tax penalties with respect to quarters of 1984 prior to the date by which the election is required to be made.

Effective Date

This provision is effective for services performed after December 31, 1983.

Revenue Effect

This provision will reduce fiscal year receipts by $50 million in 1984, $12 million in 1985, $9 million in 1986, $5 million in 1987, $7 million in 1988, and $3 million in 1989.

2. Social Security Coverage for Legislative Branch Employees Not Covered by the Civil Service Retirement System (sec. 982 of the bill)

Present Law

The Social Security Amendments of 1983 (P.L. 98-21) extend social security coverage to newly hired legislative branch employees and to those legislative branch employees not already covered by the Civil Service Retirement System (CSRS) as of December 31, 1983. Current legislative branch employees who are exempt from social security coverage maintain that exemption even with a break in Federal service, provided the break is less than 365 days.

Due to a drafting oversight, legislative branch employees who, by participating in CSRS, established an exemption from social security on December 31, 1983, can subsequently elect out of CSRS and be covered by neither retirement system.

Explanation of Provision

The Committee provision would require legislative branch employees to be continuously covered by CSRS in order to retain the exemption from social security. Individuals electing to take a refund of CSRS contributions would thus become subject to social security on a mandatory basis since receipt of the refund necessitates a break in service and the termination (at least temporarily) of participation under CSRS. Individuals who leave employment in the legislative branch for any period less than 365 days would be covered by social security upon return to Federal employment only if they elected to receive a refund of CSRS contributions.

Effective Date

On enactment. Legislative branch employees exempt from social security but not still covered by CSRS on the date of enactment of this amendment would be permitted 30 days after the date of enactment in which to reenroll in CSRS.

Revenue Effect

This provision will have a negligible revenue effect.

3. Employees of Nonprofit Organizations Who Are Required to Participate in the Civil Service Retirement System (sec. 983 of the bill)

Present Law

The Social Security Amendments of 1983 (Public Law 98-21) extend social security coverage to employees of nonprofit organizations. Due to an oversight, employees in certain nonprofit organizations (Legal Service Corporations, for example) who are covered on a mandatory basis by the Civil Service Retirement System will thus be covered on a mandatory basis by social security as well. Because such employees are not actually Federal employees, they are not provided relief from double-taxation under Title II of the Federal Physicians Comparability Allowance Amendments of 1983 (Public Law 98-168), known as the Federal Employees' Retirement Contribution Temporary Adjustment Act.

Explanation of Provision

Under the Committee provision, employees of nonprofit organizations who are covered on a mandatory basis by CSRS would be treated like Federal employees for purposes of social security. They would therefore be covered by social security if newly hired after January 1, 1984, or if they had a break in Federal service lasting more than 365 days.

Effective Date

Effective with respect to service performed on or after January 1, 1984.

Revenue Effect

This provision will have a negligible revenue effect.

D. Grace Commission Provisions

1. Income and Eligibility Verification Procedures (sec. 991 of the bill)

Present Law

Wage data is used by the Social Security Administration and the Department of Agriculture for use in verifying eligibility for the AFDC, SSI and food stamp programs. The SSI program annually crosschecks data supplied by beneficiaries with the IRS/SSA data. State and local welfare agencies must request this data for use in verifying AFDC eligibility, unless quarterly wage data are available from their State unemployment compensation agencies; 42 jurisdictions collect wage data on a quarterly basis through their unemployment insurance (UI) programs, and three other States obtain this data through means other than the UI system.

Explanation of Provision

The provision would authorize and require the Internal Revenue Service and SSA to make available to Federal and State agencies data on earned and unearned income for use in administering means-tested Federal benefit programs. This data may be used only for the purpose of verifying eligibility for the programs. Agencies receiving data would be subject to the restrictions on unauthorized disclosure of confidential information that are currently applicable. The Committee anticipates that data would be provided to agencies by means of low-cost computer exchange of information.

The provision prescribes a new income verification system under title XI of the Social Security Act. Under this system: (1) all beneficiaries must provide social security numbers; (2) programs must obtain and utilize for verification purposes, earned and unearned income data provided to the Secretary of HHS by the IRS and SSA; (3) each State must maintain a system under which employers make quarterly wage reports to a State agency (the quarterly wage system may, but need not be, a part of the State's unemployment insurance system); (4) the State must use wage report information for purposes of verifying its eligibility requirements for any program.

The quarterly wage reporting requirement does not mandate a State to collect data through its unemployment insurance program, nor would any State be required to change its UI system to comply with the amendment. Further, no State now collecting quarterly wage information through the UI system, or by any other means, would be required to alter its existing wage reporting format or the extent of its coverage so long as an existing system is reasonably comprehensive.

States which do not have quarterly wage reporting systems would have the option of developing such systems either within their unemployment compensation programs or elsewhere in State government. If States use the unemployment program to operate the wage reporting system, its costs would be reimbursable as an unemployment administrative expense on the same basis and under the same conditions as now apply to those 40 States which currently use wage reporting for the unemployment program. (However, the amendment requires that other programs utilizing the data make appropriate payments for the costs involved in providing information. If a State elects to establish a wage reporting system in a manner which would not, under existing rules, qualify for reimbursement as an unemployment insurance program cost, the costs of the wage reporting system would be appropriately shared among all those programs required by the amendment to use the information it provides and among any other programs for which the State uses the system.

The provision also requires State agencies to adopt, to the extent possible, a standardized format and procedures for administering benefit programs to allow exchange of information between agencies authorized to receive this data for purposes of verifying eligibility. Procedures must be implemented to target the use of this information in those ways which are most likely to be productive in identifying and preventing ineligibility.

Effective Date

IRS is authorized to disclose unearned income data on the date of enactment, and is required to disclose such data as soon as is practicable to implement disclosure agreements including required safeguard reviews. The requirement to implement an income verification system under Title XI will be effective on April 1, 1985. However, the Secretary of HHS (Secretary of Labor, in the case of quarterly wage reporting) is authorized to grant a reasonable extension of time (in no event beyond October 1, 1986). Such extensions may be granted only when States adopt a good faith plan to achieve full implementation of the requirements no later than October 1, 1986.

Estimated Savings

Fiscal year:	*Millions*
1984	0
1985	−$31
1986	300
1987	391
4-year total	$660

2. Collection and Deposit of Payments to Executive Agencies (sec. 992 of the bill)

Present Law

The Department of Treasury has introduced the Treasury Federal Communications System (TFCS) and lockbox systems to provide for accelerated deposit of Federal receipts. (TFCS enables the Federal Government to effect immediate fund withdrawals by electronic transfer, while lockboxes permit faster bank deposit of Federal payments.) In fiscal year 1983, $94 billion in Federal receipts (both tax and nontax) were collected by TFCS, and another $1 billion through lockboxes. There remains, however, approximately $55 billion in annual nontax receipts that are collected by means other than accelerated deposit.

Explanation of Provision

Under this provision, the Secretary of the Treasury is authorized to prescribe the mechanisms that Federal agencies are to employ to collect revenues due the Government. Under the legislation, the Secretary is also authorized to prescribe the time frames within which funds collected by or for Federal agencies must be deposited for credit in the Treasury's account. In addition, the legislation generally reduces from 30 days to three days the statutory period for timely deposit of funds by custodians. Finally, the legislation confers the necessary enforcement authority. It is anticipated that the Bureau of Government Financial Operations will exercise the authority in this legislation as the Secretary's delegee.

It is expected that the Treasury will select from among six major collection mechanisms now available to it. These are automated paper processing techniques, electronic funds transfer under TFCS, preauthorized automatic withdrawals for recurring payments, corporate-to-corporate Automated Clearing House, Point-of-Sale, and home banking. However, as more efficient or effective mechanisms become available, the Treasury is authorized to require their use by agencies.

The regulations will require that agencies adopt collection and deposit methods prescribed by the Secretary. Agencies not complying with the regulations will be assessed a charge equal to the cost to the general fund of noncompliance, as determined by the Secretary. Any such charges will be deposited into a Treasury Cash Management Improvements Fund to be used for developing and implementing cash management initiatives.

Effective Date

The Secretary is required to issue regulations as soon as practicable, designed to achieve by October 1, 1986, full implementation of the accelerated deposit systems.

Estimated Savings

Fiscal year:	*Millions*
1984	0
1985	0
1986	$800
1987	800
4-year total	$1,600

3. Collection of Nontax Debts Owed to Federal Agencies (sec. 993 of the bill)

Present Law

Under section 6402, the Secretary may credit the amount of any overpayment of tax in one year (including any interest thereon) against any liability in respect of an internal revenue tax for the same taxpayer for another year. Overpayment of income taxes can be credited against any taxes due from the taxpayer, including stamp, excise or employment tax, and any interest, additional amount, addition to the tax or assessable penalty. When a debt to the United States has been reduced to judgment, or when a taxpayer is in bankruptcy, the IRS may offset the taxpayer's refund by the amount of the debt. There is, however, no clear authority to offset administratively refunds prior to when the taxpayer's obligation has not been adjudicated.

Beginning with tax returns filed in 1982, tax refunds due taxpayers who are delinquent in making child and spousal support payments must be applied against past-due support obligations if (1) the person designated to receive the support is receiving Aid to Families with Dependent Children from a State welfare agency and the State has received that person's assignment of the support obligation; (2) the State has made a reasonable effort to collect the support; (3) the amount of past-due support is at least $150; (4) the support has been delinquent for at least 3 months; and (5) none of the past-due support has been received by the IRS through the State agency's notification to the Department of Health and Human Services.

Explanation of Provision

The provision amends section 6402 to provide that the amount of any refund of internal revenue taxes would be reduced by the amount of any certified debt owed to the Federal government. The agency responsible for collecting the debt must certify to the Treasury that specific attempts to notify debtors have been made, as required in regulations to be issued by the Secretary, and that the debtor has not disputed the nature or the amount of the debt (or any dispute has been resolved by agreement between both the debtor and the agency), has not begun to repay the debt, and exhibits no reasonable intention to repay the debt. The agency must have entered into an agreement with the Secretary providing for the transmission of certified debt information to the Secretary before transmission occurs.

The Secretary is given the authority to prescribe the terms of agreements with other agencies. The Secretary will prescribe the format in which the information must be transmitted. In addition, the Secretary is authorized to test the offset procedures with selected programs at first, before fully implementing the program. The Secretary is authorized to disclose the amount of the refund being offset against the debt to the Federal agency for the purpose of, and only to the extent necessary in, administering this offset procedure. Disclosure would be required to be in the same manner and with the same safeguards as when disclosure is made to a State.

The Committee intends that AFDC child support obligations will be subject to offset before other Federal debts. The offset could not, however, be applied to beneficiary debts under the OASDI programs.

Effective Date

This provision would be effective for refunds to be paid after December 31, 1985 and before January 1, 1988. This is intended to provide an opportunity for the Congress to evaluate the program.

Estimated Savings

Fiscal year:	*Millions*
1984	0
1985	0
1986	$300
1987	500
4-year total	$800

E. Cover Over of Certain Federal Excise Taxes

1. Clarification of Definition of Articles Produced in Puerto Rico or the Virgin Islands (sec. 996 of the bill)

Present Law

Present law imposes a special excise tax on articles coming into the United States from Puerto Rico and the Virgin Islands. The tax is equal to the Federal excise tax that would be imposed if the articles had been manufactured or produced in the United States (sec. 7652). This tax is in lieu of the excise tax that would be imposed if the articles had been manufactured or produced in the United States or imported from another country.

Revenues collected from the tax on articles coming into the United States from Puerto Rico or the Virgin Islands are covered over (paid) to the treasury of the possession from which the article comes. No restrictions are imposed on the use of these revenues by Puerto Rico or the Virgin Islands.

The Government of Puerto Rico presently sponsors a redistillation program under which spirits originally distilled in the United States are transported to Puerto Rico and redistilled in that possession. Following redistillation, the spirits are returned to the United States for processing and marketing. As a result of their redistillation in Puerto Rico, the Puerto Rican Government receives a payment of $10.50 per proof gallon with respect to these redistilled spirits (i.e., the amount of Federal excise tax presently imposed on distilled spirits) because redistillation is considered to be Puerto Rican production.

Reasons for Change

The Committee is concerned that Federal excise tax revenues are being covered over to Puerto Rico when there is little or no economic nexus between the articles with respect to which payments are made and Puerto Rican input into the production of these articles. The Committee believes that payment of Federal revenues to Puerto Rico and the Virgin Islands should not continue with respect to articles not having a substantial economic nexus with those possessions. The redistillation program presently sponsored by Puerto Rico involves a process that likely would not occur without (1) the availability of Federal excise tax payments to Puerto Rico, and (2) the availability of subsidies by Puerto Rico to participants in the redistillation program.

The Committee also is concerned about cover over of Federal excise tax revenues with respect to cane neutral spirits because of subsidies provided to producers of those spirits by the Governments of Puerto Rico and the Virgin Islands. The Committee believes that permitting these cover overs to continue could result in adverse competitive pressures on U.S. mainland distillers of neutral spirits who receive no similar subsidy.

At the present time, the Committee decided not to address the overall question of whether cover over of Federal excise tax revenues to Puerto Rico or the Virgin Islands is appropriate in any circumstances when those revenues are not similarly covered over to the States. Therefore, the Committee bill limits the payment of Federal excise tax payments with respect to articles containing distilled spirits to articles consisting of at least 92 percent rum.

Explanation of Provisions

The provision limits the cover over to Puerto Rico and the Virgin Islands with respect to articles containing distilled spirits to articles of which at least 92 percent of the alcoholic content is rum. The Committee understands that cover overs of excise taxes are determined under present law at the time an article enters the United States. The Committee further understands that this determination is not affected by any change in the character of the article after entry into the United States. Therefore, the full cover over will be available with respect to articles containing distilled spirits satisfying the 92-percent test upon entry into the United States even if these spirits are subsequently blended with other distilled spirits into an article not satisfying that requirement. However, if such blending occurred before entry into the United States, the cover over would be denied.

Effective Date

These provisions generally are effective with respect to articles coming into the United States from Puerto Rico or the Virgin Islands after February 28, 1984.

A transitional rule permits cover over to Puerto Rico of revenues from articles containing redistilled spirits and cane neutral spirits, which articles come into the United States after February 28, 1984 and before July 1, 1984. However, cover overs under this transitional rule are permitted only to the extent that the total payments with respect to such redistilled spirits and cane neutral spirits do not exceed the excess of $130 million over the total cover overs received with respect to these articles after June 30, 1983, and before February 29, 1984.

A second transitional rule provides that cover overs after February 28, 1984, and before July 1, 1984, with respect to redistilled spirits and cane neutral spirits will terminate immediately if the Government of Puerto Rico or the Virgin Islands provides any incentive payment to a United States producer (other than reimbursement for direct costs of transportation between the United States and Puerto Rico in the case of redistilled spirits). For purposes of the second transitional rule, an incentive payment means any payment directly made by the applicable possession's government or any payment made by a business located in Puerto Rico to a U.S. producer, which payment is directly or indirectly related to receipt by that business of a payment from the Government of Puerto Rico.

Estimated Savings

Fiscal year:	*Millions*
1984	
1985	$260
1986	276
1987	296
4-year total	$832

2. Limitation on Transfers of Certain Excise Tax Revenues to Puerto Rico and the Virgin Islands (sec. 997 of the bill and sec. 7652 of the Code)

Present Law

Present law imposes a special excise tax on articles coming into the United States from Puerto Rico and the Virgin Islands. The tax is equal to the Federal excise tax that would be imposed if the articles had been manufactured or produced in the United States (sec. 7652). This tax is in lieu of the excise tax that would be imposed if the articles had been manufactured or produced in the United States or imported from another country.

Revenues collected from the tax on articles coming into the United States from Puerto Rico or the Virgin Islands are covered over (paid) to the treasury of the possession from which the article comes. No restrictions are imposed on the use of these revenues by Puerto Rico or the Virgin Islands.

Reason for Change

The Committee is concerned with the effect of the provisions allowing transfer of Federal tax revenues to Puerto Rico and the Virgin Islands. At the present time, however, the Committee decided not to address the overall question of whether cover over of Federal excise tax revenues to Puerto Rico or the Virgin Islands is appropriate in any circumstances when those revenues are not similarly covered over to the States. The Committee does believe that this practice should not be expanded absent a thorough examination of the issue. Therefore, the bill limits those payments to $10.50 per proof gallon, the present rate of the Federal excise tax imposed on distilled spirits.

Explanation of Provision

The provision limits the maximum cover over with spirits to any otherwise qualifying article containing distilled spirits to $10.50 per proof gallon, the amount of the present Federal excise tax on distilled spirits.

Effective Date

This provision is effective with respect to distilled spirits coming into the United States from Puerto Rico or the Virgin Islands after December 31, 1984.

Estimated Savings

Fiscal year:	*Millions*
1984	0
1985	$45
1986	57
1987	61
4-year total	$163

VI. COSTS OF CARRYING OUT THE COMMITTEE PROVISIONS AND VOTE OF THE COMMITTEE

Budget Effects

In compliance with paragraph 11(a) of Rule XXVI of the Standing Rules of the Senate, the following statement is made relative to the budget effects of the Committee provisions.

The budget effects of the provisions are presented in the tables in Part IV.

Summary statements about budget revenues and outlays follow.

The revenue provisions of the committee bill involving statutory changes are estimated to increase net budget receipts by $2.5 billion in fiscal year 1984, $10.6 billion in fiscal year 1985, $16.0 billion in fiscal year 1986, and $18.9 billion in fiscal year 1987. Thus, the total net revenue raised during the fiscal years 1984 through 1987 equals $48.0 billion.

The changes to the earned income credit affect both revenues and outlays, both of which are included in the above revenue totals. As a result, these changes will reduce revenues by $3 million in 1985, $93 million in 1986, $85 million in 1987, $77 million in 1988, and $73 million in 1989, and increase outlays by $5 million in 1985, $129 million in 1986, $120 million in 1987, $110 million in 1988, and $100 million in 1989.

The statutory changes made in the outlay provisions in the bill will reduce fiscal year budget outlays by $0.1 billion in 1984, $2.8 billion in 1985, $5.3 billion in 1986, and $6.6 billion in 1987. During the period including fiscal years 1984 through 1987, outlays will be reduced by a total of $14.8 billion.

(See also statements submitted, in Part VII of this report, by the Congressional Budget Office regarding the revenue and spending provisions of the bill.)

Vote of the Committee

In compliance with paragraph 7(c) of Rule XXVI of the Standing Rules of the Senate, the following statement is made relative to the vote by the committee on the motion to approve the deficit reduction provisions. These provisions were approved by a record vote of 20 ayes and 0 noes.

VII. REGULATORY IMPACT AND OTHER MATTERS TO BE DISCUSSED UNDER SENATE RULES

Regulatory Impact

Pursuant to paragraph 11(b) of Rule XXVI of the Standing Rules of the Senate, the committee makes the following statement concerning the regulatory impact that might be incurred in carrying out the Committee provisions.

Revenue Provisions

Numbers of individuals and businesses who would be regulated

The provisions involve new or expanded regulations with respect to the Internal Revenue Code that will facilitate compliance with the Federal income tax laws.

Economic impact of regulation on individuals, consumers and business

The provisions have no regulatory impact on substantive economic activities of individuals, consumers or businesses other than through the provisions that are intended to improve the administration of, and compliance with, Federal income tax laws.

Impact on personal privacy

The provisions generally do not relate to the personal privacy of individuals, but authority will be made available for disclosure of tax return information in order to reduce the error-rate in the payment of benefits under Federal means-tested programs.

Spending Reduction Provisions

Number of individuals and businesses who would be regulated

The provisions to a large extent reduce the current regulatory requirement placed on individuals and businesses.

Economic impact of regulation on individuals, consumers, and business

The provisions have no new substantial economic impact on individuals, consumers or businesses.

Impact on personal privacy

The provisions generally do not relate to the personal privacy of individuals, but authority will be made available for disclosure of tax return information in order to reduce the error-rate in the payment of benefits under Federal means-tested programs.

Revenue and Spending Reduction Provisions

Determination of the amount of paperwork

Any change in the amount of paperwork that taxpayers and other individuals may have to do is incidental to their compliance with the provisions in the Internal Revenue Code, the medicare and medicaid programs, or Aid to Families with Dependent Children program.

Other Matters

Consultation with Congressional Budget Office on budget estimates and new budget authority

In accordance with section 403 of the Budget Act, the commitee advises that the Director of the Congressional Budget Office has examined the committee's estimates (as shown in Part IV) and has submitted the following statements (one with respect to the revenue provisions and a separate one with respect to the spending provisions) with respect to the committee provisions.

U.S. CONGRESS,
CONGRESSIONAL BUDGET OFFICE,
Washington, D.C., April 2, 1984.

Hon. ROBERT J. DOLE,
Chairman, Committee on Finance, U.S. Senate, Washington, D.C.

DEAR MR. CHAIRMAN: The Congressional Budget Office has examined the tax provisions adopted by the Committee on Finance on March 21, 1984. The provisions are in the form of a committee amendment to the reconciliation recommendations incorporated into S. 2062 last year. The amendment is in the nature of a substitute and consists of the original provisions included in S. 2062 and provisions agreed to during the course of subsequent committee deliberations.

The amendment contains both revenue and spending recommendations. A cost estimate of the spending provisions is being provided under separate cover. Titles I through VIII affect revenues. These titles are:

TITLE I—TAX REFORMS GENERALLY

Title I contains the bulk of the amendment's revenue raising measures. The title's many provisions fall into the following categories: (A) deferral of certain tax reductions, (B) tax-exempt entity leasing, (C) treatment of bonds and other debt instruments, (D) treatment of corporations and their shareholders, (E) partnership provisions, (F) trust provisions, (G) accounting changes, (H) provisions relating to tax straddles, (I) pension provisions, (J) foreign provisions, (K) tax compliance and administration provisions, (L) depreciation provisions, and (M) miscellaneous provisions.

TITLE II—LIFE INSURANCE TAX PROVISIONS

Title II provides new rules for the taxation of life insurance companies, replacing, among other things, the temporary life insurance provisions enacted in the Tax Equity and Fiscal Responsibility Act of 1982.

TITLE III—REVISION OF PRIVATE FOUNDATION PROVISIONS

Title III would modify rules for the tax treatment of private foundations and charitable contributions to foundations.

TITLE IV—ENTERPRISE ZONES

Title IV would provide for the designation of certain distressed areas as enterprise zones. Over three years, up to 75 areas may be designated by the Secretary of the Department of Housing and Urban Development as enterprise zones. Each enterprise zone is eligible for federal tax and regulatory relief designated to spur economic activity.

TITLE V—FOREIGN SALES CORPORATIONS

Title V would replace the existing export incentive that provides special treatment of export income earned by certain domestic subsidiaries (Domestic International Sales Corporations) of U.S. companies engaged in exporting. Title V would allow creation of Foreign Sales Corporations (FSCs), typically foreign incorporated subsidiaries of U.S. parent companies in the export business. The bill would exempt a portion of an FSC's export income from U.S. tax as long as certain criteria are met.

TITLE VI—HIGHWAY REVENUE PROVISIONS

Title VI would restructure the highway use tax to apply only to vehicles weighing 55,000 pounds or more, and to cap the tax at $600 per year. The tax on diesel fuel would be increased by 6 cents per gallon (the diesel differential) with a rebate of the diesel differential for vehicles weighing less than 10,000 pounds. Title VI would also make minor alterations to several other highway taxes.

TITLE VII—TAX-EXEMPT BOND PROVISIONS

The bill extends the authority of state and local governments to issue mortgage bonds for single-family housing for four years, until December 31, 1987. It also permits state and local governments to exchange mortgage bond authority in any year for authority to issue mortgage credit certificates. Finally, the bill imposes new restrictions on industrial bonds and on student loan bonds. The IDB restrictions include extension of the cost-recovery periods for IDB-financed property and prohibition of the use of small issues by firms with more than $40 million of outstanding tax-exempt debt. The student loan bond provisions include a requirement that issuers devote all profits from bond proceeds to the acquisition of additional loan notes under the issuer's loan program.

TITLE VIII—MISCELLANEOUS REVENUE PROVISIONS

Title VIII contains miscellaneous revenue provisions that fall into the following categories: (A) estate and gift tax provisions, (B) charitable provisions, (C) excise tax provisions, (D) employee benefits, (E) miscellaneous Treasury administrative provisions, (F) simplification and extension of income tax credits, (G) treatment of capital gains and losses, and (H) miscellaneous revenue matters.

The committee amendment would eliminate or reduce some tax expenditures and would create some new ones. On balance, it would reduce overall tax expenditures.

The CBO has reviewed and concurs with the estimates of the revenue effects of the bill's tax provisions prepared by the staff of the Joint Committee on Taxation. For scorekeeping purposes, CBO excludes the outlay effects of the earned income tax credit provision (under Title VIII, Miscellaneous Revenue Provisions) from the total revenue effects. These outlay effects are included in the separate CBO cost estimate of the bill's spending provisions.

Should the committee so desire, we would be pleased to provide further details on this estimate.

With best wishes.

Sincerely,

RUDOLPH G. PENNER, *Director.*

TABLE 1.—ESTIMATED NET REVENUE EFFECTS OF TAX PROVISIONS OF COMMITTEE AMENDMENT TO S. 2062, AS ADOPTED BY THE COMMITTEE ON FINANCE, FISCAL YEARS 1984-89

Provision	1984	1985	1986	1987	1988	1989
Title I: Tax reforms generally	2,241	11,278	18,143	23,326	25,217	26,131
Title II: Life insurance provisions	−120	−353	−397	−476	−529	−603
Title III: Private foundation provisions	0	−21	−24	−26	−29	−32
Title IV: Enterprise zones	(1)	(1)	(1)	(1)	(1)	(1)
Title V: Foreign sales corporations	0	−43	−33	36	88	−98
Title VI: Highway revenue provisions	−128	50	−69	−133	−42	−72
Title VII: Tax-exempt bond provisions	−26	−114	−247	−401	−523	−503
Title VIII: Miscellaneous revenue provisions [2]	510	−65	−834	−2,490	−3,185	−2,667
Total, tax provisions	2,477	10,634	16,119	19,061	19,980	21,105

[1] The budget effects of this provision will depend on the number, size, and characteristics of the enterprise zones designated by the Secretary of Housing and Urban Development. Grand totals in this table reflect Treasury Department estimates which show decreases of fiscal year budget receipts of $98 million in 1985, $420 million in 1986, $775 million in 1987, $1,017 million in 1988, and $1,051 million in 1989.

[2] Excludes outlay effect of earned income tax credit provision which would increase outlays by $5 million in 1985, $129 million in 1986, $120 million in 1987, $110 million in 1988, and $100 million in 1989.

U.S. CONGRESS,
CONGRESSIONAL BUDGET OFFICE,
Washington, D.C., March 30, 1984.

Hon. ROBERT DOLE,
Chairman, Committee on Finance, U.S. Senate, Washington, D.C.

DEAR MR. CHAIRMAN: The Congressional Budget Office has prepared the attached cost estimate for the spending provisions in the Senate Finance Committee Amendments to S. 2062, as approved by the Senate Committee on Finance on March 22, 1984.

Should the Committee so desire, we would be pleased to provide further details on this estimate.

Sincerely,

RUDOLPH G. PENNER, *Director.*

CONGRESSIONAL BUDGET OFFICE COST ESTIMATE

1. Bill number: Unknown.
2. Bill title: Unknown.
3. Bill status: As approved by the Senate Committee on Finance on March 22, 1984.
4. Bill purpose: Unknown.

5. Estimated cost to the Federal Government: The estimated costs to the federal government are shown in Table 1.

TABLE 1.—ESTIMATED COST TO THE FEDERAL GOVERNMENT

[By fiscal year, in millions of dollars]

	1984	1985	1986	1987	1988	1989
DIRECT SPENDING						
Medicare:						
Part B premium:						
Budget authority	0	0	−384	−884	−1,507	−2,249
Outlays	0	0	−384	−884	−1,507	−2,249
Delay eligibility:						
Budget authority	0	−10	1	19	24	44
Outlays	0	−145	−230	−255	−290	−325
Modify working age:						
Budget authority	0	−28	−12	12	39	76
Outlays	0	−260	−380	−415	−455	−485
Freeze physicians' fees:						
Budget authority	−217	−801	−964	−1,127	−1,295	−1,483
Outlays	−40	−750	−910	−1,070	−1,230	−1,410
Limit increase in hospital costs:						
Budget authority	0	10	50	95	135	190
Outlays	0	−190	−430	−460	−390	−430
Fee schedule for clinical labs:						
Budget authority	−116	−274	−344	−301	0	0
Outlays	−70	−255	−320	−400	0	0
Disallow revaluation:						
Budget authority	0	5	10	30	45	75
Outlays	0	−50	−110	−170	−220	−280
SNF reimbursement:						
Budget authority	−1	−4	−8	−12	−17	−23
Outlays	20	30	35	40	45	50
Round down part B payments:						
Budget authority	−27	−67	−72	−78	−88	−99
Outlays	−15	−65	−70	−75	−85	−95
Competitive bidding:						
Budget authority	0	−14	−20	−27	−29	−28
Outlays	0	−15	−25	−35	−40	−40
Lesser of costs or charges:						
Budget authority	0	5	15	25	35	50
Outlays	0	−80	−90	−105	−120	−140
Hepatitis B vaccine:						
Budget authority	[1]	[1]	[1]	−2	−4	−4
Outlays	3	−1	−2	−2	−4	−4
Limit foot care:						
Budget authority	−6	−11	−11	−12	−13	−14
Outlays	−5	−11	−11	−12	−13	−14
Index part B deductible:						
Budget authority	0	−50	−95	−105	−115	−125
Outlays	0	−35	−90	−100	−110	−120
Copayment for DME:						
Budget authority	1	2	5	8	11	14
Outlays	−10	−20	−25	−25	−30	−30
Transfers to HI:						
Budget authority	0	1,000	1,600	2,400	2,800	3,700
Outlays	0	0	0	0	0	0
Medicaid:						
Extend medicaid penalties:						
Budget authority	0	−562	−353	−432	210	0
Outlays	0	−562	−353	−432	210	0
Assignment of rights:						
Budget authority	0	−7	−7	−8	−9	−10
Outlays	0	−7	−7	−8	−9	−10

TABLE 1.—ESTIMATED COST TO THE FEDERAL GOVERNMENT—Continued

[By fiscal year, in millions of dollars]

	1984	1985	1986	1987	1988	1989
Increase reimbursement for Puerto Rico:						
Budget authority	20	20	20	20	20	20
Outlays	20	20	20	20	20	20
Pregnant women:						
Budget Authority	4	11	12	13	14	15
Outlays	4	11	12	13	14	15
Recertification of SNF and ICF:						
Budget authority	−3	−4	0	1	1	1
Outlays	−3	−4	0	1	1	1
Psychiatric hospitals:						
Budget authority	5	10	6	3	0	0
Outlays	5	10	6	3	0	0
Other:						
Medicare effect on medicaid:						
Budget authority	−19	−74	−57	−29	85	134
Outlays	−19	−74	−57	−29	85	134
Medicare effect on premuiums:						
Budget authority	0	223	310	335	341	376
Outlays	0	223	310	335	341	376
Medicaid effect on medicare:						
Budget authority	1	3	6	10	13	17
Outlays	−13	−27	−29	−31	−33	−35
AFDC:						
Expand filing unit:						
AFDC:						
Budget authority	−35	−135	−140	−145	−150	−155
Outlays	−35	−135	−140	−145	−150	−155
Offsets—medicaid:						
Budget authority	20	80	90	100	110	120
Outlays	20	80	90	100	110	120
Require minor parent to live with parents:						
AFDC:						
Budget authority	−5	−20	−20	−20	−20	−20
Outlays	−5	−20	−20	−20	−20	−20
Offsets—medicaid:						
Budget authority	([1])	−5	−5	−5	−5	−5
Outays	([1])	−5	−5	−5	−5	−5
Clarify definition of earned income:						
Budget authority	−8	−24	−24	−24	−24	−24
Outlays	−8	−24	−24	−24	−24	−24
Permit CWEP work for Federal agencies:						
Budget authority	([1])	([1])	([1])	([1])	([1])	([1])
Outlays	([1])	([1])	([1])	([1])	([1])	([1])
Exclude earned income of children who are full-time students:						
Budget authority	([1])	([1])	([1])	([1])	([1])	([1])
Outlays	([1])	([1])	([1])	([1])	([1])	([1])
SSI:						
Eliminate windfall benefits:						
Budget authority	([1])	−12	−17	−18	−19	−20
Outlays	([1])	−12	−17	−18	−19	−20
)ASDI:						
Church employees:						
Budget authority	−51	−17	−16	−11	−14	−11
Outlays	0	0	0	0	0	0
ther:						
Income verification:						
Budget authority	0	5	−310	−360	−380	−410
Outlays	0	31	−300	−391	−411	−441
Offset debts—IRS:						
Budget authority	0	0	−300	−500	−700	−900

TABLE 1.—ESTIMATED COST TO THE FEDERAL GOVERNMENT—Continued

[By fiscal year, in millions of dollars]

	1984	1985	1986	1987	1988	1989
Outlays	0	0	−300	−500	−700	−900
Require Treasury—Cash management:						
Budget authority	0	0	−800	−800	0	0
Outlays	0	0	−800	−800	0	0
Puerto Rican excise tax:						
Budget authority	0	−305	−333	−357	−362	−364
Outlays	0	−305	−333	−357	−362	−364
Earned income tax:						
Budget authority	0	5	129	120	110	100
Outlays	0	5	129	120	110	100
Total direct spending:						
Budget authority	−437	−1,045	−2,038	−2,066	−758	−1,012
Outlays	−151	−2,642	−4,860	−6,136	−5,291	−6,780
Authorizations:						
Maternal and child health block grant:						
Authorization	53	26	1	−28	−61	−96
Outlays	33	30	12	−14	−45	−78
Sport fish restoration program:						
Authorization	0	28	29	30	30	31
Outlays	0	7	15	21	25	29
Food stamps:						
Offsetting effect of AFDC and SSI programs:						
Authorization	15	52	54	59	60	62
Outlays	15	52	54	59	60	62
Total authorization:						
Authorization	68	106	84	61	29	−3
Outlays	48	89	81	66	40	13
Total:						
Authorization/budget authority	−369	−939	−1,954	−2,005	−729	−1,015
Outlays	−103	−2,553	−4,779	−6,070	−5,251	−6,767

[1] Less than $500,000.

Basis of estimate

We have assumed an enactment date of May 1984 for the purpose of estimating provisions that would become effective upon enactment.

The authorization estimates are shown as changes from the CBO baseline. The estimates assume corresponding appropriation action.

The estimates are based on preliminary draft language and on Committee descriptions of the proposals. Since final language was not available, the estimates should be considered preliminary.

The estimates include the provisions in the spending title. Also included are spending estimates for provisions included in the tax title that have spending implications.

6. Estimated cost to State and local governments: The estimated change to State and local budgets result from several major provisions. The income verification proposal would result in state savings in AFDC, SSI, and Medicaid. Changing the AFDC filing unit would result in state savings in AFDC and state costs in Medicaid. Additional state Medicaid costs would also result from the extension of the Medicaid penalties. The net estimated cost to state and local budgets is shown below.

[By fiscal year, in millions of dollars]

	1984	1985	1986	1987	1988	1989
Estimated State and local costs	−70	380	0	75	−470	−235

7. Estimate comparison: None.

8. Previous CBO estimate: None.

9. Estimate prepared by: Diane Burnside, Hinda Ripps Chaikind, Mary Ann Curtin, Robert Lucke, Janice Peskin, Jack Rodgers, and Robert Sunshine.

10. Estimate approved by:

C. G. NUCKOLS
(For James L. Blum,
Assistant Director for Budget Analysis).

Tax expenditures

In compliance with section 308(a)(2) of the Budget Act, with respect to tax expenditures, and after consultation with the Director of the Congressional Budget Office, the committee states that the bill, on balance, reduces total tax expenditures. The provisions that reduce the minimum holding period required for long-term capital gain treatment, extend certain energy tax credits, provide for enterprise zones, and make permanent the research and equipment donation credits increase tax expenditures. Generally, the other provisions in the bill reduce tax expenditures or are neutral in their effect on tax expenditures. More detailed information is presented in the discussions of the specific provisions in Part V, Explanation of Provisions, and in Part IV, Revenue Effects of Tax Provisions (Table IV–2).